Comparative Analysis of FDI in China and India

Can Laggards Learn from Leaders?

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COMPARATIVE ANALYSIS OF

FOREIGN DIRECT INVESTMENT

IN CHINA AND INDIA:

CAN LAGGARDS LEARN FROM LEADERS?

A Dissertation Submitted to
The Faculty of the Ageno School of Business

In Partial Fulfillment
Of the Requirements for the Degree of
Doctor of Business Administration

By

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Abstract

Some emerging markets have been leaders in the world and have grown at a higher rate benefiting from higher Foreign Direct Investments (FDI) by Trans National Corporations (TNCs) and some have been laggards and have not able to attract as much FDI and grow that efficiently. Why China gets 60 billion dollars FDI annually as compared to India which does not even get 6 billion dollars, is an intriguing question? This dissertation explores the determinants of FDI in such emerging economies to answer the above question. What has India done till now to attract FDI? What has been China's strategy to become the most FDI attracting country in the world? What lessons India can learn from China and improve its FDI inflow? The study attempts to theorize what lessons emerging markets that are laggards in attracting FDI, such as India, can learn from leader countries in attracting FDI, such as China in the global economy.

This study fills the gap in the literature by analyzing the Indian data at the relevant micro state level for the period 1992-2005 and comparing it with the Chinese data for period of 1978-2005 at the economic zone level. Indian FDI attraction model was tested using OLS and autoregressive models and it was found that India has grown due to its human capital, size of the market, rate of growth of the market, and political stability. For China, congenial business climate factors comprising of making structural changes, creating strategic infrastructure at SEZs, and taking strategic policy initiatives of providing economic freedom, opening up its economy, attracting diaspora, and creating flexible labor laws were identified as drivers for attracting FDI and the model using these variables was tested with OLS regression and autoregressive regression analysis and were found significant. This study might help countries such as PIN (Pakistan, Indonesia, and Nigeria) which, will follow the BRIC economies in growth, want to grow, to broaden their understanding and formulate policies to attract FDI. At the enterprise level, it might help TNCs in understanding markets and formulating entry and growth strategies in these markets.

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As I have to carry this work forward, I would welcome feedback and suggestions from readers at swapnassinha@yahoo.com.

Chapter 1

Introduction

Before any discussion can be started on foreign direct investment, it is important to define it for the benefit of readers and for creating common understanding. There are many definitions of the term Foreign Direct Investment, hereinafter referred to as 'FDI', but the most commonly accepted is the one given by the IMF. IMF defines FDI as "where an investor residing in one economy owns 10% or more of the ordinary shares or voting power/effective voice in management in another country….. and comprises those entities in the host country that are subsidiaries (> 50% ownership); associates (<= 50% ownership) or branches (wholly or jointly-owned, unincorporated enterprises) of the parent." (IMF, 1993). A simple definition would be –"An investor based in one country acquires an asset in another country with the intent to manage that asset". (OECD, 2000) More than two third of the FDI activities (one third as trade between affiliates of the same TNC and another one third between a TNC and another enterprise) are involving Trans National Corporations (Ramamurti, 2004), hereinafter referred to as TNCs.

It is important to understand the significance of FDI in global trade and in economic development. Also it is required to understand the shift in FDI towards the developing world, and the future trends of FDI. The global stock of FDI in 2004 stands at $9 trillion (WIR, 2005) which is equal to the total GDP, in 2005, of the three largest economies of the world, after the US- Japan, Germany, and China. Total revenues for the Global 500 TNCs in 2006 add up to $18.9 trillion, a third of the world's GDP. 70,000

TNCs and their 6, 90, 000 foreign affiliates, contributing $19 trillion in sales, a third of world GDP, create major component of this FDI stock and worldwide FDI flows. GE (US), Vodafone (UK), and Ford (US) are the top three non-financial TNCs worldwide contributing maximum FDI flows. The global FDI in 2005 increased to $730 billion registering a growth of 18% over $648 billion of 2004. Of the total FDI flows, the developed world contributed $637 billion, out of which half is from only three countries- US, UK, and Luxemburg. In 2005 the net outflows from the developed world exceeded the inflows by $260 billion. For the US, the largest economy in the world with $ 12.5 trillion GDP, FDI outflow increased by 90% to $ 229 billion in 2005. The developing world FDI grew by 40% to $ 233 billion in 2004 mainly due to M&A activity and also due to green field FDI rising consecutively for the third year. Studies suggest that FDI flows by TNC's have transformed international trade in the last two decades and created new giants and a new world order (Blonigen, 2005). For 2006-07, global FDI flows are expected to rise further if economic growth is consolidated and becomes widespread, corporate restructuring takes hold, profit growth persists and the pursuit of new markets continues (UNCTAD, 2005).

A study of the existing literature suggests that FDI patterns contributing to the growth of the emerging markets have undergone significant changes over time. The FDI trend in last five years indicates a shift of flows from the developed world to the developing world and emerging markets (Appendix XV). FDI is impacting development in these emerging markets in a significant way. During the 1950-60's most of the foreign investment came into the developed world and Reuber et al (1973) who studied FDI volumes and patterns in various countries, observed that FDI flows into the developed world were disproportionately high when compared to the developing world. Even in the modern times, United States the most developed country in the world, still attracts the highest FDI and in 2005 it absorbed the highest FDI of $ 94.5 billion as compared to China which consumed $ 60 billion only. Till 2000, more than 75% of the trade was within the developed nations of the 'triad'- US, Europe, and Japan (Porter, 1990; WIR, 2005). According to AT Kearney FDI confidence index 2005 study, even though the US received the highest FDI in 2005 it does not command the number one position, in terms of FDI attractiveness, and trails behind at third position after China and India.

In the developing world, the East Asian countries were the pioneers in realizing the potential of FDI from TNC's in developing their economies. These countries devised strategies to attract FDI to meet their growth objectives (Zhang, 2001; Lall, 1993). As a result of opening up their economies to FDI from TNCs these countries grew rapidly and within a relatively short time period became a significant economic force. These came to be recognized as the "four tigers"--South Korea, Hong Kong, Taiwan, and Singapore. The success of the 'Asian tigers' in the last two decades has created a role model for less developed countries. Modern emerging markets can learn lessons from the experience of these tiger economies. East Asia saw a 46% increase in inflows, to reach $105 billion, in 2005 alone, driven largely by a significant increase in flows to Hong Kong (China).

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[1] Over the past seven years, AT Kearney, a global management consulting firm, has interviewed CEOs and CFOs of the world's largest 1,000 firms about their opinions of various FDI destinations and their investment intentions. Responses, views of 68 countries, which receive more than 90 percent of global FDI, reveal likely foreign direct investment flows and point to the factors that drive corporate decisions to invest abroad. Companies included in the survey are responsible for about 70 percent of global FDI flows and generate more than $27 trillion in annual revenues representing all major regions and sectors.

As a result of significant growth of ASEAN countries from FDI, the developing world is competing to have a larger 'share of the FDI pie'. Wheeler and Mody (1992) describe the competition between host countries to attract foreign investors to their respective countries as 'location tournaments' in which host countries are trying to attract FDI by making available substantial incentives to attract TNCs to their homeland. Desire for FDI may encourage governments to adopt competitive and investment oriented economic policies (Dunning, 1994). The governments are setting up agencies to attract FDI (Dicken and Tickell, 1992; Mudambi, 1999). For more than 15 years now, emerging markets are vying with each other for getting a larger share of the global FDI pie. During 1991-96 over one hundred countries made a total of 599 changes to liberalize FDI regulations, in 1997 alone, 76 countries made 151 liberalization changes (United Nations, 2005). A Large number of such countries are in Asia (Sethi et al, 2003). Countries continue to adopt new laws and regulations with a view to making their investment environments investor friendly. Out of 271 such changes pertaining to FDI introduced in 2004, 235 involved steps to open up new areas to FDI along with new promotional measures. In addition, more than 20 countries lowered their corporate income taxes in their bid to attract higher FDI (WIR, 2005). In order to attract FDI, at the international level, the number of bilateral investment treaties (BITs) and double taxation treaties (DTTs) increased to an all time high of 2,392 and 2,559 respectively in 2004, with developing countries concluding more of such treaties with other developing countries (UNCTAD, 2005).

The global trade is undergoing a significant transformation and there is an opportunity for the developing and underdeveloped nations to utilize this opportunity to their advantage by giving up restrictive old patterns of thought and pursuing economic growth. World Bank report (World Development Indicators, 2003) suggests that globalization is giving an opportunity to emerging markets to integrate their economies and societies with the modern unified world. Globalization can mean rapid growth and poverty reduction in countries like China and India that were poor twenty years back. During the period 1990-99, 125 million people were moved out of poverty because of globalization. Highlighting consequences of globalization a Goldman Sachs study: *'Dreaming With BRICs: The Path to 2050'* reports, that the BRICs economies (Brazil, Russia, India and China) together could be larger than the G8 in dollar terms in less than 40 years from now. China has been growing at the rate of around 9% annually consistently for more than a decade now and doubled its GDP in last six years but other countries have not seen such a consistent growth as China. On the one hand when there is an opportunity, there is a threat of losing out on the growth train. Emerging markets need to strategize their resources to achieve growth. This is the right time for emerging markets to learn from leaders in attracting foreign investment and formulate ambitious growth plans.

Emerging markets have an option to grow faster if the current trend of globalization continues in the future. It is important to define the term emerging market for common understanding. The term Emerging Market Economies (EME) was coined by Atoine W.Van Agtamael of IFC World Bank, in 1981. An EME was defined as an economy with low-to-middle per capita income, which constitutes 80% of world population, and represents 20% of world economies. It relates to business and market activity in industrializing or emerging regions of the world. The term EME was used for emerging economies that are in a phase of transition (Appendix I). Prahlad, 2005 elaborates on the definition, meaning, and the significance of ‘emerging markets’ in the global economy. Although, there is no standard definition of which countries are considered as emerging markets, but the Morgan Stanley Emerging Market Index (MSEI) gives a list of 25 such countries (Appendix I). US Department of Agriculture defines EME as a country that is taking steps towards a market oriented economy, has a per capita of less than $10k and is having a population of 1million or more, and is a market for US agriculture products. The list includes China and India. The Economist also lists the same group of 25countries as MSEI with an exception of adding three more countries (Hong Kong, Singapore, and Saudi Arabia) which are excluded from the MSEI list. University of Iowa, Iowa Center for Financial Development analyses the impact of ‘Emerging Economies’ on global trade and concludes that the ‘big-five’ EMEs- China, India, Russia, Brazil, Indonesia can contribute 16.1% of global trade in 2020 as compared to 7.8% in 1992. The expected future growth might not be evenly distributed amongst all the EME’s but can go to the market that creates structures and policies to benefit from it.

Although India is on the radar of the global investors and has attracted lot of media attention in last few years due to ‘Outsourcing’ and ‘BPO services’ from US and EU, it has been a laggard in opening its economy to foreign direct investment (Bajpai and Sachs, 2000). On the other hand, China has attracted ten times more FDI than India and grown at a faster pace to become three times larger economy as compared to India. India has to learn a lesson from China. Though the AT Kearney confidence index[1] ranks India ($5 billion) second after China ($ 60 billion) in FDI attractiveness but the gap between the two seems significant and the investor confidence for India has to yet translate into actual flows comparable to China. What has made China the leader in absorbing FDI? What led to the growth of FDI to China in last 20-25 years that transformed China from being a $ 300 billion economy to becoming a $ 2.2 trillion economy? What determines the inflow of FDI in host emerging markets is an interesting question? What determines FDI inflow to India and how India can learn from the Chinese experience to improve its flows and grow at a faster pace, is the central thesis of this paper. Blonigen and Davies (2004) state that the factors that determine FDI into developed countries are different from the factors that govern the FDI flows to the less developed countries. The differences are not yet captured adequately in empirical specifications that need to be estimated. This dissertation intends to fill that gap. From a philosophical perspective, laggards in emerging markets can learn from leaders, increase their foreign direct investment inflows, and grow at a higher rate. Countries with high population such as Pakistan, Indonesia, and Nigeria (PIN) can adopt this model of growth and grow their economies. Also, countries in the Middle East and Sub-Saharan countries are still isolated from global market and need to integrate into the global trade (Lee, 2005). These laggard countries can learn from the experience of leading emerging markets and develop their economies.

Research purpose

What are the drivers of foreign investment in the emerging markets? Emerging markets cannot defy the concepts of developmental economics. Economies have to transition from agriculture to manufacturing to services. Most developed economies such as the USA, Japan, Germany, and UK have followed that route. Even within the BRIC economies, the current developing economies such as China, Russia, and Brazil have followed the same route. However, some emerging markets such as India seem to have defied the pattern and skipped the manufacturing sector.

The current stress in India is on services that contribute more than half of the economic growth. While cashing on the current Internet and telecommunications induced boom apparently seems to be a rational opportunistic behavior but supplementing it with manufacturing activity is desirable. Otherwise India might miss that phase and as China grows, consumption might increase, resources might become scarce, and efficiency seeking manufacturing might shift to other countries. Thus, having a developed service sector growth is good but it has to be supplemented with if not preceded by a manufacturing sector growth. India has to take emergent steps to augment its manufacturing activity. There is not much manufacturing activity in the country and the country is flooded with Chinese goods. Whatever limited manufacturing is there it is in the skill intensive sectors such as in forgings, automobile component manufacturing, etc. The skill intensive and service sector growth has resulted in 'jobless' growth. One part of the population is untouched by the current economic boom. One geographical region of peninsular India is experiencing rapid growth, the other part of the country is unaffected by this growth. The growth pattern does no seem balanced and appears to be lopsided. China started with intensive manufacturing in Shenzhen and graduated into services sector in Shanghai but India seems to have missed the manufacturing sector growth. The growth in India does not appear to be balanced and seems to be lopsided in terms of sector, demography, intent, and class of the society. The current pattern of growth might create pressure on the inadequate infrastructure and put burden on the urban areas. Continued services sector growth might lead to migration of significantly larger labor force to urban areas and might create social tension.

Development has to be compatible with demographics. The central, northern, and eastern states in India that are not as developed can be integrated in the current growth. India has to create conducive business climate suited to attract manufacturing. Strategic structural changes have to be made to create a strategic infrastructure suited to export oriented manufacturing and move away from import substituting manufacturing model being currently adopted. A relatively faster route to augment export oriented infrastructure and keep transactions cost low is to develop coastal areas of Bihar, and Orissa to impact development in Bihar, Madhya Pradesh, Orissa, Uttaranchal, Uttar Pradesh, Chattisgarh, and Jharkhand States. Strategic policy initiatives can provide economic freedom, open up the economy to trade, create flexible labor laws, attract Diaspora, and lead to an overall balanced and sustainable economic growth. The purpose of this research is to highlight this balanced pattern of growth by attracting FDI in right places, sector, strategic intent, and for the right segments of the society. The research deliberates on the question- What strategies emerging markets can adopt to attract FDI and grow their economies?

Research motivation

There are gaps in the literature on FDI from an Indian perspective. There are a few studies such as Anantaram, 2004 that explore and analyze determinants of FDI in India at a micro state level and the results cannot be generalized. Wei, 2004 also makes an attempt to compare China with India but his study is focused on Chinese. There are only a few studies on FDI in India from Kumar (1989), and Venktachalam (2000) as compared to myriad studies on China, East- Asia, and ASEAN countries. There are not enough studies on how India can learn and improve from China. There is no study that is from the Indian standpoint that combines national level and state level factors and that suggests concrete steps in learning from Chinese experience. For example, a search for the terms ‘China and India’ and ‘Foreign Direct Investment’ on Proquest online search for dissertations and peer reviewed academic journals returned only six entries. Of these only three are relevant. Of the three relevant dissertations, first discusses the FDI from Chinese perspective and makes a passing reference to India, the second discusses the role of overseas Chinese investment, and the third discusses the ASEAN economies. There is no study from the Indian perspective. This study intends and attempts to fill that gap. Theoretically, the study might help philosophize the lessons emerging market laggards need to learn from the leaders in transforming their economies in a globalized scenario.

Chapter 2

FDI impacts development in emerging markets

The benefits of FDI to the TNC and the host country are many. Theoretically, the literature suggests that TNC's provide many benefit to the emerging markets, some of them are:

There is lack of sufficient internal capital in emerging markets as the governments are devoid of resources, the private sector does not have enough capital, and the country lacks the know-how to invest in relatively large projects. The savings in these markets are not enough to create intrinsic economic growth. Therefore, emerging markets need foreign capital for growth. FDI is one of the major sources of foreign capital for these countries [Seid (1988); Srinivasan (2002); Jenson (2003)]. TNCs and emerging markets get into a symbiotic relationship whereby TNC provides capital in lieu of seeking efficiency and/or market access (Dunning, 1996). FDI is considered important driver for economic development particularly for the developing countries (Borensztein, De Gregorio, Lee, 1998). TNC's bringing capital into a host country, allows the country to free capital from unproductive investments and utilize it in infrastructure development. For example, China, the fastest growing country in the world growing at 9% pa for last ten years, has received 90% of its foreign investment through FDI and built its infrastructure. Growth of FDI stock in a country impacts economic development by optimizing inputs, promoting exports, attracting further FDI, promoting domestic