Revamping Institutions: Understanding What Drives FDI in the Developing Economies.

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Submitted to

Central European University

Department of International Relations

In partial fulfillment of the requirements for the degree of Masters of Arts in International Relations

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Word Count:16,557

Budapest, Hungary

2017

Abstract

This thesis dissects what constitutes as attractors of "quality" Foreign Direct Investments (FDI) in developing countries, arguing that institutional changes are essential for facilitating an environment which attractors investors. It is argued that while the period immediately following liberalization and opening-up of the economy is concerned with merely bringing in investors in manufacturing and primary sectors, the larger focus must be to diversify opportunities for investments in the economy. It is further argued that creation of institutions to support diversification--specifically those that help imbibe skills in domestic labor across geographic regions of the country. In order to assess this hypothesis we review the case of India and China - the two largest developing economies. The case of China highlights that volume of investments does not guarantee quality investments, when accompanied by lack of sector and geographic diversity has tendencies of slowing down FDI inflow rates. In contrast is India-which has invested significantly in skills training to create a workforce that is employable across sectors. The thesis explores various factors that have contributed to decline of investments in China and upticks in India.

Acknowledgment

I would like to thank my supervisor Professor Laszlo Csaba for all his support, patience and guidance, the same has been invaluable and instrumental in writing this thesis. His approach has been ideal as he allowed me explore through diverse literature - some relevant, some not, and provided me feedback as often as I needed. I hope this dissertation meets the high standards that he set for me.

I would also like to thank ZsussanaToth for providing me with her invaluable feedback on my writing style. Lastly, I would like to express my gratitude to my parents, Chirag Singhi, and, Divyashree Suri as for proof reading the thesis as often as I demanded of them and providing me with the necessary moral support, this thesis would not have been possible without their patience.

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Introduction

a.1. Context & Background

The world has seen an upsurge in the number of countries participating in the global market since the 1990s. The fall of the Iron Curtain altered how the countries towards the east of Europe interacted with those in the west - opening up newer economies in Europe and Eastern European countries joined those on the West in the market place.[1] The same period was also privy to earnest attempts from the Asian Economies had begun to make a space for themselves in the market place. China, most notably, decided to open itself to international markets in 1980s and was shortly followed by India in 1990s. The increase in the number of possible global players meant that capital had a distinctively increased advantage as the number of venues to turn to increased. The increase in competition between states to attract higher volumes of FDI inflows--eventually shifting the focus to the quality of the inflows, thereby, was awaited and accepted future for capital and states alike. It is in this context that countries attempted to reduce tax rates, adjust the inflation rates, consumption habits and other aspects of the domestic market to make it more habitable for FDI. The preferential treatment that FDI receives is for the simplest reason: it possesses the long term stability that other forms of financing such as portfolio investments and loans from international organizations or foreign governments.

Mainstream discourse over the desirability of FDI is premised in large part around the spillover effects that it causes. MacDougall's work- the first to note the spillovers, analyses the effect that FDI has on the welfare capabilities and programmes of the host country.[2] The research in

[1]KalmanKalotay, "The European flying geese: New FDI patterns for the old continent?," *Research in International Business and Finance* 18 (2004): 27-49.
[2] G.D.A. MacDougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach," *Economic Record* 36 (1960): 13-35.

question highlighted a positive relationship as the country in this case could afford investing in social infrastructure and welfare schemes. This research is further extended and the argument has found its place in contemporary arguments made by Blomstrom and Kokko, who note that it is the spillovers that make it so much more desirable for developing economies.[3]Blomstrom's analysis expands on the preliminary works of these authors and notes that FDI brings with it a multitude of benefits for the host countries. The MNCs that choose to come to a host country bring with it the possibility of industrial training and technological transfers.[4] The studies posit that FDI may contribute to breaking of bottlenecks, introduction of new technology and fresh competition--which breaks monopolies and upsets the normalized control of a single firm.[5] It is clear that FDI is proactively seen as the harbinger of benefits for the marketplace and a means to upset any transience that may have descended upon the domestic market.

The benefits that FDI brings in for the host country are not provided by sources of finance such as portfolio investments or loans. Portfolio investments are best characterized as selfish capital from the perspective of the state because it cannot be relied upon for long-term stays.[6] Further, these investments are susceptible to and may create liquidation shocks.[7] Creation of such shocks and susceptibility of the investment to crash itself owing to volatile market behavior may make investors wary of investing in developing markets. It is essential to note that capital and its investor remains beholden to external influences, sans any control in cases of portfolio

[3] Magnus Blomstrom and Ari Kokko, "FDI and Human Capital: A Research Agenda" (paper presented at FDI, Human Capital and Education in developing Countries: Technical Meeting, Paris, France, December 12-14, 2001).
[4] MacDougall, "The Benefits and Costs of Private Investment," 13-35.
[5]Blomstrom and Kokko, "FDI and Human Capital: A Research Agenda."
[6] Robert E. Lipsey, "Interpreting developed Countries: Foreign Direct Investments," in *Investing Today for the World of Tomorrow*, ed. Bundesbank D. (Springer: Berlin, Heidelberg 2001), 285-325.
[7] Italy Goldstein and AsaafRazin, "Volatility of FDI and Portfolio Investments: The Role of Information, Liquidation Shocks and Transparency"(paper Presented at the Conference on FDI, Tel Aviv University, Tel Aviv, Israel August, 2002).

investments which is markedly different from the freedom FDI provides them.[8] Portfolio investments, thereby, remain far from an ideal source of finance or capital for the host country, especially when in the transition or developmental phase.

Similarly, borrowing from international institutions such as the World Bank (WB) or the International Monetary Bank (IMF), while an available option, is largely unattractive for the countries in the developmental or transition phase. Accumulation of voluminous debt is not a feasible option for countries that fall outside the "Core", which implies states such as the USA, Great Britain, France and Germany.[9] Heavy borrowing from lending institutions brings with it a substantial risk of insolvency for the developing/ underdeveloped states. The premise thereby remains that countries seek out FDI over other forms of financing.

It is of essence, then, to ask what constitutes the best mechanisms to be adopted by the developing countries to attract the highest quality of FDI, with sustained inflow rates. Higher quality FDI can best be understood as that which is export-oriented leads to transfer of technology from the investor country to the host and thereby leads to spillovers.[10] The study of FDI and trends thereof, is not novel. The study of investments is of interest for students of international relations and economics because of changing nature of investment flows.

Hecksher-Ohlin's theory on international trade failed to predict correctly the movement of capital in the 21st Century.[11] The theory states that traded commodities are bundled factors - land, labor and capital, positing that countries will move or export their surpluses which utilize

[8]Imad A. Moosa, *Foreign Direct Investment: Theory, Evidence and Practice*, (Palgrave 2002).
[9] Galina Hale and Maurice Obstfeld, "The Euro and the Geography of International Debt Flows," *Journal of the Economic Association* 14, no. 1 (February 2016): 115-144.
[10] Peter Enderwick, "Attracting "Desirable" FDI: Theory and Evidence," *Transnational Corporations*, 14, no. 2 (August, 2005).
[11] Laszlo Csaba, "How Much Trade and FDI Theories Help Analyzing Competitive-Related Issues?," in *Competitive of New Europe*, ed. Jan Winiecki, (Routledge 2008), 157-173.

cheap factors of production, while importing those that use the scarce ones.[12] In the case of FDI, therefore, capital will move from countries that have surplus where the rate of return on investments as a result is reduced, to developing countries. The surplus factor in the case of FDI for developed countries is capital which ought to be exported, while the imported factors necessarily involve labor from the developed countries. The data displayed in subsequent paragraphs, however, highlight that such movements are not taking place. The failure of speculation is not unique to the duo as many others stated that taxation policies are essential for attracting increased inbound investments or that market size is the most important factor. The majority of theories that have been treated as normative were not adequately factoring the differences for the macro and microeconomic conditions of the developing countries.[13]Blomstrom,[14] Dunning,[15] Jorgenson[16] and others, offer differing takes on the reasons for capital movements across borders. The reasons listed range from the simple such as market size to the rate of economic growth in the host country, and regulation mechanism in the Host Country.[17] However, the post-recession investment market has been less than kind to the developing world even if they possess the characteristics mentioned in the dominant theories. The most striking example of the failure of the theories is in the case of China.

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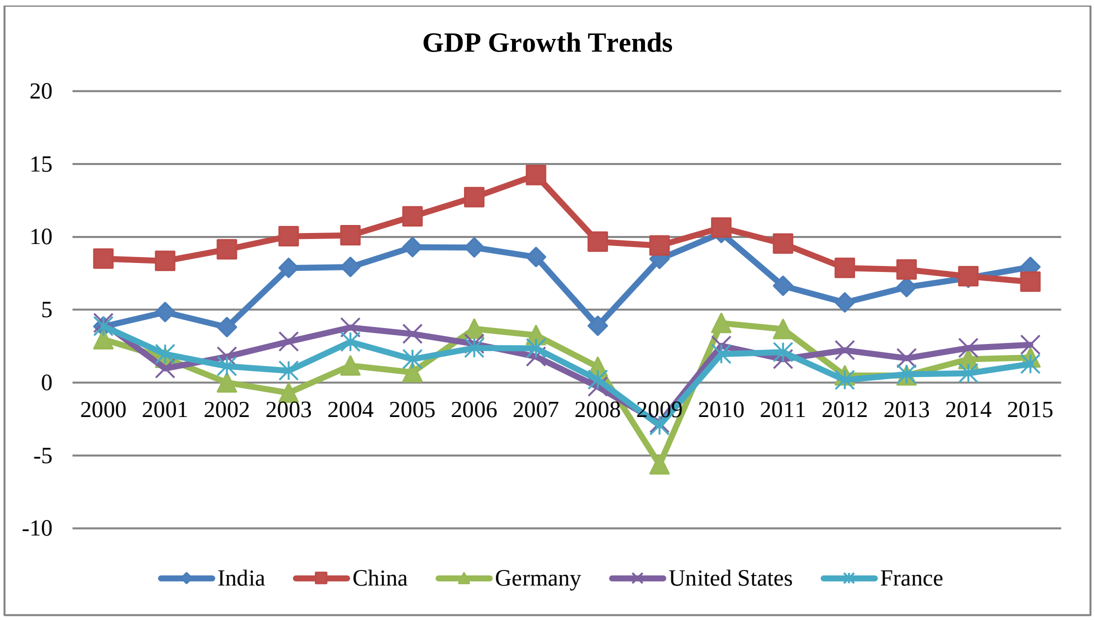
[12] Edward E. Leamer, "The Hecksher-Ohlin Model in Theory and Practice," *Princeton Studies in International Finance* 77 (1995): 5-38.
[13]AssafRazin and EfraimSadka, *Foreign Direct Investment: An Analysis of Aggregate Flows*, (Princeton: Princeton University Press, 2007), 3-20.
[14] Magnus Blomstrom and Ari Kokko, "The Economics of Foreign Direct Investment Incentives," *NBER Working Paper Series: Working Paper* 9489 (2003), accessed April 18, 2017, http://www.nber.org/papers/w9489.pdf.
[15]John H. Dunning, *International Production and the Multinational Enterprise*, (London: Allen &Unwin ,1981).
[16] Dale W. Jorgenson, "Capital Theory and Investment Behavior," *The American Economic Review*: 53, no.2 (May, 1963): 247-259.
[17] Ibid.

Figure 1 shows India and China have been performing significantly better than the countries which have been the target destination for investments in the past year.[18] China, like the remainder of the developing economies barring India, has witnessed a slump in inflow rates of FDI despite an aggregate GDP annual growth rate of 9.74 from 1989 to 2017, with an average of 6.9 for 2017--which remains above the market consensus of 6.8.[19] The country houses the largest population of the world--thereby providing a ready internal market and possesses a highly skilled workforce.[20]

Figure 1.GDP Growth Rates from years 2000 - 2015.



Source: World Bank, "GDP Growth Rate: China, India, Germany, United States of America, France,"https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?start=2000; accessed April26, 2017.

[18]The World Bank Database, "GDP Growth Rate: China," accessed April26, 2017, http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?start=2000.
[19]Trading Economics, "China GDP Annual Growth Rate," accessed April 24, 2017, http://www.tradingeconomics.com/china/gdp-growth-annual.
[20]World Bank, "China: Improving Technical and Vocational Education to Meet the Demand for High-Skilled Workers," Last modified September 14, 2015, accessed April24, 2017, http://www.worldbank.org/en/results/2015/09/14/china-improving-technical-and-vocational-education-to-meet-the-demand-for-high-skilled-workers.

Prescribed metrics governing the inflows of FDI would state that FDI inflow rates would continue to climb in China as it continues to grow, even though the rates of growth have slumped overtime, they are relatively well-performing. Data derived from the World Bank from 2000 to 2016 highlights that China and India is comparatively performing much better than their Core counterparts such as USA, Germany, and France. It is essential more than intriguing to note what it is that India is getting right which is leading to the positive inflow rates as opposed to the rest of the developing world.

The slump in the developed economies is attributed to low productivity growth, the hangover of the 2008/09 crises, an ageing demographic and thereby a weak demand market.[21] The largest economies in Eastern Asia's development belt and most of Africa have succumbed to the downturn. The declining global commodity prices of crude petroleum, minerals and ores[22] have contributed in part to the declining investments in the African nations that had come to rely on their natural resources for generating revenues or attracting investors. The most prominent example of this is the glut of investments in Democratic Republic of the Congo and Angora. While the latter managed to hit record inflows in 2015, it had be generated as a mix of loans to local affiliates in the country and heavy borrowing to compensate for the significant decline in the interests in the oil sector.[23]

The glut in investment rates is most significantly experienced by the developing economies i.e. the region which houses the larger chunk of human population, thereby requires a steady inflow of capital to acquire a louder voice in the international sphere. The inflow of FDI in the

[21]IMF News, "IMF Survey: Global Economy Faltering from Too Slow Growth for Too Long," last modified April 12, 2016, accessed April 27, 2017, http://www.imf.org/en/News/Articles/2015/09/28/04/53/sonew041216a.
[22]UNCTAD, World Investment Report 2016, x-xii.
[23]Ibid., 40-47.

developing economies has increased only marginally in the post-recession era.[24] While the global FDI flows increased by 38% in 2015, they are still 10% short of the 2007 peak inflows. 2016 marked a poor year for not only the developing economies, but also for developed. The global dip in FDI is expected to carry through from 2015 until 2018.[25] The movement thereby, must be understood in congruence with the theories - which in turn must evolve and adapt to the changing behavior of capital.

a.2. Research Question

This thesis seeks to highlights that the domestic or municipal institutions, along with the financial and investment regulation systems of the host country determine whether there will be sustained and positive inflow rates. The divergence between theory and actual capital movement following the 2009 financial-crisis for the developing economies necessitates the need to review what leads to quality FDI movements into developing economies. Due emphasis is placed on institutions because they reflect the state's official position on issues of inflows, regulations and other relevant factors. The setup also reflects how much a compromise a state can afford in status quo over issues such as welfare, sectoral importance etc. Lastly, the emphasis in this case is not on institutions in specific sectors, nor are they on the specific types of institutions. The thesis focuses on the general systems of institutional reforms and mechanisms adopted, positing that there cannot be an isolated study of the issue.

For the purposes of such inquiry, two cases need to be compared - one where the investment rates have increased over time, another where the rates have begun to take a downward plunge. The comparative case study made is that of two-most different countries on a State-State basis.

[24]UNCTAD, World Investment Report 2016.
[25] Ibid.

India and China are compared in the subsequent chapters to highlight that the political makeup and institutional frameworks are of the essence to attract greater FDI. The thesis expands, thereby existing theories and presents a novel way to look at the post-crisis strategy making for acquiring sustained inflow of quality FDI.

In light of the premise exhibited, the following research questions are probed in the course of the subsequent portions of this thesis -

1. What is the impact of focusing on quantity as opposed to quality of FDI?
2. How do factors such as rule of law and market regulations (protectionist or liberalization policies, demonstrated through greater shareholder's rights' protection, reduced bureaucracy and other measures) affect the inflow of FDI into the host country?

The remainder of this thesis is structured as follows - Chapter 1reviews the existing literature on FDI--discussing the dominant theories and theoretical framework within which this thesis is placed. Chapter 2 reflects on China's economic growth pattern following the liberalization in 1978 and developments made in the economy since. Chapter 3 reflects on discusses the background of India's economic development from through multiple decades through 2016. Chapter 4 analyses the differing situations of China and India, comparing the nature of changes undertaken by the two radically differently organized/structured economies that are also neighbors that do not get along well.

Chapter 1. Literature Review & Research Methodology

This chapter discusses the dominant theories of FDI, the problematic nature of existent literature and the source of data that is used through the course of this thesis.

1.1. Dominant Theories on FDI

There is no dearth of literature on the importance of institutional infrastructure or on FDI in status quo. A myriad of authors have written extensively on the issues pertaining to the flow of capital from developed economies to developing economies and the role that governance plays in inspiring such movements. Existing literature neither follows a homogenous methodology nor possesses a homogenous view on the mechanisms essential to acquire investments or higher quality thereof. The theories on FDI can either be understood as those that assume perfect markets and those that do not,[26] or those that focus on specific determinants and those that do not, and other dichotomies. However, there is consensus across the theories that market size and proximity is an essential factor to consider while making investments.[27]

Much of this literature, however, is focused on fostering increased competition between the host countries vying for better quality of FDI.[28] Thereby, we must note individually and cumulatively the literature and theory available on the issues of institutional reform and inflow rates. Further, it must be noted that this thesis does not differentiate between the natures of institutions, rather focuses on the relevance of institutional changes that take place in order to increase inflow rates.

The general departure from statist, inward looking and import-substitution practices across the developing world has rendered the models of Stopler-Samuelson, Ricardo's Model and

[26]Moosa, *Foreign Direct Investment*, 23-29.
[27] Ibid.
[28]Csaba, "How Much Trade and FDI Theories Help," 157-173.

Hecksher-Ohlin generally inapplicable.[29] This has also brought to the fore the fact that general demand/supply and outflow in cases of surplus is not sustainable in practice as capital has generally maintained a home bias when it flows from developed to developing countries.[30] Dunning notes that there is an essence of ethics that is being sought out by capital in status quo--a loose sense of requirement that is undefined.[31] The argument made by Fukuyama further massages this point as he notes that from the standpoint of the investors, States' institutions represent self-imposed incentives that determine their approach to the commercial world.[32] Thereby, a State's moral standpoint and priorities is seen to be reflected in its commercial institution. The social capital becomes an essential aspect of institutional framework and thereby a precautionary bell or catnip for an investor. Such behavior also helps explain the home bias when it comes to capital flowing from developed countries. The same sentiment echoes through in Giersch's seminal piece where he argues that the morality of property, contract, individualism and republicanism help foster economic growth, which in turn has a positive or negative impact on FDI.[33] The more general trend that is highlighted in the literature is that institutions that help foster or emulate an alliance and partnership based capitalism that is primed towards institutional upgrading and thereby establishes a somewhat uniform body of institutions to inspire investor confidence[34]. The international community too attempts to emulate such behavior and thereby paves way for reports and NGOs such as the Global Reporting Initiative[35] (an organization the

[29] Ibid.
[30] Ibid.
[31] John H. Dunning, "Towards a New Paradigm of Development: Implications for International Business Research," *Transnational Corporations*15, no.1, (2006): 173-227.
[32]Francis Fukuyama, *The Great Disruption*, (London: Profile Books, 1999).
[33] Herbert Giersch, "Economic Morality as a Competitive Asset", in *Market, Morals and Community*, eds. Hamlin, Giersch & Norton, (St. Leonards, Australia: Centre for Independent Studies 1996), 19-41.
[34] John H. Dunning, *Alliance Capitalism and Global Business*, (London & New York: Routledge, 1997).
[35]World Governance Indicators, "Worldwide Governance Indicators: Data Source," accessed on April 19, 2017 http://databank.worldbank.org/data/reports.aspx?source=Worldwide-Governance-Indicators.

WGI looks to while compiling data).[36] Existing data on the drivers for FDI in the developing world highlights that there is a positive relationship between the degree of schooling i.e. labor quality, stock market performance, degree of international integration of the host country in the international market, economic growth and macroeconomic factors such as inflation, risk management and sovereign risk.[37]

The dominant theory on FDI, however, is a lot more scattered than that on the importance of institutions. Aside from the market-size hypothesis, the remainder of the factors such as political risk, inflation rate control etc. is debatable. In status quo, even the market-size hypothesis does not apply in toto.[38] The lack of capital movement from the developed countries despite the availability of the large internally serviceable populous has not seen any movement. Winiecki's championing of liberalization and insistence on departure from statist, protectionism as the path forward for the "southern economies" has yielded very little results for the "southern economies" he speaks of in large parts owing to the home bias previously alluded to.[39] FDI movement has been far more nuanced than existing literature allows it. It is essential to note, however, that all theories and theorists are in some form, in congruence--either wittingly or not, that what is essential to focus on in status quo is the institutional set up in the host countries. While the case is made that there has been transfusion of intellectual property through affiliation to institutions such as WTO and WIPO etc. or the open market allows local competitors access to technology

[36] John H. Dunning, "Towards a New Paradigm of Development: Implications for International Business Research", *Transnational Corporations*15, no. 1, (2006): 173-227.
[37] Peter Nunnenkamp, "Determinants of FDI in developing Countries: Has Globalization Changed the Rules of the Game", *Kiel Working Paper* no. 1122(2002).
[38] Jan Winiecki, "Shortcut or Piecemeal-Economic Development Strategies and Structural Change", (CEU Press 2015).
[39] Ibid.

they would not otherwise.[40] The transfer of IP is seen as intangible capital transfers, however, does not still replace the value of FDI.

It is evident that there is a differing stance on the nature of FDI drivers, ranging from competitiveness of a country to political stability. Dunning's hypothesis/theory called the "Eclectic Theory"[41], which builds on Stephen Hymer's theory that firms will seek to establish solidarity in states where they stand to face or do face competition from local manufacturers and service providers[42]. The Eclectic theory states that FDI behavior and flows can be understood through the conditions that mitigate such inflows.[43] It claims that industries/investors look for three specific identifiers - a.) access to cheap capital and raw material (i.e. geographic ease of doing business), and the ability to create a market monopoly; b.) the firm must benefit from utilizing the comparative advantages in questions as opposed to merely leasing it; and c.) the advantages must be capable being used in combination with the inputs from abroad. Dunning's theory, thereby, looks at the ability of the host country to attain a degree of integration with the international market. However, Dunning does not identify the nature of institutions either, nor does he remark upon the functionality of institutions that are essential for greater inflows. Moosa attempts to summarize and highlight the role of institution and impact of specific institutions on the inflow for developing countries.[44] The author's emphasis is largely upon the theoretical underpinning of the relevance of the market hypothesis, sovereign risk and political risk. Moosa identifies that there is a positive correlation between sovereign risk reduction and every other variable that has been deemed necessary for the purposes of attracting FDI, however, the

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[40] Ibid.
[41] Dunning, *International Production,* (London: Allen & Unwin 1981).
[42] Stephen Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investments,* (Cambridge, Massachusetts 1976).
[43] Dunning, *International Production,* (London: Allen & Unwin 1981).
[44]Moosa, *Foreign Direct Investment*, (Palgrave 2002).

author's conclusions show that there is no singular or insular factor that influences the inflow rates.

Existing literature largely focuses on the traditional factors and variants and often at loggerheads with each other over what is essential for driving FDI inflows, much less explain the quality of investments. However, in status quo, it is highly improbable to state that mere liberalization of the economy or economic growth as traditional theories emphasize cannot be relied upon for explaining the totality of the behavior that is visible in status quo. This thesis seeks to add to the existing literature by examining the causes of decline and increase of quality investment inflows. The analysis is made through a comparative study of India and China and the nature of investments in the two developing economies.

1.2. Research Methodology

1.2.1. Case Selection Rationale

As indicated in the introduction, this thesis compares the growth rates and circumstances of India and China over time to understand the role that institutions play in boosting FDI. China and India rank in the top ten GDPs of 2016 and have become essential geopolitical and economic players as they have been the hub for investments in the manufacturing sector (in the case of China) and IT (in the case of India). The two countries are also organized differently. While India is a democratic welfare state[45] that opened itself up to trade liberalization and globalization in 1991--shedding its past of statist, planned economy, China still maintains the remnants of a planned economy, despite opening up in 1978.[46]

[45] Preamble, Constitution of India, 1949.
[46] Shujie Yao, "On Economic Growth, FDI and exports in China," *Applied Economics* 38, no. 3(2006): 339-351.

China's prima facie make up is still that of a socialist nation, but internally has structured its own brand of pseudo-capitalism - Bamboo Capitalism[47]; China gave up the command economy of 1970 in exchange for a market-oriented "wild west capitalism" in 1980s.[48] However, it cannot be plausibly described as a neo-liberal society nor may it be described as a post-communist country. The Chinese Government exercises considerable control over the market as it wields greater influence than any other developing or middle income nations does over its domestic market, national income flows and capital-intensive structures.[49] State-owned enterprises (SOE) and banks are still dominant and largely present in the service sector. Naughton's research reveals that close to 85% of the banking assets, the entirety of telecom and transport networks as well as education, scientific and technological services.[50] The structure of the two nations and their developmental tracks create a contrasting picture, made further interesting by the fact they are neighbors entrenched in border and territorial conflicts. The declining inflow rates in China, coupled with its need to move towards consumption based economy, opposed to India's burgeoning IT sector and investment seeking manufacturing sectors - both of which have become investment magnets for the country.

The decline in the Chinese inflow with the uptick in the Indian thereby necessitates a study of potential drivers of investment interests and faiths, considering that both nations have fairly large internal markets and the former has simpler and more comprehensive investor protection laws and privileges[51]. The cases so contrasted help identify and highlight the structural changes that are essential for attracting better quality FDI into the economy to help maintain growth of the

[47] "China's Economy: Bamboo Capitalism," *The Economist*, May 10th, 2011, accessed May13, 2017, http://www.economist.com/node/18332610.
[48] Barry Naughton, "Is China Socialist?," *Journal of Economic Perspectives* 31, no. 1(Winter, 2017): 3-24.
[49] Ibid.
[50] Ibid.
[51]RohitSachdev, "Comparing the Legal Foundations of Foreign Direct Investment in India and China: Law and the Rule of Law in the Indian Foreign Direct Investment Context," *Columbia Business Law Review* 167 (2006).

economy. It is argued that over time, FDI must yield results that are positive for the economy for the long term as opposed to creating mere shock-based bumps. The cases of India and China highlight the importance of the quality of FDI that is inbound and the institutional changes made to adjust and attract such investments.

1.2.2. Time Period Selection

The period chosen for analysis is from 2000 to 2016, i.e. 32 years of combined country-years, spanning three periods in history for the countries - the time period from 2000 to 2007 provides the growing space where we can note the initiation of market-based adjustments for both economies. The World Investment Report for 2000 marked the rebounding of East and South-East Asian economies after a tumultuous 1990s. The region began its recovery after a sharp decline. China specifically rebounded particularly well owing to Hong Kong-facilitated largely by re-domiciling of funds owned by Hong Kong investors and reinvestments of turnaround earnings of 1999.[52] While China was the second highest recipient of investments in its region (after Japan), India was the largest recipient in the South-Asia.[53] The uptick that was taken note of in the 2000 Report was carried through in the next year where it was noted that there was a palpable change in the nature of institutions to facilitate liberalization of FDI regimes.[54] The time period so selected also covers the 2007 through 2009 period which marked the record highs in investment inflows assisted heavily by the volume of trans-boundary mergers and acquisitions across various sectors[55], such that 2015/2016 was still 10% shy of the highs registered in 2008/2009. The latter half of 2010 marked the beginning of a downfall in the volume of

[52]UNCTAD, World Investment Report 2000, http://unctad.org/en/Docs/wir2000_en.pdf.
[53] Ibid.
[54]UNCTAD, World Investment Report 2001, http://unctad.org/en/Docs/wir2001_en.pdf.
[55] UNCTAD, World Investment Report 2008, http://unctad.org/en/Docs/wir2008_en.pdf; UNCTAD, World Investment Report 2009, http://unctad.org/en/Docs/wir2009_en.pdf.; UNCTAD, World Investment Report 2010, http://unctad.org/en/docs/wir2010_en.pdf.

investments especially in the developing world. The sustenance of such downfall mires the importance of this thesis. While China remained relatively impervious to the global shocks in 2010, the same has not translated over time.[56] The only exception to such movement however, remained India, as it saw an increase in the volume of inflows.

1.2.3. Data Sources

The data for the purposes of this thesis have been derived and drawn from the World Bank Databank and World Investment Reports from 2000 to 2016, published by the UNCTAD, available on the UNCTAD website. The data for the World Governance Index is available through the World Bank website.[57] Both websites contain extensive data on all countries from around the world and make it available for the readers at large. The methodology of the reports too are published and made available online. The UNCTAD report recognizes investments that include a long-term relationship and reflect persistent interest as well as control by an investor residing in an economy other than the host country, the investor may be either natural person or a parent enterprise.[58] The investments in question involve initial/set-up transaction costs between the parent company or investor and the investing partner and any subsequent transactions between the two parties. The FDI Flow comprises of capital provided by the foreign investor to the enterprise invested in. The components of the investments are comprised of - Equity capital; Reinvested earnings; and Intra-company loans.

FDI Flow is calculated on net basis i.e. credit of capital transactions minus debit between direct investors (including direct affiliates), or on through net acquisition of assets--acquired via

[56]UNCTAD, World Investment Report 2010.
[57]World Governance Index, “Worldwide Governance Indicators.”
[58]UNCTAD, Methodological Note 2016, accessed on April 29, 2017, http://unctad.org/en/PublicationChapters/wir2016chMethodNote_en.pdf.

outbound FDI and the liabilities netted through inbound FDI.[59] The methodology recognizes any decrease in net acquisition of assets or incurrence in liabilities as negative FDI.[60] In any case, at least one of the three components of FDI is to be negative and cannot be offset by positive inflows of the other two--these are recognized as disinvestments. The UNCTAD collects data from a variety of sources - published and unpublished albeit official rates. The sources of data that are referred to are - Central Banks, Statistical Bureaus and Offices on aggregate bases.[61] The information so acquired is complemented and thereby doubly verified by data from other international bodies such as the IMF, the ASEAN Secretariat, Banque Centrale de Etats de l'Afrique de l'Ouest, and others, as well as UNCTAD's own projections and estimates.

The World Governance Index's (WGI) report aggregates individual indices for the time period of 1996-2016, thereby covering the time period essential for this thesis. The WGI looks at the following six factors to access and rank countries[62] -

- Voice and Accountability;
- Political Stability and absence of violence;
- Government Effectiveness;
- Regulatory Quality;
- Rule of Law;
- Corruption Control.

The report, like UNCTAD's combines the information from a variety of sources in order to assess the standards that can be recognized as subjective or arbitrary in order to reduce such

[59] Ibid.
[60] Ibid.
[61] "FDI Statistics," UNCTAD, accessed on April 30, 2017, www.unctad.org/fdistatistics.
[62] World Governance Indicators, "World Governance Index: Home Page," accessed April 30, 2017, http://info.worldbank.org/governance/wgi/index.aspx#home.

arbitrariness. The indicators combine multiple individual data sources produced by NGOs, think tanks, survey institutions, private firms as well as firsthand accounts of household experiences.[63] The Index draws primarily for, thereby, four data sources - a) firms and households; b) business information providers; c) NGOs; and d) public sector organizations. [64]

Kaufmann, Massimo and Kray's report[65] in 2010 further highlights that the methodology in question of the WGI remains the most objective means to assess the overall health of the country's governance capabilities and thereby the assessments remain the most convenient options to be used for this thesis.

[63]World Governance Index, "World Governance Index: Data Sources," accessed April 30, 2017, http://info.worldbank.org/governance/wgi/index.aspx#doc.
[64] Ibid.
[65]DanielKaufmann, Mastruzz Massimo and KraayAart, "The Worldwide Governance Indicators - Methodology & Analytical Issues,"(The World Bank Development and Research Group 2010).

Chapter 2. Understanding Investments in China

2.1. Characterization of the Chinese Market in Status Quo

Figure 2 portrays a success story of sorts. The graph highlights the declining rates of poverty across the BRICS nations compared against the rest of the world. While it is no secret that poverty rates have been declining across the board, China remains as one of the most striking portrayals of turnarounds in the 21st Century as it effectively utilized liberalization policies to alleviate itself from poverty.[66]

Figure 2. Share of Population Living in Extreme Poverty, 1980-2013.

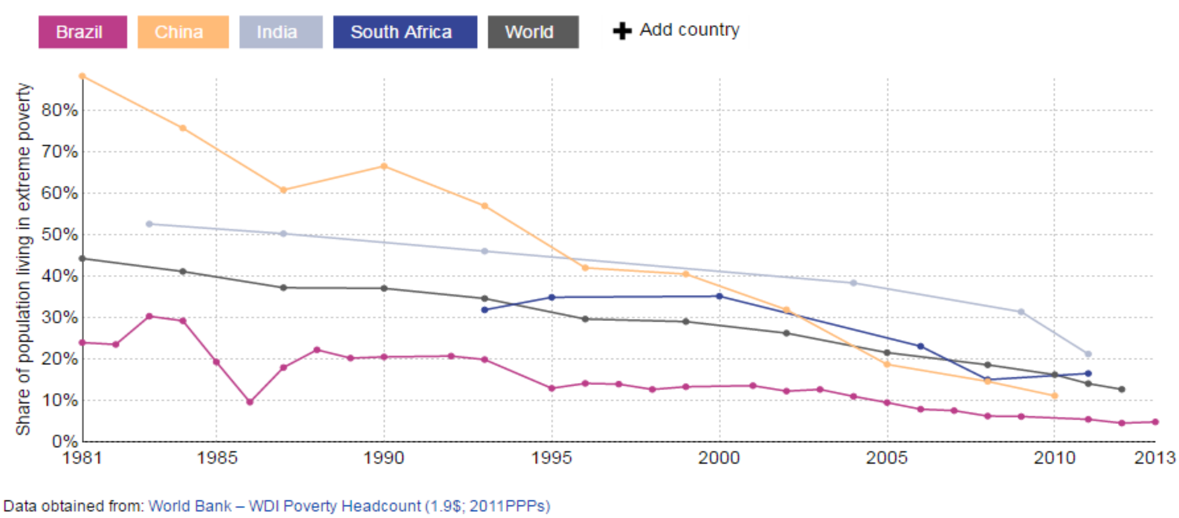

Image source - "8 Facts about China", World Economic Forum, accessed May 2, 2017 https://www.weforum.org/agenda/2016/06/8-facts-about-chinas-economy/.

The Nation's dramatic ascent to the top of the global GDP food chain remains largely unmatched. Since the end of the Cultural Revolution in 1976, the People's Republic has been

[66]Wang Zhengyi, "Understanding Transition in China: Domestic Tensions, Institutional Adjustment and International Forces," Paper presented at Joint Workshop on Cleaner Vehicle Development International Forces, Harvard University, Massachusetts (2002) ," accessed May 2, 2017,https://www.princeton.edu/~pcglobal/conferences/beijing08/papers/Wang.pdf.

able to reach record growth rates and became the second largest economy in the world as early as 1999, only two short decades after initiating market liberalization policies.[67]

The Chinese economy has been able to move through three distinct macroeconomic transitions from 1978 to 1990s--following which it began to aggressively attract greater volumes of FDI. The shift from an agrarian to urban, non-WTO to a WTO and command to a market-oriented economy went smoothly in China.[68] For all means and purposes, thereby, China is a beaming tale of success gained via market liberalization. The growth in the Chinese economy has been largely fuelled by focusing on the manufacturing sector and sustained investments into the manufacturing sector from the mid-1980s as well as instantaneous introduction to the free market for the agricultural sector in the 1970s.[69] However, recent years have raised grave concerns about the sustenance of the Chinese growth story over the years. While on the macro-level China remains an unparalleled success-story, there are hazardous repercussions of the Chinese growth upon the microcosm of the local populations.

The GINI coefficient index highlights that India and China both are competitively inching towards a more unequal society, in terms of wealth and income.[70] While India was marked at 33.9 in the most recent markings, China fared much worse at 42.1.[71] The income inequality, coupled with declining growth GDP rates and inflow rates after a meteoric rise to the top of the global economic order makes China a particularly important and unique case to study. It is essential to understand what caused the meteoric rise and thereby lead to the decline. The

[67] Ibid.
[68] Lee G. Branstetter and Robert C. Feenstra, "Trade and foreign direct investment in China: A Political Economy Approach," *Journal of International Economics* 58 (2002): 335-358.
[69] Congressional Research Service, "China's Economic Rise: History, Trends, Challenges, and Implications for the United States," accessed May 4, 2017, https://fas.org/sgp/crs/row/RL33534.pdf.
[70] World Bank Database, "GINI Index (World Bank Estimate)," accessed May 4, 2017, http://data.worldbank.org/indicator/SI.POV.GINI?locations=CN-IN.
[71] Ibid.

analysis conducted through the course of this chapter does not focus on merely the macroeconomic policy making, but rather the microeconomic situations that have shaped this chimera economy.

The chapter shines light upon the changes that the Chinese economy has undertaken since 1978 - when it took upon liberalization policies, while exploring the impact that investments have on the economy. The purpose of the chapter is to highlight the creation of the dual economy inside the Chinese borders and the role that FDI has played in facilitating such an economy. The nature of policies employed by the Government, along with the quality and volume of FDI that has been attracted and the impact that the same has had on the economy is of particular interest in order to assess the Chinese Economy.

2.2. The Chinese Entrance into the Global Market & FDI Traction

Deng Xiao-Ping performed one of the greatest turnarounds in economics and political history in the 1978 after he took over from Mao Zedong as the Chairman. Xiao-Ping's China differed starkly from that of Mao, such that Chinese economic history can be recognized as that of a command economy from 1950 to 1978, and from 1978 onwards as the period of liberalization and administrative decentralization.[72] Xiao-Ping decided to implement liberal economic policies in China in the effort to alleviate itself from high inflation rates and abject poverty in large pockets.[73] Following years of state control over productive assets, there was a stark pivot in the 1980s through the following decades towards setting up an economy that was receptive to foreign markets and investments.[74] The reform measures employed by the government brought

[72] Françoise Lemoine, "FDI and the Opening up of China's Economy," *Center D'EtudesProspectives by D'InformationsInternationale*, No. 2000 - 11 (June, 2000), accessed May 7, 2017, http://cepii.fr/PDF_PUB/wp/2000/wp2000-11.pdf.
[73] Ibid.
[74]Branstetter and Feenstra, "Trade and foreign direct investment in China", 335-358.

along great relief to the market. The effort made was to move from an agrarian, rural society to one which has thriving foreign trade, private enterprises and is heavily fuelled by investments.[75]

The jet-pack straddled growth has, naturally, incited widespread attention and the consensus over the issue is that the manner of growth of the economy is untenable for the long term.[76] The strategy of 1978 has been for all tangible, prima facie reasons, a success. While an essence of price control has still been maintained, the comparative freedoms have guaranteed profitability for the manufacturing sector, the delisting of industries from the "protected list" ensured that household savings, which would now increase, had new avenues to invest. The state firms thereby were subjected to harsh market disciplining courtesy of increasing competition. However, other than the known factors so mentioned remained the political willpower--the factor that was exceptionally missing during the times of Mao.[77] As Naughton argues, command economy, by nature would have unraveled in due time if adequate political will is made apparent.[78] The motivating factor that actually allowed the pathway for the opening of the markets was not only the soaring inflation and growing poverty, but the root cause behind the same: the inability to break bottlenecks in the agricultural sector. The same took place once the "command" was taken off of the economy albeit administrative coordination was essential for such facilitation.

The policy of 1977 was expected to break the stagnation in the agricultural sector and rehabilitate the industrial growth in the energy as well transportation sector and driven by

[75]Erlin Zhou and Yulin Zhang, *Research on the Coordinating Development between Cities and Rural Areas*, (Jiangsu People's Press 1991).
[76]Zuliu Hu and Mohsin S. Khan, "Why is China Growing So Fast?," *Economic Issues* 8, (International Monetary Fund 1997).
[77] Barry Naughton, "Growing Out of the Plan: Chinese Economic Reform, 1978-1993", (Cambridge University Press 1995).
[78] Ibid.

aggressive crude oil extraction.[79] Upon the failure of such extraction, the plan collapsed and thereby gave way to the political willpower to opt for market liberalization policies - which were adopted without even a coherent commitment to the market, initially.[80] The argument concerning willpower is one that is shared by Lardy, relying on Ballassa as well.[81] The emphasis of the authors so mentioned lay on the fact that centralized command economies--like that in China, Soviet Russia and many Eastern European countries, including Hungary, were built around the leaders' lack of faith in the market systems.

The linkage between power retention of the leader and the freedom of the market are inversely proportional.[82] The realignment of interests did, however, perform excellently during the time of execution. Such transition is remarkable, considering that the same remained absent in the cases of post-Soviet and Eastern European states.[83] The performance is somewhat surprising considering that Soviet Russia as well as Eastern Europe remained more industrially developed than China in the years preceding the reforms in the society.[84] It is important to note that while China attempted to emulate the centralization policies in Soviet Russia, while being significantly behind the Russians in terms of industrialization and mechanization.[85] Despite the differences in development, however, the experience of Soviet Russia and Communist China remained the same with regards to investments and asset mobilization.[86] The mobilization of resources in the economy required a degree of mechanization which simply did not exist in the communist

[79] Ibid.
[80] Stephen J. McGurk, review of *GrowingOut of the Plan: Chinese Economic Reform 1978-1993 by Barry Naughton*,*The China Journal* 39 (January 1998): 124-126.
[81] Nicholas R. Lardy, *Economic Growth and Distribution in China*, (Cambridge University Press 1978), 26-28.
[82] Ibid.
[83] Ibid.
[84]Winiecki, *Shortcut or Piecemeal*, 164-169.
[85] Lardy, *Economic Growth and Distribution*, 27-30.
[86]Winiecki, *Shortcut or Piecemeal,* 164-169.

nations.[87]Winiecki refers to Lin's comparison of China against other major Asian powers through the 1950s to 1978 and highlights that while China's GDP grew at the rate of 2.33% per annum against Japan's 6.68% as well that of the Little Dragon's average of 2.56%.[88] Deng's China, however, is not saddled with such problems. The departure from the olden Mao days helped boost the economy under Deng, however, only because the rate of development in China was low.[89] The reason why it edged past the European or Soviet counterparts remains the low level of industrial growth that dominated the Chinese landscape - saturation of which would limit its ability to grow.[90] The growth potential of the GDP progressively declines as the market evolves from agriculturally-dependent and underdeveloped to developing and eventually transforming into a developed market. The shift from labor-intensive to capital-dominant manufacturing dictates that the economy is to cross the Fatas-Mihov "Great Wall"[91] - the transition from a low income to middle income to a high income economy.[92] This transition, however, flails if the economic growth and expanse is not supplemented with adequate institutional reforms - which are where China underperforms woefully, like its Soviet counterparts.

The Chinese economy, despite market liberalization, remains a financially repressed economy as it remains rife with government-imposed interest rate ceilings on deposits and state-owned banks' control over the SOEs.[93] It is essential to note that SOEs have been able to gain larger access to short as well as long term debt as opposed to private enterprises in China following the

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[87] Ibid.
[88] Ibid.
[89]Winiecki, *Shortcut or Piecemeal,* 164-169.
[90] Ibid.
[91] Ibid.
[92]AnotonioFatas and IlianMihov, "Another Challenge to China's Growth," *Harvard Business Review* (March 2009), accessed May 6, 2017, https://hbr.org/2009/03/another-challenge-to-chinas-growth.
[93]Winiecki, *Shortcut or Piecemeal,* 169-172.

release of large scale stimulus programme, despite their inability to outperform or effectively compete with the private enterprises in China.[94]The problem is further exacerbated in the inefficiency that dwells in the utilization of FDI in China. The Chinese response to the global meltdown in 2010 through 2011 remained rather reckless as the Authorities depended upon public sector infrastructural investments and state owned enterprises (SOEs).[95] The result of such dependence was that the inflows boomed from 43.266% in 2008[96]--which remained the all-time high until 2008 until the new peak was reached in 2011 at 47.686%[97] - a number that must be understood as clearly abhorrent and unsustainable in the long-term, evidenced by steadily declining share of FDI in GDP. The share decreased from the substantial high to a meeker 45.401% in 2015.[98]

The unsustainable nature of the share is coupled with the fact that such high intakes also mar the effectiveness as well as the usefulness of investments.[99] The lack of economic freedoms has crippled in large parts the possibility of the private firms from optimal resource allocation. The lack of intangible investments[100]--investments in research and development that are implementable, patents issued, alongside lack of civic and political rights will effectively starve the Chinese market of growth.[101] The decline is furthered by the fact that the economy is now moving towards the developed end of the spectrum, it actively needs to restructure its economy from a still-centralized, repressive, manufacturing based to a consumption-based economy that is

[94] Anders C. Johansson and Xunan Feng, "The State Advances, the Private Sector Retreats? Firm Effects of China's Great Stimulus Programme," *Cambridge Journal of Economics* 40, no.6 (2016):1635-1668/

[95] Lee Jones and Yizheng Zou, "Rethinking the Role of State-owned Enterprises in China's Rise," *New Political Economy* (May, 2017): 1-18, accessed May 8, 2017, http://www.tandfonline.com/doi/full/10.1080/13563467.2017.1321625.

[96]The World Bank Database, "Gross Capital Formation (% of GDP)," accessed May 8, 2017, http://data.worldbank.org/indicator/NE.GDI.TOTL.ZS?locations=CN&start=2000.

[97] Ibid.

[98] Ibid.

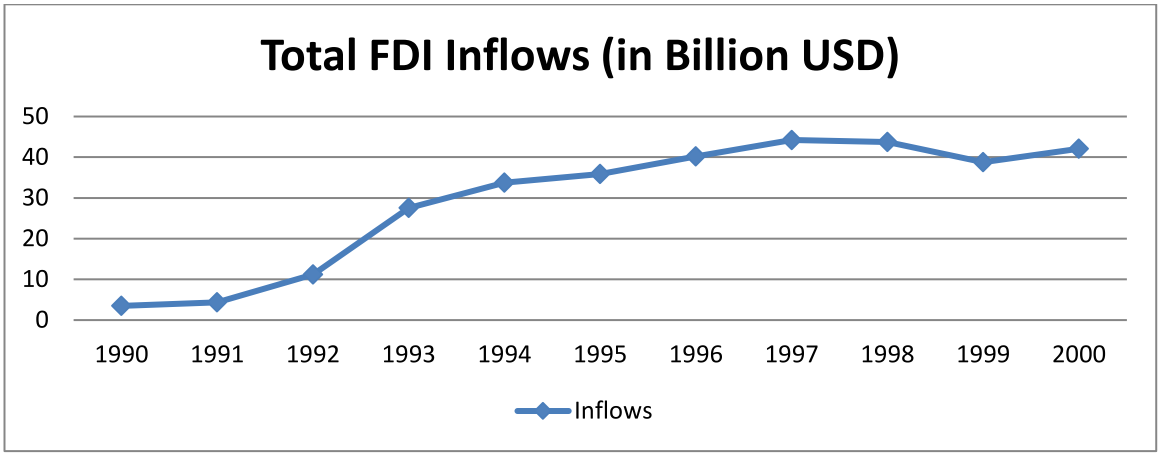
[99]Winiecki, *Shortcut or Piecemeal*, 170-171.

[100] Ibid.

[101] Ibid.

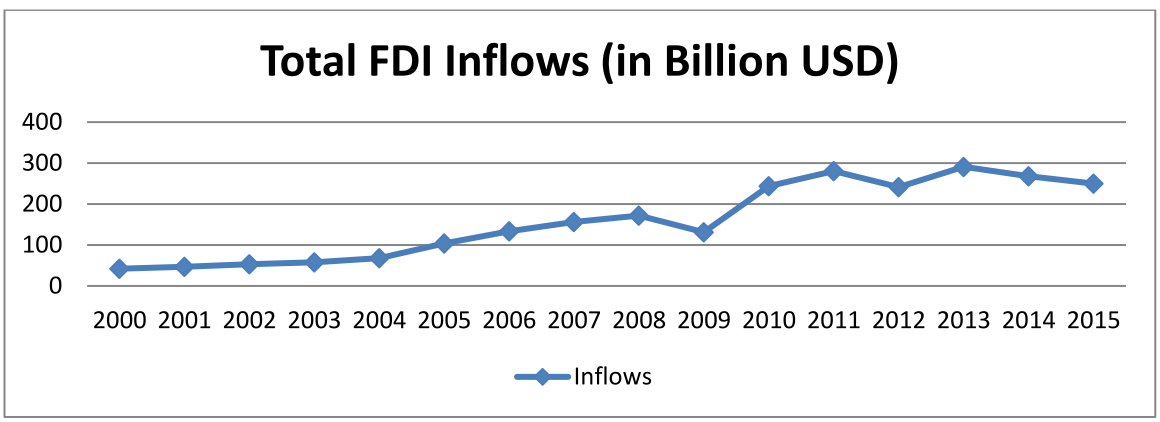
far more liberal and decentralized administratively. The lack of such pivot holds back investor interests in the Country for the long-term.[102]

Figure 3. FDI Inflows into China from years 1990 - 2000.



Source: Data adapted from The World Bank Databank, accessed May 6, 2017,http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2000&locations=CN&start=1990.

Figure 4. FDI Inflows into China from years 2000 - 2015.



Source: Data adapted from World Bank Databank, last accessed May 6, 2017,http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2015&locations=CN&start=2000.

[102] Yiping Huang and Xun Wang, "Does Financial Repression Inhibit Economic Growth? Empirical Examination of China's Reform Experience," (Presented at Conference on Economic Growth in China, Oxford University, Oxford, England, July 3, 2010), accessed May 6, 2017, https://www.rba.gov.au/publications/workshops/research/2010/pdf/huang.pdf.

While the government decentralized governance powers to local bodies, it maintained a considerable degree of control over the performance over the market for the most part - more fully illustrated in the next segment of this chapter. Figures 3 and 4 highlight the FDI inflow rates into the Country from 1990 through 2015 and portray two separate stories. While Figure 3 highlights the growth story and the ascent of the Chinese economy, Figure 4, however portrays a markedly different situation as it records the downward trajectory in inflows. It is apparent however, that the volume of investments in China is still remarkably high; however, it is the downturn that is of essence.

2.3. Creation of a Dual Economy in China

Market dualism and economic growth in China bear a symbiotic relationship, whereby one feeds the other and keeps it alive. The economic growth of China is resultant of the development of the dual economy married to a labor surplus.[103] Dualism may be understood as a product of sociological, technological, socioeconomic, economic or geo-economical--such that it could be attributable to just one or a multitude of such factors.[104] This thesis looks at dualism as a product of geo-economic factors, which has furthered in practice economic cleavages present between the Eastern Coast and Western or Inland regions of the country. The dominance of dualism in the market, while gave way to the inflow of FDI into the market, is turning into a problem because is facilitating a lock-down of the investments and the spillover thereof into the geographic region where it is made.

Following the economic reforms of 1978, there was a lag in the amount of investments that were inbound. The annual utilization of investments from 1978 to 1984 remained at a meager $0.4

[103] Marco G. Ercolani and Zheng Wei, “An Empirical Analysis of China’s Dualistic Economic Development: 1965-2009,” *Asian Economic Papers* 10, no. 3(2011): 1-29.
[104]Xiaolan Fu, “Trade-cum-FDI, Human Capital Inequality and Regional Disparities in China: the Singer Perspective,” *Economic Change and Restructuring* (June, 2007).

Billion and managed to accumulate only $4 billion until 1991.[105] The move did, however, progressively discard the past of import-substitution and extremely rigid price control--substituting it with different taxation schemes and mechanism to still maintain control, but not micromanage the behavior of the capital.[106] The latter still remains in play, but not in the classical essence of communism that thrived under Mao. China's retention of some of its planned economy attributes exposes its Government's inability to generate revenue vis-à-vis taxation of the relatively new private economy that has boomed in the coastal pockets of China. Pricing control has loosened over a variety of goods and products while the factors of production have made significant progress.[107] The Chinese government faces a unique conundrum - it has helped create a dual economy for itself - one where the cities on the Eastern Coast are booming courtesy of special economic zones (SEZs), while Central China is alien to any such development.[108]

While the Chinese economy, as noted in the previous section, has become a beacon of rapid growth, it has immensely fractured itself internally. Investments are largely concentrated into the eastern cities of Guangdong, Shanghai, Tianjin, Fujian, Jiangsu, Liaoning, Hainan, Zhejiang and Hebei.[109] The Eastern flank of the nation accounted for 88% of the total investments in 1995 when the boom of the inflows began with stead and the stronghold of the eastern banks has continued through the years as 70% of the total inbound investments in 2015 were held by the Eastern Shore Cities.[110] A prima facie explanation for such skewed inflows remains that cities on the eastern shore were selected as those which were to be converted into SEZs, and thereby

[105] Yao, "On Economic Growth, FDI and exports", 339-351.
[106]Weiying Zhang, *The Logic of the Market: An Insider's View of the Chinese Economic Reform*, (CATO Institute: Washington D.C. 2014), 158-165.
[107] Ibid.
[108] Daniel Abebe and Jonathan S. Masur, "A Nation Divided: Eastern China, Western China, and the Problem of Global Warming," *University of Chicago Public Law & Legal Theory Working Paper*, no. 232 (2008).
[109] Yao, "On Economic Growth, FDI and exports", 339-351.
[110] Alex Granneman and Meine Pieter van Dijk, "Foreign Direct Investment in China, the Factors Determining a Preference for Investing in Eastern or Western Provinces," *Modern Economy* 6 (2015): 924-936.

garnered a competitive edge over the remainder of the country. When contrasted with the mainland, the coast had higher productivity in agriculture as well as the industrial sector. Accompanying reasons of heightened productivity was the fact that the east coast cities also possessed an efficient transport system, higher skilled labor and better environmental resources - and remained most proximate to the biggest Chinese Investor - Hong Kong. Of the principle investors in the Chinese economy, a significant share belongs to Hong Kong - a staggering 54% of the total inflows, followed shortly by other regional heavyweights such as Japan, South Korea and Singapore.[111] The projections for the inflows in the eastern do not show signs of slowdowns or drastic reductions in the inflows into the developed seaboard of China.

The inflows are most ideally understood through Dunning's Eclectic Theory or the OLI (Ownership-Location-Internationalization Advantages) Tripod.[112] Investments that have flowed inwards have sought out a competitive edge and have thereby accumulated in the pockets of the country that have the ability to further massage the firms' needs to maintain monopoly over their intangible assets - an ability that remains missing from the parts of China that are not constitutive of the SEZs.[113] The local market in such SEZs allows firms to further finesse intangible assets such as brand value, research and development and cultural authenticity of the product, which would not be possible in other regions of the country. The location-specific advantages that is available to firms in the SEZs. Lastly, the internalization advantage or "firm-specific ownership advantages" available in the SEZ outdo those in the Western and Inland Regions of China, as highlighted through the works of Granneman and Van Dijk.[114] The growth rates, according to the regression analysis published by the authors mentioned highlights that LnPatents in the Eastern

[111] Ibid.
[112] Ibid.
[113]Winiecki, *Shortcut or Piecemeal*, 170-171.
[114]Granneman and van Dijk, "Factors Determining a Preference for Investing in Eastern or Western Provinces", 924-936.

flank clocks off at -0.269614 as opposed to that in the West, where the mark off is at -0.2728365, and GDP Growth in the Eastern model is at 0.0186402 versus that of 0.0354196.[115] The summary of their comprehensive findings shows that FDI has a positive relationship with GDP growth and is linked to wage increases. Higher quality FDI requires better trained labor, the cost of acquiring which is significantly higher than training new or unskilled labor.[116] Considering that the Eastern Shores and the SEZs as a consequence possess the requirements that FDI desires to flourish, as Dunning identifies.

A more striking argument that is made is the financial repression in China has become instrumental for the thriving nature of the investments in the singular pockets. The repression paves the way for capital import and export, such that China became the hotbed for exporting capital to, since it provides a significantly higher rate of return, considering that it provides a tax-arbitrage opportunity which thereby provides a higher rate of return - the performative aspect of investments in this scenario defies the convention that it would move towards areas which are not saturated and provide newer investment opportunities.[117]

FDI in China is thereby incredibly unique. The investments' percolation in the eastern shore is justified by the presence of the manufacturing sector and comparatively higher skills training as compared to the inland regions or external economies--which paradoxically is a product of the flight of investments into the region. The inland regions through the course of trading with the coastal regions created a core-periphery relationship within in China itself - setting itself up as providers of less-technical support and sans the ability to provide anything more.[118] This also

[115] Ibid.
[116] Ibid.
[117]Meng Miao and Oren Sussman, "Financial Repression in China and Global Economic Imbalances," accessed May 7, 2017, http://eureka.sbs.ox.ac.uk/5839/1/FinancialRepression%20paper.pdf
[118] Ibid.

implies that the growth of labor or human capital in the inlands has been stagnant and thereby lead to the expansion of existent cleavages across the society. The spillover that was presumed to as well as espoused to have taken place through the course of FDI has barely taken place across the China, remaining limited to the coastal cities for the most part. The next chapter discusses the relationship of FDI and India.

Chapter 3. Understanding Investments in India

3.1. Characterization of India's Market in Status Quo.

India stands as prima facie testament to the benefits of liberalization, bringing growth spurt to the otherwise flailing economy, however, there are multiple undercurrents that need to be explored in order to better understand the economy.

The Indian economy is truly fascinating to look at because, like China's, it is not uniformly evolving. While the Chinese economy possesses a dualist economy with uneven distribution of resources,[119] India has a developmental paradox. India carves a niche for itself in the information & technological (IT) and Biotechnological sectors in the global market - two sectors that are scientific and technological development dominant.[120] Normative understanding of the market dictates that such spaces are expected to be dominated by post-manufacturing societies, and thereby markets to be occupied by the Northern economies.[121] Not only is the nation booming these sectors, they are producing outputs that are qualitatively competitive with the Northern economies'. It is of the essence to note that the development in India is a product of long term interests in specific sectors that were identified as regions for possible growth, as Douhan and Norberg identify, somewhat problematically however as they attribute the growth and identification of the markets wholly to the government and not to the market.[122] However, India holds the unenviable record of the poorest country in the BRICS on a per capita basis[123]--emulating at best, a middle income economy with a burgeoning middleclass, however, close to three hundred million people in India or 40% of the total population lives below the poverty line-

[119]*See*, Chapter 2.
[120] Arvind Panagariya, "India and China: Trade and Foreign Investment," in *Economic Reform in India*, eds., Nicholas C. Hope, AnjiniKochar, Roger Noll, and, T.N. Srinivasan, (Cambridge University Press, 2013), 96-106.
[121]Winiecki, *Shortcut or Piecemeal*, 174.
[122] Ibid.
[123] Jan Winiecki, "The BRIC Group - How Strong a Challenge to the West?," 13, no. 2 (April-June 2012): 31-74.

-the population size that compares to that of the entirety of the American Population.[124] This chapter seeks to identify the role that FDI has played in helping create such a market place in the second largest market in the world, while identifying the reasons why it continues to move into the relatively newly liberalized economy.

3.2. The Nature of Indian Economy: Before and After Liberalization

India embraced liberalization only in 1991--after suffering from decades of sluggish growth rates and eventually facing a market collapse due to the fast and loose games with protectionism that the governments had taken to. It is highly incorrect to state that the economy remained low-functioning throughout its history until 1991, however. The rate of growth in the 1950s remained respectable-showing signs of acceleration and has maintained itself in the same manner, barring the interruption of 1965-1981, which marked a particularly dark time for the economy. 1951 to1965 saw the economy grow at a speed of 4.1% per annum (p.a.) as opposed to 1% that dominated the early half of the century for the country.[125] A closer look still highlights a p.a. growth remained at 2% on a per capita basis.[126] The policy for the 1950s remained largely liberal and envisioned a greater role for the public sector industries--in particular for licensing of private investments in few segments, the liberal policies eventually lead to a balance of payments crisis which in turn caused the government to adopt foreign exchange restrictive policies.[127]

The policies did essentially spell the doom for the economy from 1965 through 1981 as the period recorded extremely sluggish growth rates. GDP during 1965-1975 dropped to 2.6% from

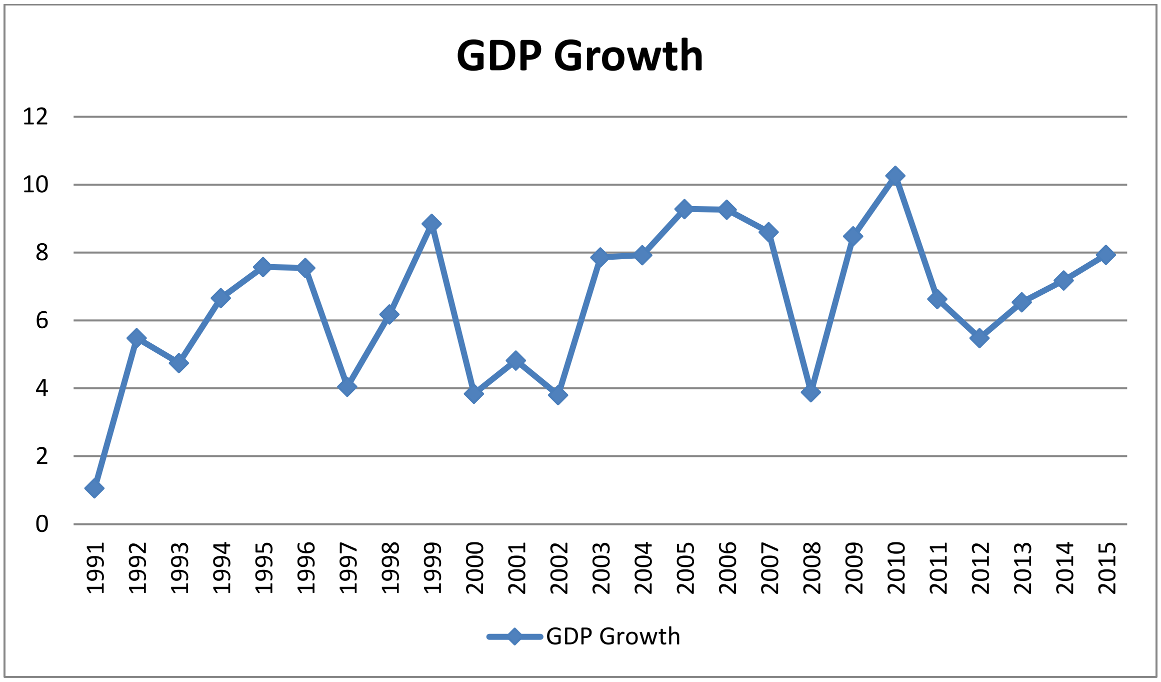
[124] Ibid.
[125] Rakesh Mohan and MuneeshKapur, “Pressing the Indian Growth Accelerator: Policy Imperatives,” *IMF Working Paper* (March 2015), accessed May 12, 2017, https://www.imf.org/external/pubs/ft/wp/2015/wp1553.pdf.
[126] Ibid.
[127] Arvind Panagariya, “India: The Emerging Giant,” (Oxford University Press, 2008), 23-26.

4.1%.[128] Industrial growth during this time fell from 6.7% to 3.6%, [129]with the Incremental Capital to Output Ratio (ICOR) skyrocketing throughout the 60s as it increased from high rates of 4-4.5:1 in from the mid-60s to morbid high of 10.5:1 towards the mid-70s.[130]The declining efficiency of the capital was accompanied by stagnation in the quality of life and standards of living. [131]The Government, under the leadership of Indira Gandhi, responded to these problems with aggressive nationalization, initiating rapidly protectionist policies. Imposition of burdensome regulations on big-businesses, nationalization of banks, oil and gas companies triggered a phase of socialism in India which was as kind to India's growth as it was to China's.[132]

The implementation of the liberalization policies in India, like those in China, was an abject need to prevent the economy from collapsing owing to the continual accumulation of foreign debt and ill-performing industries at home. The decision to liberalize the economy, in agreement with the IMF, implemented by Manmohan Singh (who later became the Prime Minister of the Nation from 2004 to 2012) focused on removing the regulations that made it difficult or cumbersome to acquire investments in existent businesses or new firms courtesy of the infamously inefficient Indian bureaucracy, and on any rules or regulations connecting the imported investments and production inputs with the permit-based bureaucracy.[133] The emphasis that India placed, thereby, was placed on liberating businesses from the often corrupt and time consuming "permit-raaj"-the colloquial terming of the Indian Bureaucracy.

[128] Ibid.
[129] Ibid.,26-29.
[130]Winiecki, *Shortcut or Piecemeal*, 175-177.
[131] Arvind Panagariya, "India: The Emerging Giant", (Oxford University Press 2008), 23-26.
[132] Ibid.
[133] Ibid.

Figure 5. GDP Growth Rates Post-Liberalization in India from years 1991 - 2015.



Source: Data adapted from World Bank Databank, accessed May 11, 2017,http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=IN&start=1991.

The response to the new-found liberty remained largely positive, even though the GDP has shown violent tendencies of fluctuations as Figure 5 highlights. However, the fluctuations are still a result of a rapidly and newly industrialized economy that was not privy to a high quality of competition. It is further important to note that even the downturns in the years succeeding the liberalization were significantly better off over all than the darker days under Indira Gandhi.

The flow of investments into India is, thereby, a result of a careful assessment of the needs of the Indian economy and to prevent a total insolvency following drastic balance of payment crisis and expansion of external debt.[134] The utilization of FDI is linked to the government's perception of the requirement of the market as opposed to the actual needs of the market; the initial favorable attitudes were replaced by more restrictive approaches. The pre-1991 era can best be

[134]PravakarSahoo, GeethanjaliNataraj, and Ranjan Kumar Dash, *Foreign Direct Investment in South Asia: Policy, Impact, Determinants and Challenges*, (Springer, 2014), 41-48.

characterized as a cautious, somewhat paranoid, and highly selective approach to devising FDI policies and thereby inflows into the economy to keep in tune with the dominance of import-substitution industrialization policies.[135] The policy recognizably emphasized on the de-licensing the industrial rules and promoting Indian exports while promoting domestic industrial modernity - which was to be supplemented through the moderate trade liberalization reforms.[136] The reforms in question were largely limited to tariff reduction and moving products manufactured from import licensing to Open Game Licensing (OGL).[137] The post-1991 era has been FDI friendly with the scrapping of industrial approval systems - meaning that all sectors, barring 18 strategic sectors (which were later reduced further) and eventually introduced fast-tracking or automatic approval assignments for FDI in most sectors-most importantly in Non-Banking Financial Companies (NBFC).[138] The opening up of the market to FDI in energy, single brand retail, defense, and telecom sectors has helped pump up the economy and drive it towards the post-manufacturing markets in large parts.

The efforts were further massaged by the simultaneous establishments of various SEZ throughout the country.[139] The initial phase of SEZ policy offered little growth in the volume of FDI inflows or exports, the share of FDI increased from only 12% in 1989 to 18% in 2000, the trend of slow growth carried through in the SEZ realm until 2005 when it accounted for 5% of total exports.[140] However, since 2005, the role that SEZs have played in both - attracting foreign investments and foreign exports has amplified significantly, such that the overall export growth

[135] Ibid.
[136] Ibid.
[137]Sarabjit Chaudhuri and UjjainiMukhopadhyay, *Foreign Direct Investment in Developing Countries: A Theoretical Evaluation*, (Springer, 2014), 88-89.
[138]Sahoo, Nataraj, and Dash, *Foreign Direct Investment in South Asia*, 41-48.
[139] Chaudhuri and Mukhopadhyay, *Foreign Direct Investment in Developing Countries*, 80-82.
[140] Ibid.

from 2003-2010 was 1,493%,[141] while the total investments in the SEZ until 2013 was registered at $36.27 Billion[142]. The slow start and sudden jump in the ability to attract FDI was attributed to the fact India was yet inexperienced in rolling out a national model of SEZs, the relative small size of the SEZs when contrasted against the larger Chinese counterparts, and lastly - the firms' tendencies to relocate on regular basis.[143]

The quality of FDI in India is of most importance owing to the abnormal way it grows. Available data on the sectoral shifts of FDI stocks highlights that there is a marked shift of interest in the investors from manufacturing sectors to service sectors.[144] Further, on a whole, it is arguable that India's FDI policy is as competitively open as China's. The opening of the retail sector in particular has been a boon as it opens up further avenues of consumption dependent investments, while China struggles to implement the same. As Panagariya notes, the latest phase of the Indian economy, i.e., the phase beginning from 1991 is best understood as one with rapid growth acceleration in the GDP, Foreign Investments, and Foreign Trade, such that the three are highly correlated and dependent. The market's disciplining nature has been a boon for India as it was, in its limited ways for China.[145]

The interrelation between GDP and FDI in particular, for the case of India was illustrated through successive panel data analysis by Dondeti and Mohanty. The authors highlight that post-liberalization structural change in developing economies - China, India, Malaysia and Singapore have contributed heavily towards attracting FDI into the economy, such that these changes have

[141] Ibid.
[142] S. Chandrachud&Gajalakshmi, "A Study on Role of FDI in SEZ: Special Reference to MEPZ, Chennai", *International Journal of Business and Management Invention* 2, no. 3(March, 2013): 25-30.
[143] Ibid.
[144]Sahoo, Nataraj, and Dash, *Foreign Direct Investment in South Asia*, 41-48.
[145] Arvind Panagariya, *India: The Emerging Giant*, (Oxford University Press, 2008), 108-109.

triggered economic growth.[146] The return per dollar, their study shows is 3.27 dollars for the GDP of the host country, i.e., each dollar that flows into the economy through FDI routes adds $3.27 towards the GDP of the host country.[147] The role that FDI play for the Indian economy and the role that liberalization, lowering of tariffs and removal of NTBs has played in such growth is apparent. Khawar has shown that there is a positive nexus between FDI and economic growth, particularly in cases of developing economies that are integrated with the world economy and are identifiably growing domestically.[148]

The benefits of liberalization have translated well in the case of India, in particular. Net FDI inflows for India have been reported at 2.107% in 2015.[149] The key driver for the economic growth for the economy has been the service sector as the Ministry of Finance (MoF) declared via press release in February of 2016.[150] The MoF noted that the service sector contributed to 66.1% of the growth on a gross value basis.[151] The importance of the service sector therefore is not overstated; the sector has been the benefactor of the significant increase of inflow of FDI into the economy.

While the FDI inflow has seen a significant bump, the flow into the service sector has increased by 70.4% in 2014-15and equity inflow for 2015-16 increased by 74.7%[152]. The total volume of investments into the service sector-the biggest attractor for investments, stay at 18% of total

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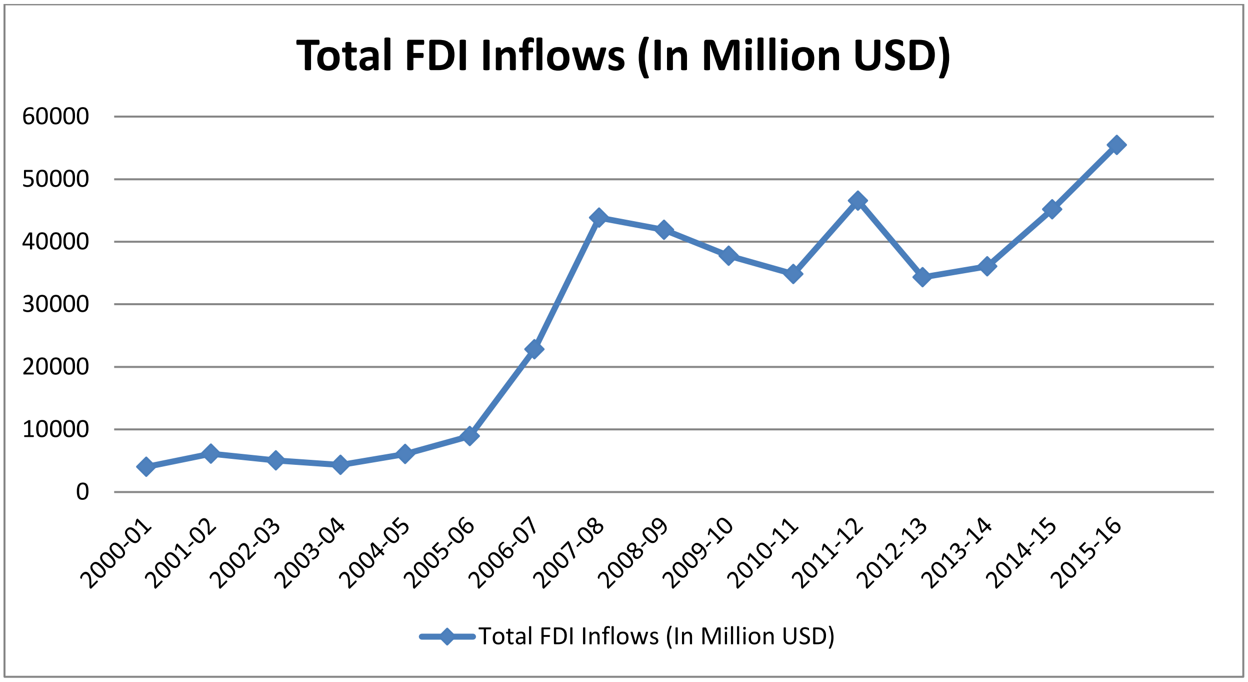
[146] V. Reddy Dondeti and Bindhu B. Mohanty, "Impact of Foreign Direct Investment on the Gross Domestic Product, Exports and Imports of Four Asian Counties: A Panel Data Analysis," *Delhi Business Review* 8, no.1 (January-June 2007).
[147] Ibid.
[148]MaraimKhawar, "Foreign Direct Investment and Economic Growth: A Cross-Country Analysis," *Global Economic Journal* 5(2005).
[149]Trading Economics, "India - Foreign Direct Investment, net inflow %," accessed on 13th of May, 2017, http://www.tradingeconomics.com/india/foreign-direct-investment-net-inflows-percent-of-gdp-wb-data.html.
[150]Press Information Bureau, Government of India, "Economic Survey 2015-16: Service Sector Remains the Key Driver of Economic Growth," Last modified February 26, 2016, accessed May 13, 2017, http://pib.nic.in/newsite/PrintRelease.aspx?relid=136868.
[151] Ibid.
[152] Ibid.

inflows for 2015-16, while the computer software and hardware sector, along with telecommunications sector, and pharmaceutical sector combined attract 19%.[153]

Figure 6. Total FDI Inflows into the Indian Economy from years 2000-2015.



Source: Department of Industrial Policy and Promotion, Government of India, "Quarterly Fact Sheet on Foreign Direct Investment," Last modified September 2016, last accessed May 14, 2017, http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_April_Sep_2016.pdf.

Figure 6 highlights the growth of investments over time, signaling largely an upward growth barring years concerning the financial crisis of 2009-2010, which were acknowledged in previous sections of this thesis as down years for investments globally. The data on 2016-2017 remains preliminary and limited from April, 2016 to September, 2016 and therefore not present

[153] Ibid.

on the graph. However, the preliminary data signals that the inflows until September 2016 remain at $29,016 Million.[154]

It is worth noting that India has transformed into the pharmaceutical manufacturer of the world--accounting for a third of the global exports of generic drugs. The success in the pharmaceutical industry, which is a far remove from the conventional and primary goods such as textiles, leathers and jewelry that India had been exporting upon its introduction to the world market is a large part to the structural reforms that are the subject of this thesis.[155] Governmental intervention in the realm of patent laws by adopting a regime that prohibited patenting generic drugs in most part encouraged developing generic medicines in India.[156] The export structure clearly moved from traditional, primary goods towards greater value added products such as generic medicines, transportation and automotive parts (Delphi Systems and Visteon manufacture parts for General Motors and Ford, respectively) and refined petro-chemical products.[157] While the degree of exports in the technological hardware sector climbs at incremental pace, it is still competitively lower than those made by East Asian economies -particularly, China. It is also important to note that while statistics show that the computer and technology hardware shares are contributing significantly to the GDP of the country, it still remains only marginally competitive when compared to the other major Asian economies as it accounts for only 7% of the Indian exports basket as opposed to 26.2% in the East Asian Markets'.[158] Kumar argues that the decline of India's electronics export sector can, in part be attributed to premature signing of the WTO IT Agreement in 200 which pit India in direct

[154]Department of Industrial Policy and Promotion, Government of India, "Quarterly Fact Sheet on Foreign Direct Investment," Last modified September 2016, accessed May 14, 2017, http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_April_Sep_2016.pdf.
[155] Kumar, "Reforms and Global Economic Integration of the Indian Economy," 129-130.
[156] Ibid.
[157]Ibid., 131.
[158]Ibid., 130-132.

competition with the Chinese, Korean and Japanese competitors. Thereby, while the volume of FDI into the technology manufacturing sector increases to the tune of 82% in 2016 and the total volume of investments in the telecom sector during 2000-2016 reaches $23,921 Million[159], it still does not generate enough revenue through exports to assist the balance of payments.[160]

The inflows in question speak to the quality of FDI that had been alluded to previously. The behavior of investors in the Indian market highlights that the New Industrial Policies starting from 1991 have been bolstered further by the continual streak of barriers to entry into the market.[161] The initial inflow remained concentrated in the secondary market but has shifted rapidly to the tertiary sectors--a product of what Bhagwati notes is the outward oriented trade policies.[162] The base of companies that may be referred to as "FDI Companies" has shifted from agro-based and light-manufacturing based to service and development based sectors-both reflective of an open trade regime.[163] The interpretation of such change in preferences however, is contingent on the sector-specific compositions and the effect that liberalization has had on individual sectors. The effect on the manufacturing sector and the primary sectors come across as straight-forward. Existing data shows that the manufacturing sector continually became less attractive for FDI over years--particularly the chemical and, electronic/non-electronic machinery industries.[164] The volumes of investments in the Chemicals sector highlight a volatile pattern, even though it remains the eighth highest attractor for investments in the economy. While the

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[159] Department of Industrial Policy and Promotion, Government of India, "Quarterly Factsheet: Fact Sheet on Foreign Direct Investment (FDI) From April, 2000 to December, 2016," last modified December 2016, accessed May 16, 2016, http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_OctoberNovemberDecember2016.pdf.
[160] Kumar, "Reforms and Global Economic Integration of the Indian Economy," 129-130.
[161]ChandanaCharkraborty and Peter Nunnenkamp, "Economic Reforms, FDI, and Economic Growth in India: A Sector Level Analysis", *World Development* 36, no.7 (2008):1192-1212.
[162]JagdishBhagwati and T.N. Srinivasan, "Trade and Poverty in the Poor Countries", *American Economic Review* 92, no. 2(2002): 180-183.
[163] Ibid.
[164]Charkraborty and Nunnenkamp, "Economic Reforms, FDI, and Economic Growth in India", 1192-1212.

sector attracted $763 Million in 2014-15, it nearly doubled the next year to $1,760 Million, falling back to $783 Million for 2016. Similarly, the Electronics sector remains 29th on the list, while Industrial Machinery sector stays at 19th.[165]

It is apparent from the data that is collected the primary attractor remains the service sector, which comprises of the financial, banking, insurance, non-financial, outsourcing, courier, research & development, and technological testing and analysis sub-sectors.[166] The boom in the service sector too is difficult to explain in detail because of the large swath of sub-sectors.[167] The manufacturing sector remains primarily susceptible to being affected by lack of technological and knowledge transfers. A combination of Dunning's Eclectic Model and Alfaro's hypothesis[168] reinforces the notion that the manufacturing sector is ideal for attracting investment projects as it provides a great environment for spillovers and technological transfers to thrive and increases the absorptive capacity of the industry, further it helps create meaningful linkages between the foreign and the domestic companies - evading the creation of any enclaves.[169] The sector needs to be supplemented by meaningful efforts from the policy makers to improve the quality of labor available in the local markets to enhance the ability of the market to absorb and benefit from the inflow of investments, considering policy makers cannot predict the quality of FDI that the economy would attract.[170] The policy consideration in question has been wholly embraced by the Indian policy makers as due emphasis has been placed upon facilitating better quality higher

[165]Department of Industrial Policy and Promotion, Government of India, "Quarterly Factsheet: Fact Sheet on Foreign Direct Investment (FDI) From April, 2000 to December, 2016."
[166] Ibid.
[167]Charkraborty and Nunnenkamp, "Economic Reforms, FDI, and Economic Growth in India", 1192-1212.
[168] Laura Alfaro, *Foreign direct investment and growth: Does the sector matter?*, (Boston, Massachusetts: Harvard Business School, 2003).
[169] Ibid.
[170]Charkraborty and Nunnenkamp, "Economic Reforms, FDI, and Economic Growth in India", 1192-1212.

education--which has resulted in creating a large reserve of technologically sound workforce.[171] The service sector, which is garnering the most stead as the attractor of FDI remains one that resembles the primary sector more stringently in India. The stymied ability to establish linkages between the foreign and local along with limited spillovers in the service sectors and thereby emulates more closely the primary sector.[172] The increasing inter-tradability of the services aside, investments in the service sector are still largely market-seeking and furthered more through mergers & acquisitions and holding company interests than greenfield investments.[173] It is interesting to note that the investments in the software industry by foreign companies act more as export enclaves than anything else. The inference drawn is that the FDI the service sector attracts is not as concerned with spillovers as much as it is with transmutability of skills.[174] A productivity analysis carried out by Arnold et al highlights that the service sector productivity in India has contributed heavily to the manufacturing sector productivity-primarily through banking and telecom support.[175] Bhandari and Kale adopt the hypothesis mentioned and utilize it with panel data from 4,000 firms from 1993-2005 and empirically highlight that service liberalization has objectively lead to an increase in service productivity by 11.7% for domestic firms whereas 13.2% for foreign firms.[176] Following liberalization, the net exports of services increased, primarily because of India's ability to capitalize on the change in technology of production and

[171] Ashish Arora and Suma Athreye, "The Software Industry and India's Economic Development," *Information Economics and Policy* 14 (2002):253-270.
[172]Charkraborty and Nunnenkamp, "Economic Reforms, FDI, and Economic Growth in India", 1192-1212.
[173] Ibid.
[174] Ibid.
[175] Jens Matthias Arnold, Beata Javorcik, Molly Lipscomb, and AadityaMatoo, "Services Reform and Manufacturing Performance Evidence from India," *The Economic Journal* 126:590 (February 2016):1-39.
[176]Laveesh Bhandari and Sumita Kale, "Drivers of Growth: Sources and Sectors," in *A Concise Handbook of the Indian Economy*, ed. Ashima Goyal (Oxford University Press, 2015), 15.

distribution, which in turn was aided by the IT-assisted fragmentation and modularization--the reduction of spillovers while amplifying the transmitability of skills.[177]

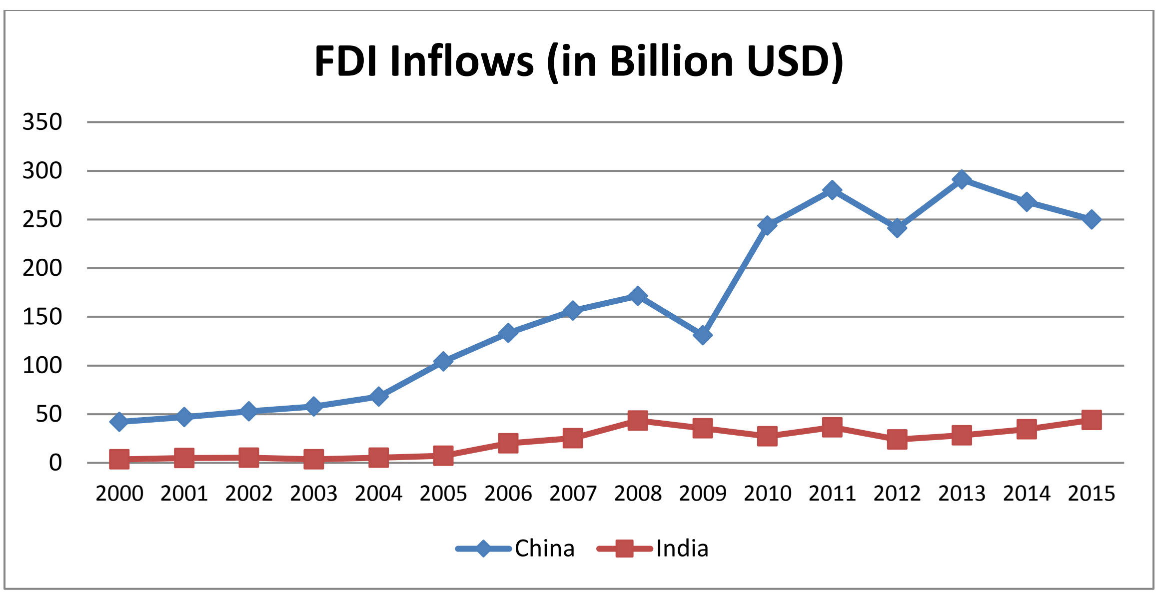
The pattern of growth and the role that FDI has played in creating such growth in the two largest developing is similar yet different in many ways. While Investments have played a large role in the economic growth of the countries while creating paradoxes in both economies--resulting in lopsided internal growth. The influence of FDI in China is not as straightforward as it in India where investments have catapulted exports, sectoral development as well as facilitated the grounds for better work-force training. While exports have boomed in China and the spillovers experienced include technological development-which in turn has increased its technological readiness. FDI has, however, also lead to increased localization and isolation of investments in pockets of the country - the SEZs, which has created a vicious cycle in itself as explained in Chapter 2. The comparison between the two cases is more fully made in the following chapter.

[177]SoumyenSikdar, "Openness and Growth in the Indian Economy", in *A Concise Handbook of the Indian Economy*, ed. Ashima Goyal (Oxford University Press, 2015), 107.

Chapter 4. The Comparison of Investment Situations in China and India

The preceding two chapters highlight that the two largest economies in the developing took two distinct approaches to international markets, however, it triggered from the repercussions of a similar economic set-up. The restrictions and subsequent unhealthy consequences of a closed or restricted economy was felt acutely in India and China alike as local industries failed to constructively make use of resources, while the standard of living continually deteriorated. The post-liberalization period too, for the two countries showed some similar trends, with initial years still struggling to gain traction or definitively focusing on the path forward. However, upon establishment of new regimes-through laws and deregulation mechanisms, while China focused on its manufacturing sector, directing investments primarily towards the Eastern short, India diverted its attention to the service sector. Figure 7 compares the inflow of FDI in India and China from 2000 through 2015 and displays two distinct information sets.

Figure 7. FDI Inflows into China and India between years 2000-2015.



Source: Data adapted from The World Bank Databank, accessed May 17, 2017,http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2015&locations=CN-IN&start=2000.

The primary information that the graph conveys is the sheer volume investments and the disparity between the volumes of inflows into India and China, with the latter taking the unquestionable lead. However, the secondary information relayed is that there is a sharp decline in the rate of inflows in China, while those in India are increasing steadily. Through the course of this chapter, two questions will be explored, a. what is the role that governance plays in attracting FDI?; and b. what leads to the rise or decline in the investment into the economy? The questions necessitate the reflection upon the quality of investment and the sectoral spread of investments. The concern over China's economic sustainability is neither novel, nor unspoken about. However, a qualitative analysis of the FDI that it receives and employs is essential for understanding the downturns. Similarly, India is viewed as emerging market with the ideal tools to be a hotbed for FDI.

As alluded to earlier, there is a distinct difference between the volume of inflows of FDI and the quality of such inflows. Alfaro and Charlton highlight that there are distinctions within the class of FDI, such that they must be differentiated on the basis of the effect that each unit of investments has on the economic growth of the host country.[178] The argument made intimately links economic growth to FDI such that the latter is seen as driving the former. An analysis of dataset from 29 countries on industry-level between 1985 and 2000 highlights that as effects of FDI on sector and GDP growth changes as the quality of FDI is taken into account.[179] Prima facie affecters for inflows include the mode of investments, country of origin of the investment and similar factors.[180] The determination of the function that any investment is expected to

[178] Laura Alfaro and Andrew Charlton, "Growth and Quality of Foreign Direct Investment: Is All FDI Equal," *Harvard Business School Working Paper* 07-072 (2007), accessed on May 17, 2017, http://www.hbs.edu/faculty/Publication%20Files/Growth%20and%20the%20Quality%20of%20Foreign%20Direct%20Investment-%20Is%20all%20FDI%20Equal_8de61b6b-1bb6-491c-a750-9f32d251a4ce.pdf.
[179] Ibid.
[180] Ibid.

perform in the economy remains largely contingent upon the policies that the country's legislators draft.

Target investors for a given economy are defined by the sectoral developmental priorities of the host nation, the degree of match between the local capabilities of the host country.[181] The same behavior is exhibited explicitly in the cases of post-liberalized India and China. The prioritization of the service sector in India and the manufacturing sector in China remained conscious efforts.[182] The supposition made is that there is no channeling of investments into a sector unless the government puts its weight behind it; rather the government plays at deterministic role in the sectors that get most attention. Government policy has played an incremental role in the way investments have affected the ground realities of China.[183] The inflows were directed towards the coasts and into the manufacturing sector in order to ensure rapid industrialization of the industry. Thereby, the role of policymakers in the case of funneling of FDI is not overstated in this thesis. It is of further importance to note that the long-term quality of the inflows.

China's longstanding commitment towards the eastern coast and developing a manufacturing sector that is globally dominant came at the cost of the central and western sections of the country--which drastically affects its ability to diversify its investment base. Further, investments from specific regions have specific characteristics. Inflows from Hong Kong-the largest investor for the country[184], are more primed towards using China's infrastructure, low-cost, low skilled-labor and employed in the labor-intensive industries in order to manufacture goods and products that are exportable to the rest of the world, thereby export-oriented as opposed to market

[181]UNCTAD, World Investment Report 2001, 212.
[182]Kumar, "Reforms and Global Economic Integration of the Indian Economy," 148.
[183]*See*,Chapter 2.
[184] Santander Trade Portal, "China: Foreign Investment," accessed May 18, 2017, https://en.portal.santandertrade.com/establish-overseas/china/foreign-investment.

seeking.[185] This stands in stark contrast from the nature of investments from USA (the second largest investor)[186]. Investments from U.S. firms are more geared towards serving the domestic market, more concerned with local demands and sensitive to change in the cost of labor as they are routed towards the industries that are capital and technology-intensive industries.[187] The investments too, are further locked in pockets or zones of the country. Panel regression carried out by Fung et al highlights that the investments from Hong Kong are largely locked into the SEZs and Open Coastal Cities (OCCs) where it enjoys tax breaks and access to cheap capital as well as well-formed infrastructure in the form of highways.[188] The investments from the U.S. firms however are unaffected by the changes or conditions in SEZs and OCCs as it remains concentrated in the Economic and Technological Development Zones (ETDZ) as these zones are technologically forward and remain connected with provincial capitals.[189] It is essential to note, however, that OCCs, SEZs are exclusively east coast bound whereas most of the cities classified under ETDZ are also on the eastern shores. Central and western China remains largely untouched by the boom that the east enjoys and that adversely affects it FDI inflows in status quo. The manufacturing sector saw a drop to 31% of total inflows in 2016 while the focus of investments shifted towards the service sector because of the expensive nature of producing in China in status quo.[190]

Market dualism has resulted in the preservation and in many senses, limitation of development to the eastern sect of China, which has tried to rebalance since the 1990s; however the means have

[185] K.C. Fung, HitomiIIzaka, Chelsea C. Lin and Alan Siu, "An Econometric Estimation of Locational Choices of Foreign Direct Investment: The Case of Hong Kong and U.S. Firms in China," in *The Chinese Economic Series: Critical Issues in China's Growth and Development*, eds. Yum K. Kwan and Eden S.H. Yu (Ashgate 2005), 97-104.
[186]Santander Trade Portal, "China: Foreign Investment."
[187] Fung et al, "An Econometric Estimation of Locational Choices", 97-104.
[188] Ibid.
[189] Ibid.
[190]UNCTAD, World Investment Report, 2016, http://unctad.org/en/PublicationsLibrary/wir2016_en.pdf.

paled in comparison to the efforts that were implemented to the eastern coast.[191] The same remains exceptionally important considering that the manufacturing sector in China has begun to stagnate owing to increasing costs of production in the eastern cities. Booming costs of labor and production in the coasts signals that the costs of performing businesses in the SEZs and OCCs thereby adversely affect the inflows from Hong Kong, which, as noted are cost-sensitive and thereby cost China the significant edge that it had in the manufacturing sect-especially in the labour-intensive and non-specialized sector.[192] It is of further importance to note that the capital that has flown into the economy too has a fast-declining efficiency as the ICOR continues to climb to pre-1978 levels, touching 4.6:1 in 2011, while the benefit derived from financing has declined as the return on each $1 has been $0.17 in 2012 while it was $0.83 in 2007.[193] The rising labor costs in the labour-intensive manufacturing sector can inspire new investments to move to countries with lower costs of production, like those in South East Asia, Latin America and Africa. While it is safe to say that Western China would be the first stop before the investments flee to Central Africa, there are substantial issues concerning the efficiency of investing in China which is a by-product of governmental policies. While the investment climate in China remains more favorable than those in most parts of the world owing to coherent policies to streamlining and decentralization of FDI administration and strengthening enforcements[194]. China and India remained most active in continually opening up new sectors for FDI. China's revision of the "Catalogue for the Guidance of Foreign Investment Industries" makes the manufacturing sector more accessible for the foreign investors in order to minimize the flight

[191]Shaoming Cheng, "From East to West: The Evolution of China's FDI Preferential Policies", *Journal of Washington Institute of China Studies* (Online) 1, no. 1(March 2014), accessed on May 18, 2017, https://www.bpastudies.org/bpastudies/article/view/11/26.
[192]UNCTAD, World Investment Report, 2016.
[193]Winiecki, *Shortcut or Piecemeal*,170.
[194] Ken Davies, "China Investment Policy: An Update?," *OECD Working Papers on International Investment*, 1(2013), accessed on May 18, 2017, https://www.oecd.org/china/WP-2013_1.pdf.

from the labor-intensive manufacturing sector.[195] The Chinese story speaks of two essential aspects - a.)government policies that have been ineffective at homogenizing growth across the country; and b.)plateauing of the competitive advantages that gave China the edge over other economies.[196]

Winiecki notes that the current rates of inefficiency and rising costs can be the tell-tale signs of economic crisis.[197] The underutilization and over inflows of investments, coupled with rising costs in China signals a slow down especially when compared against the markedly low commodity prices from Bangladesh and Philippines, but also has adverse effects on other regional economies-particularly Mongolia and Indonesia.[198] The Global Competitiveness Report states that China as well as Taiwan has been reportedly losing its innovation edge since 2007 steadily. The loss of edge is coupled with reduced financial development--which reflects upon the soundness of the financial sector of the country.[199] Recent data from the Bank for International Settlements highlights a credit-to-GDP gap of 27.2[200] which is close to three times the acceptable threshold of 10 and outside the preferred limit of 2 and 10.[201] A high gap signals impending banking crisis, while a negative gap signifies that a "safe" amount of borrowing is possible-for investment or consumption. It is important to further note that the ease of getting

[195] Ibid.
[196] Ibid.
[197]Winiecki, *Shortcut or Piecemeal*, (CEU Press 2015), 170.
[198] Klaus Schwab, "The Global Competitiveness Report: 2016-2017", *World Economic Forum*, 16-19.
[199] Ibid.
[200]Bank of International Settlements, "Credit to GDP Gaps," accessed May 18, 2017, http://www.bis.org/statistics/tables_j.pdf.
[201]MathaisDrehmann and Kostas Tsatsaronis, "The Credit-to-GDP gap and countercyclical capital buffers: questions and answers," *BIS Quarterly Review* (March 2014):55-73, accessed May 18, 2017, http://www.bis.org/publ/qtrpdf/r_qt1403g.pdf.

credit in China has continued to get easier, while the protection available for minority investors ranks at 123rd in the world.[202]

While China has a bloated score, India's credit-to-GDP gap is at -3.1,[203] implying that the economy can successfully accommodate capital into the economy without panic. The ratio further adds weight to Winiecki's supposition previously referred to notes that the manner of growth that China exhibits behavior that ought to raise red flags. However, the FDI Confidence Index as recorded by AT Kearney - a global investments consultancy firm, notes that China still ranks 3rd on the global rankings even while there is a decline in investor faith as opposed to that in 2015 for 2016.[204] The bullish behavior in China is premised upon the continued efforts of deregulation and increasing ease of doing business--albeit remain aware of the political risk and cost increments involved. India meanwhile climbed up the ranks (FDI Confidence Index rankings place India 8th on the list)[205]--indicating increasing investor faith in the country, driven by the continuance of deregulation and reduction of red-tape in the country.[206] The rise in the inflows denotes a bettering investment climate--something that can be said generally for the economy since 2003. The Ease of Doing Business (EODB) rankings for India, paint a dissimilar picture. The country ranks 130th in the world in terms of running a business in India[207], a close analysis of rankings reveal that India lacks substantially in enforcement of contracts (ranking at 172nd) as well. The World Governance Indices rank India in the 17th percentile for political stability and absence of violence, 40th in regulatory quality, 44th in the control of corruption and

[202] The World Bank Database: Doing Business, "Ease of Doing Business in China," accessed on May 19, 2017, http://www.doingbusiness.org/data/exploreeconomies/china#protecting-minority-investors.
[203] Bank of International Settlements, "Credit to GDP Gaps."
[204] "2017 A.T. Kearney Foreign Direct Investment Confidence Index," A.T. Kearny, accessed on May 18, 2017, https://www.atkearney.com/gbpc/foreign-direct-investment-confidence-index.
[205] Ibid.
[206] Ibid.
[207] The World Bank Database: Doing Business, "Ease of Doing Business in India," accessed on May 19, 2017, http://www.doingbusiness.org/data/exploreeconomies/india.

56th in rule of law.[208] It is apparent in this case as well as China's that the investors are attracted to countries more by the dynamic abilities of the host country as opposed to ease of entry. Kumar interprets, correctly, as indicative of the firms' willingness to deal with potential hardships instead of opting to move to countries where ease of doing business is high but the possibility of growth and return on the investment is high.[209]

India undertook five specific measures through 2015 in addition to the massive changes made in 1991. Similar moves as China includes increase in the number of sectors that are capable of receiving investments - including defense, mining, civil aviation and agriculture - all of which were closed off sectors previously. Increase in the investment cap from 26% to 49% in insurance and pensions, increasing the minimum amounts of FDI that require prior approval from the government to INR 500 Million, and, allowing for 100% FDI under the automatic route to manufacture medical devices remain hallmarks of the FDI policies amended in 2015.[210] It is of further importance to note that while China's investments cause concern because of the increase in costs in the dominant sector, India has been able to strategically combat the stagnation that settled into the economy between 2007 and 2014 which caused the economy to slip in the competitiveness rankings-falling to 48th and remaining in the periphery until recently when it climbed back to 39th. The reason attributed to such an increase is the attention to diversity that the Indian government has paid, emphasizing on distribution of attention to different sectors to raise overall competitiveness, while focusing on socio-economic growth.[211] Governmental emphasis on basic health and education improved through much of the 2000s, which added to creating a rich demographic of young, skilled and affordable labor.

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[208] World Governance Indices, "World Governance Indicators: India," accessed on May 19, 2017, http://info.worldbank.org/governance/wgi/index.aspx#reports
[209] Kumar, "Reforms and Global Economic Integration of the Indian Economy," 148-149.
[210]UNCTAD, World Investment Report, 2016.
[211] Schwab, "The Global Competitiveness Report: 2016-2017," 16-19.

The in-flight of investments following a particularly dull and corruption scandal laden pre-2014 era could be attributed primarily to the government's initiative to undo the image of unmanageable inefficiencies plaguing the system.[212] Focus on infrastructure in order to support the manufacturing initiatives under the "Make in India" programme remains essential in the marked uptick in the inflows, which was also supplemented by a drop in commodity prices, a rebalancing of capital deficits and controlling of the inflation in the market. The financial institutions and macroeconomic health of the economy improves as substantial changes made by the Reserve Bank of India in order to increase transparency in the financial market and highlight the volume of non-performing assets that had not been reported previously on the balance sheets of Indian Banks.[213] The Indian economy bears the benefits and developments that the Chinese economy lacks or lags in, while it lacks the benefits of the Chinese markets. The distinct different between the Indian and Chinese markets is that while they try to compete for the same investors, they bear different attractive markers in status quo, as the research highlights.

The natural gravitation of MNCs to India, owing to its rich stock of skilled albeit cheap labor drove up its ability outperform most of its developing as well as developed economy peers.[214] The investments that India has attracted since liberalization have been centric towards the tertiary sector, where it feeds into creating high value service products. It is essential to note thereby that the investments are qualitatively driven towards the modern technology-intensive sector, producing serviceable, export quality products as opposed to the conventional sectors.[215] While the initial policy regarding investments was to focus on the manufacturing sectors-especial the heavy machinery and chemical sectors, the policy took a sharp turn after 1991 when the

[212] Ibid.
[213] Ibid.
[214]Sikdar, "Openness and Growth in the Indian Economy," 107.
[215] Kumar, "Reforms and Global Economic Integration of the Indian Economy,"148-149.

State-policy became more service-centric.[216] Manufacturing sector has still been the larger recipient of FDI, amounting for roughly 40% of total inflows since 1991;[217] however, the service sector remains the driver of FDI in more recent years. India's growth is attributed to two essential factors - a. steady internal, institutional changes; and b. spreading of FDI across sectors - service and manufacturing. This stands in contrast against China's focus where investments have been routed largely export-oriented manufacturing sector for the most part and focus has been placed on services only recently.[218] It can be argued that India had to route its investments to the tertiary sector because it never successfully acquired the capabilities to outcompete China in the manufacturing sector where close to 11% of the FDI acquired by China flows into its electronics and telecom sector.[219] The policy guiding the utilization of investments in China dictated its dominance in the manufacturing sector, while India's focused on the service and IT sector.

However, the nature of growth and the data highlighted through the course of this chapter signals that the investor confidence is not shaken particularly by poor political stability or impending economic destabilization. Rather, the emphasis lies on the ability to extract a return on the investment and the potential for diversification in the economy. Overreliance on one sector or geographical region has been the focal point of discord in China as it has led to the increase in costs of continuing business in the country.

[216] Ibid.
[217] Ibid.
[218]UNCTAD, World Investment Report, 2016.
[219] Kumar, "Reforms and Global Economic Integration of the Indian Economy,"148-149.

Conclusion

This thesis asked two questions - a.) Does the "quality" of FDI matter? and b.) How do governmental policies interact with the inflow of investments? Both these questions have been answered through the course of preceding chapters, leading to possible value addition to the existing literature. However, before answering these questions, it is worth noting that the argument made and conclusions drawn go against the current stream of literature on India and China. The empirics in this thesis present an alternate paradigm to the contemporary literature which envisions the future of China being brighter than India.Traditionally, FDI has been viewed strictly through the lens of economics; however this thesis emphasizes the need to also take into account the contribution of policy and institutional support.

It is highlighted that there are significant problems plaguing the investment climate in China - the manufacturing powerhouse of the world. Chapter 2 highlights the rising labor costs, accumulation of power in the hands of SOEs and state-owned banks costing efficiency to the private sector while efficiency of the investments flail, generally are some of the perils that China faces in status quo. These problems come amidst an effort to route the economy towards the service sector. While China faces these issues, India has a thriving service sector which is being increasingly supplemented by a highly-competitive and advanced manufacturing sector.[220] The difference between the two economies is that India's aim since its liberalization has been to move to the tertiary sector and a manufacturing sector that closely resembles that from the advanced countries.[221] The reasons for the decline and worry in China and increase in India are linked to the structural differences in the countries - policy considerations determine the nature of inflows into the economy. The data shows geographic and sectoral diversity of investment

[220]*See,* Chapter 3.
[221]Panagariya, "India and China: Trade and Foreign Investment," 96-106.

opportunity, supplemented by effective governmental efforts to upgrade the quality of labor is essential for attracting quality FDI at sustained rates/levels. India succeeds where China fails - diversification of opportunities, which allows investors to ignore the weakness of the rule of law and flailing corruption control mechanisms in the country, as illustrated in Chapter 3.

The essential attribute of the argument rests in differentiating between quality and volume of FDI. The thesis highlights that the volume of investments are not essential beyond the immediate years following liberalization, rather the quality of the investments is what must be focused upon. Much of contemporary literature fails to account for the quality of inflows, even if record inflows, that China has allowed and the negative repercussions that same has had on the economy. The empirics show that there are FDI in itself if multifarious in nature, best edified by the different "natures" of the capital brought in by Hong Kong and American investors in China. FDI flowing in from Hong Kong--the biggest source for China, is concentrated on the eastern shores, investing in labor intensive export sectors; it does not carry ant skill-transferring spillovers. In contrast, US investments are in technological sectors, demanding highly-skilled labor and cater to the domestic market.[222] There is an obvious disparity in the value each "kind" of FDI brings into an economy. The focus of any given economy must, after a while, shift from merely gaining volumes to attracting quality investments that are capable of developing the internal markets through technological and skill transfers, novel competition and other similar benefits.

Investments, thereby, must do more than just exploit the cheap resources available in the host country. The Central and Eastern European countries have recently discovered the hardships of focusing on manufacturing intensive investments. The in-flight of MNCs and their capital rests

[222] *See*, Chapter 2.

upon the government's decision regarding the sectors of the economy that require investments. The first step that all governments undertake in order to facilitate the inflow of investments is to liberalize the economy--removal of barriers to entry and restrictions on investment in sectors of the economy.[223]

The effect of liberalization in the short-term is almost uniform in all such countries. The inflow of MNCs is triggered initially by the availability of cheap, skilled labor that is capable of being integrated into the global value chain. This tendency explains the romance that developing and recently liberalized economies have with manufacturing.[224] The research shows that the quality of FDI is important shortly after liberalization policies are implemented, such that, some amount of interest is generated in the primary and manufacturing sectors are fostered. It is essential for the economy to move past mere manufacturing processes following such inflows--an activity that is now visibly taking place across the developing world. As FDI flows into the economies, seeking out the cheap and skilled labor, overtime the benefits offered reduce as the cost of labor increases.

It is important to note that the host countries often assume that inflow of FDI itself is adequate to lead to upgradation courtesy of spillovers and thereby fail to take enough measures to ensure such upgrading takes place. Data shows that failing to pay attention to human capital upgrading through adequate measures of skills training across the country leads to uneven growth and lopsided development--leading to inefficient utilization of investments and eventually showing signs of downturns. Lack of skill-development and spillovers are also attributes of low-quality investments which may just be exploitative. The thesis highlights that investors are willing to

[223]BalaszSzent-Ivanyi, "Conclusions: Prospects for FDI-Led Development in a Post-crisis World" in *Foreign Direct Investment in Central and Eastern Europe: Post-Crisis Perspectives*, ed. BalaszSzent-Ivanyi (Palgrave Macmillan, 2017), 242-246.
[224] Ibid.

accept hardships in the host economy if the economy itself is dynamic and provides opportunities of diversification.[225] Further brought to attention is the clear link between institutional support and the quality of inflow of investments; the focus on quality of investments would imply a conscious effort to evolve local institutions that promote education of the labor.

[225] Kumar, "Reforms and Global Economic Integration of the Indian Economy," 148-149.

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