Foreign Direct Investments (FDI) in developing nations: a closer look at China and India.

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ABSTRACT
This paper discusses Foreign Direct Investments (FDI) in developing nations, and a closer look at China and India. The paper also looks at how direct relationship investments are established, the effect of globalization and the emergence of new trade relationships to economics. Also discussed are foreign direct investment patterns and major trends and the International Monetary Fund defining foreign direct investment as a category of international investment, reflecting the objective of a resident in one economy obtaining a lasting interest in an enterprise resident in another economy, The paper discloses that a long-term relationship between the parties is desirable and that there will be a significant degree of influence by the investor on the management of the enterprise.

I INTRODUCTION

In recent decades, relations between multinational corporations and host governments in developing countries that are typically recipients of FDI have changed from being predominantly adversarial and confrontational to non-adversarial and cooperative.
This may be due in part to the overarching effects of globalization and the emergence of new trade relationships, both of which are understood as important catalysts for economic growth in developing countries. Foreign Direct Investments are an important vehicles of technology transfer from developed to developing countries that stimulates domestic investment and facilitates improvements in human capital and institutions in the host countries. Increased global interdependence is a defining feature of our current geopolitical moment. We are currently witnessing an unprecedented level of capital interdependence and cross-border economic, financial and business integration both within developed and developing nations. The global economy is dramatically transforming, resulting in a hand-off of power to rising economies. China and India are two stars of the global economy's expansion and increased interconnectivity.

II A REVIEW

Between 2000 and 2007, China has enjoyed average GDP growth of 10.2% per year and is projected to surpass the United States in GDP terms by 2030. India has enjoyed an average GDP growth of 7.8% over the same period and is expected to continue above 7.7% through 2011. Much of this growth is the result of extraordinary inflows of foreign capital to these nations due to a measured, yet profound, liberalization of foreign investment restrictions. Remarkably, both India and China are among those nations least harmed by the current global economic crisis, maintaining above average economic growth as many nations are experiencing painful economic contraction (2009, Economist).

Foreign Direct Investments flows into developing countries had a discontinuity in the 1990s. From only \$20 billion in 1980, and \$23.7 billion in 1990, FDI inflows rose to \$166 billion in 1998, a 7-fold increase, and \$334 billion in 2005. In this same period, the stock of FDI in developing countries rose from 5 percent of gross domestic product (GDP) to 20.5 percent of GDP where as imports and exports rose only slightly from 51.5 percent to 56.6 percent of GDP (Ramamurti, 2001).

Foreign Direct Investments liberalization has been quite broad in the past decade. Despite financial crises impacting upon certain developing countries and even regions, FDI has proven resilient, leading many development countries to regard this type of international capital flow as the private inflow of choice. The primary beneficiaries of FDI tend to be developing countries with relatively open economies.
At the same time, the share of FDI in total inflows is higher in riskier countries as measured either by the country’s credit ratings for sovereign or government debt or other indicators of country risk. There is also some indication that the FDI share is higher in countries where the credit risk is higher (Razin, 2002).

Governance infrastructure is an important determinant of both FDI inflows and outflows. Investments in governance infrastructure not only attracted capital, they also create the conditions under which domestic multinational corporations emerge and invest abroad.
However, investments in governance infrastructure are subject to diminishing returns, so that the benefits in terms of inflows are most pronounced for smaller and developing countries (Razin, 2002).

Foreign direct investments and trade together have a positive impact on economic growth but the size of such impact varies across countries depending on the level of human capital, domestic investment, infrastructure, macroeconomic stability, and trade policies. A combination of FDI, trade, human capital, and domestic investment are important sources of economic growth for developing countries. They identify a strong positive interaction between FDI and trade in advancing growth and that FDI stimulates domestic investment (Ramamurti, 2001).

Foreign direct investments have many artifacts, including the development of labor market regulations that improve workers income and quality of life. FDI benefits developing countries by diversifying the sources of external finance, increasing the risk-bearing by investors, reducing the cost of capital, improving incentives for managing the investment process, assisting in the development of domestic capital markets, and enhancing the mobilization of domestic resources (Neumayer, 2005).

A major trend in FDI is the decision of many investing firms to invest in developing countries with actual or perceived pre-existing relationships to the direct investor and its country. For example, in a sample of 328 Taiwanese firms engaged in FDI, well over 70 percent of these firms tended to seek out investment opportunities in the Peoples Republic of China and other developing countries in the Pacific Rim. Such investment is also facilitated by the responsiveness of host country governments to FDI overtures initiated by multinational corporations (Neumayer, 2005).

Levels of FDI were identified by the International Monetary Fund (IMF) for the period from 1990 through 2005. As of 1990, an average of $59.9 billion in FDI inflows to developing countries was recorded. By 2000, this amount had increased to $248.3 billion and as of 2001, had declined slightly to $215.4 billion only to rebound to $334 billion by 2005.

Regionally, there were significant differences in FDI flows during this time period. An educated work force is the main cause of these differences. The IMF reported that overall, Africa averaged $2.7 billion in FDI from 1990 through 1994 and as of 2001, received $17.7 billion in FDI. Asia, in contrast, received an average of $33.5 billion in FDI between 1990 and 1994 and $91.4 billion in 2001 (down from $128.2 billion in 2000). The developing countries of Europe experienced an increase in FDI from $4.4 billion in 1990 to $31.2 billion in 2001. The IMF also noted that Western hemispheric developing countries increased their share of FDI from $15.7 billion in 1990 to $69.5 billion in 2001 (down from the 1999 peak of $88.0 billion).

A cross nation analysis was undertaken by the IMF in a study which revealed that host-economy characteristics and industry characteristics such as technology intensity, factor requirements, linkages to local and foreign markets, and the degree of vertical integration of foreign affiliates are likely to shape the growth impact of FDI. Openness to trade, an established government regulatory and oversight system, and adequate human capital were also identified as variables likely to facilitate larger inflows of FDI.

According to the IMF another determinant of FDI inflows is the relationship between foreign economic capital and the level of government respect for two types of human rights in developing countries. These rights were physical integrity rights and political rights/civil liberties. Analysis on a cross national sample of 43 developing countries from 1981 to 2005 discovered systematic evidence of an association between foreign economic penetration and government respect for these two types of human rights. Of particular interest was the finding that both FDI and portfolio investment are reliably associated with increased government respect for human rights, with such respect further associated with democratization.

Despite the dramatic increase in total FDI flows to developing countries in the last few years, the bulk of FDI has been directed to only a limited number of countries. Human capital is a statistically significant determinant of FDI inflows and may be an increasingly important determinant over time. While many investors seek FDI investment climates that maximize profitability and return on investment, there is a growing sense that a developing country with limited human capital does not have the capacity to generate the level of profitability that multinational corporations seek (Noorbakhsh, 2007).

Investing In India

According to the Government of India's Ministry of Finance website, in recognition of the importance of Foreign Direct Investment (FDI) in stimulating economic growth, the government of India has been reforming laws to make India a less restrictive and more attractive place for FDI. The economic reforms that started in 1991 have brought dramatic changes in international investment in India. The rupee is completely convertible and customs duties have been reduced. These reforms are intended to foster rapid and sustainable economic growth in India. Policy reforms have reduced the complexity of licensing requirement and removed certain restrictions on FDI. The government of India is making an effort to attract and retain foreign investment from non residents including overseas corporate bodies.

The drawbacks include political instability and uncertainty, a large and complex government bureaucracy, occasional power outages and certain infrastructure deficiencies. Nevertheless, many investors believe that India represents a virtually untapped market with significant potential for foreign investors. India is also starting to develop a reputation for encouraging foreign investors (Mehta, 2007). It is important to note, President Obama left on November 5th, 2010 on a trip intended to increase trade negotiations between the U.S. and India. Many analysts believe the Obama administration wants to balance China's growing power by expediting India's trade development (CNN News).

On a broader scale, India is one of the most heavily populated countries in the world. As a result, there is significant domestic demand for products. Globally, India is considered to be one of the emerging economies.

While India falls far behind China in terms of its appeal to foreign investors, it remains attractive to some investors willing to do careful research and make an informed decision about investing in India today based on the potential for long term growth rather than on expectations of short term profits and rapid sales revenue growth (Mehta, 2007).

India is a common law country with a written constitution which guarantees individual and property rights. There is a single hierarchy of courts, with the Supreme Court of India at the top. Indian courts provide adequate safeguards for the enforcement of property and contractual rights.

There are advantages and disadvantages from the legal side relating to exporting manufactured goods into India. For example, investments and returns on investment are freely returnable except where approval to do so is subject to specific government regulations. These government regulations include lock in periods on the original investment, and caps on dividend payments. On the other hand, procedures have been simplified to permit automatic approval for foreign direct investment. An Indian company can accept FDI automatically without obtaining prior approval from the Indian government. Nevertheless, the economy remains fairly heavily regulated. For example, investors are required to notify the Indian government within 30 days of making a foreign investment. Another example of the complexity of FDI in India involves the fact that all proposals relating to the acquisition of shares of an existing Indian company by a foreign investor must first have government approval.

Another example involves the fact that a foreign company or a foreign national that wants to become a partner in an existing partnership in India is deemed to be an acquisition of the business under the laws of India which requires prior written approval of the proposed transaction by the Reserve Bank of India (Mehta, 2007).

The liberalization of the India economy continues meaning that the Indian market is being opened up to foreign investors but not necessarily to foreign exporters such as an American company that might be interested in exporting scooters and motorcycles to India. Importing scooters and motorcycles into India would probably be organized through a Branch Office.

Branch Offices can engage in the following activities: (a) Represent the parent company/other foreign companies in India (b) conduct research in the area in which the parent company is engaged if the results of the research are also made available to Indian companies (c) for the purpose of export and import trading activities, and (d) To promote collaborations between the Indian companies and foreign companies. A branch office is not allowed to carry out manufacturing activities, but may subcontract them to an Indian manufacturer. It should be noted that permission for setting up branch offices is granted by the Reserve Bank of India (RBI) on a case to case basis. RBI carefully considers the operating history of the applicant company and the impact of the proposed activity on local markets and local manufacturers before granting approval for a Branch Office (Mehta, 2007).

The goal of an American company or any foreign company considering building scooters in India would be to find a way to avoid Indian government regulations and protectionist policies (Harley-Davidson on Nov. 4, 2010 announced opening a new plant in India). There are laws that would discourage a company from building a plant to produce scooters in India. The Indian government's liberalization has still not fully accepted the idea that eliminating restrictions on imports will create a net benefit to the economy of India as predicted under the economic theory of Comparative Advantage. The alternative is to be subject to constant scrutiny and restrictive rules intended to discourage certain forms of foreign involvement in the economy of India (Mehta, 2007).

Joint ventures are the preferred business form for foreign companies interested in investing in India. There are no separate laws for joint ventures in India. Joint venture companies incorporated in India are treated in much the same way as domestic companies in India. Foreign investors are allowed to hold no more than up to 76 percent equity ownership in most of the sectors, and 100 percent equity ownership in some sectors. Tax holidays are available for a period of five continuous years in the first eight years of establishing exports. Tax concessions are available for foreign investors in certain high-tech areas, but producing scooters and motorcycles would almost certainly not qualify for this form of tax break (Mehta, 2007).

Investing In China

China still maintains a complex investment strategy combining complicated securities law and takeover law restrictions with contradictory regulatory approval requirements often overseen by a number of Chinese agencies. For authorized investments, China's investment organizations facilitate a relatively straightforward investment process through the use of standardized legal entities tailored for FDI, a centralized regulatory approval system, and clear guidance on which sectors of the economy are open for foreign investment (Nunnenkamp, 2010). To achieve sustainable growth, China may require increased openness and continued decomposition of investment restrictions. Increased openness and liberalization are not without costs. Directly, liberalization means forgoing certain political objectives such as fostering infant industries, maintaining domestic control of assets, and stabilizing domestic labor markets. Indirectly, and perhaps more importantly, liberalization makes a nation's economy increasingly vulnerable to the negative forces of the global economy, ranging from capital flight and financial crises to stunted economic growth and a reduction in the standard of living for the poor (Nunnenkamp, 2010).

In the past decade or so, China began a process of legal reform apparently motivated by the desire to open its markets in anticipation of, and in accordance with, its requirements for joining the WTO. One of China's policies is that of reducing control over state-owned enterprises (SOEs) or businesses whose ownership is government dominated. In some sectors, the government is encouraging the consolidation of SOEs into large integrated conglomerates that are intended to be global leaders in their field; in other sectors, the state is reducing the level of its equity ownership, making a large number of SOEs available for private capital (Nunnenkamp, 2010).

Of nearly 135,000 SOEs, four to five thousand are privatized annually. Nonetheless, observers disagree over the degree to which reforms represent liberalization and whether they actually result in an opening of their markets to foreign investors, or simply provide additional mechanisms by which the government may frustrate foreign entrance. Recent empirical data suggest that preliminary fears that new regulations would stifle foreign investments are premature, as the data indicate strong investment inflows. Yet even these data are not fully conclusive due to the lack of transparency in reporting (Nunnenkamp, 2010).

China's authorities have provided for a relatively centralized governmental approval process that vertically integrates local, regional, and national authorities. Chinese law distinguishes between two categories of companies based on their source of capital: (1) domestic companies, defined as having typically less than 20% foreign capital or shareholders, and (2) Foreign Investment Enterprises (FIEs), of which there are three distinct legal types, Joint-Venture, Wholly Foreign-Owned Enterprises (WFOEs), and Foreign Invested Companies Limited by Shares (FICLS). The choice of specific legal entity will be determined largely by the type of investment being made, such as whether it is a joint venture with a Chinese company or a direct acquisition of Chinese assets (Nunnenkamp, 2010).

Though Chinese law allows foreign investors to choose a variety of investment entities, the destination of the investment may be severely limited or altogether closed. Chinese regulatory agencies have divided business activities and sectors into three types: (1) prohibited, (2) restricted, and (3) encouraged. Chinese law specifically sets out which industries or sectors fall into the prohibited, restricted, and encouraged sectors. The impact of each designation is extremely important, not only in determining whether foreign investment is allowed, but also how much and through what legal entity the investment can take place. Restricted activities may require extensive regulatory authorization, and investment may be limited to a joint-venture entity (Nunnenkamp, 2010).

Acquisitions are subject to extensive regulatory review that can involve a number of distinct agencies. In August 2008, China's new antitrust laws took effect, fourteen years after drafting began. Pre-closing antitrust approval must now be sought if at least two parties have turnover in China of at least USD $52.5 million and either: (a) all parties have combined global turnover of at least USD $1.3 billion, or (b) the combined turnover in China of all parties exceeds USD $260 million. The new antitrust regulations are especially important for foreign investment in China. It already appears that China may use the new regulations as a tool for economic nationalism, blocking deals on antitrust grounds to protect certain economic sectors and prevent excess foreign investment (Nunnenkamp, 2010).

Recently, granted approval for InBev's bid to buy American beer maker Anheuser Bush, approval which was necessary as both parties have significant stakes in various Chinese breweries. However, the InBev approval was conditioned on a freeze on either party from increasing their respective stakes in Chinese breweries, despite the fact that neither party controls more than 30% of a domestic brewery (Nunnenkamp, 2010).

More importantly, however, was the recent decision to block Coca-Cola's attempted friendly takeover of Chinese juice maker Huiyuan. The decision was anxiously awaited, as it was the first case involving a friendly foreign takeover of a domestic company under China's new antitrust regulations. The deal itself was extremely favorable to Huiyuan shareholders as Coca-Cola was offering three times the current market valuation of the company. The deal was expected to pass approval, and the failure to obtain antitrust approval was both a major surprise and step backward from market liberalization (Nunnenkamp, 2010).

China's securities laws make hostile takeovers especially difficult, if not impossible. Two formal obstacles make hostile tenders offers, especially by foreigners, nearly impossible: The first is the structure of Chinese stock securities. Generally, shares of Chinese companies are divided into A and B shares. For the most part, foreign investors are limited to purchasing B shares, which account for a very small percentage of corporate shares outstanding. Additionally, A shares have subclasses which may further limit ownership rights. The result is that a large number of a company's shares may not be tradable on open markets and may only be transferred by private takeover agreement. The second obstacle is the widespread ownership of stocks by the state, which may simply refuse to sell. This situation is changing; however, as the state sells a larger number of shares, privatizes SOEs, and changes non-tradable shares into tradable ones. The result should be a significant increase in the number of hostile takeovers. Nonetheless, because of the need for regulatory approval, including antitrust approval, it is yet to be seen whether foreign investors such as private equity firms will be able to partake in this restructuring (Nunnenkamp, 2010).

III DISCUSSION

Recent research does not necessarily suggest that countries should retreat from globalization; countries differ dramatically in how they are affected by globalization. Instead the research suggests a responsible reaction to globalization: countries that take certain steps reduce the negative impact of financial globalization and position themselves to better realize positive gains. Such measures include the strengthening of financial institutions, increasing transparency especially with regard to financial regulation, use of a flexible exchange rate, and avoidance of external debt. Additionally, emerging economies have experienced greater growth when they have used domestic savings rather than foreign capital to finance investments, suggesting that a reliance on foreign capital may also limit growth potential.

IV INTERPRETATION/ANALYSIS OF FINDINGS

Increased growth from financial integration is not always correlated with broader social positives. For example, volatility in growth rates can have the effect of reducing the well being of most households in an economy, especially that of the poor.

Review of Findings-
The global economic slowdown from 2008 into 2010 is exposing some of the dangers of aggressive market liberalization and is testing the resilience of foreign investment. Indeed, the downturn has most affected some of the very countries that have opened themselves up the most.

All capital inflows are not equal: speculative "hot money" may provide temporary fuel to a nation's economy but is the most vulnerable to quick outflows. In contrast, FDI provides a stronger buffer against global economic swings, especially for developing economies. It is not just a matter of the number of dollars that flow in but also where they go.

V CONCLUSION

The global economic slowdown from 2008 into 2010 has led many to rethink about their approach to words liberalization of markets and the courting of FDI. Some even see the crisis as caused, or at least magnified by, financial globalization. Yu Yongding, a prominent Chinese economist, recently remarked: "The United States has been a model for China. Now that it has created such a big mess, of course we have to think twice”. In India, concerns over the credit crisis led the Reserve Bank of India to reverse course on liberalizing some financial regulations: it will not permit issuance of credit-default swaps, a major contributor to the crisis.

As the West increasingly talks about the need for their own re-regulation and increased market intervention, some have suggested that the West is now beginning to emulate the economic model of emerging economies like China. The Chinese government has called on the West to avoid protectionism and maintain liberalized global markets, a dramatic and telling reversal of roles that underscores the shifts in global power that are taking place.

India and China are examples of the changes brought on by globalization.
They are two of the fastest growing economies in the world and possess two of the largest domestic markets by number of consumers. FDI’s have been a major contributor to both nations growth, bringing in more than just investment capital. FDI’s have fostered the introduction of technology, human know how, and helped to link nations internationally. India and China both have complex FDI regulations that, while allowing for large nominal volumes of FDI inflows, still have major flaws. Both nations still protect large economic sectors from investment, are slow to approve foreign acquisitions of domestic firms (if at all), and are characterized by excessive bureaucracy. India and China's FDI regulations do not need to be fully liberalized. It is not necessarily prudent to open one's

economy up to the full forces of the global market, especially in the case of those nations still developing stable financial institutions and developing local human capital.

However, continued liberalization, when done strategically and carefully, may be an important source for maintaining prolonged economic growth. Substantive, yet politically minor changes to India and China's investment regulations may yield substantial positive benefits. Now more than ever, nations must reevaluate their relationship in the global economy. This involves not only looking outward, but also inward. Positive reform from within may be the most effective and efficient way to maximize the benefits from the global economy. If corporations are going to be a part of this global market they had better be able to defend themselves from this market. One of the lessons this current economic crisis has taught us is that many of our structures and institutions were not ready for this new era. Now we have to adapt ourselves to meet international standards. The whole of society expects it. They are looking for better government and transparent government. The implications of recent economic research is somewhat self evident, yet deserves being explicitly stated: countries have a significant interest in regulating how much investment enters their borders, where it comes from, what kind of investment it is, and where it is being put to use.

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