

# Term paper on foreign direct investments in asian economies

[Parts of the World](#), [Asia](#)



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### Foreign Direct Investments in Asian Economies

#### Introduction

Direct investments can be defined as physical investments that are made into building a factory in the domestic company (Graham and Spaulding, 2005). It is different from indirect investment that involves making a bundle investment in a broader category of assets. Foreign direct investment or FDI can be defined as foreign investing directly into the productive assets of a domestic company. It includes the acquisition of a lasting management interest in a company or enterprise outside the investing firm's home country (Graham and Spaulding, 2005).

FDIs have increased significantly in the past decade due to globalisation and market liberalisation. The attempt of developing economies, especially Asian economies, to liberalise their economies, multi-lateral negotiations and changing policies have all been favourable to attract FDI inflow in the economies. FDIs do help spur trade and economic activity in a nation, but the issues faced by these developing economies and their resistance to complete removal of restrictions on FDI cannot be ignored. The paper discuss the FDI regime in Asian economies, related policy reforms and attempts to understand the challenges being faced by Asian economies in their attempt to liberalise themselves and allow free flow of funds in the form of FDIs. The topic is relevant and contextual given the increasing debate and

pressure on Asian economies to further liberalise themselves and fully permit FDI flow into their economies.

The paper is divided into sections. The first section discusses the attempts made by Asian economies in recent past to allow FDI flow. The second section discusses the challenges being faced by Asian economies in complete removal of restrictions of FDI flow. The third section concludes the paper. The current research is primarily based on literature review of relevant primary and secondary research. The research process includes exploration of appropriate information through the use of internet and scholarly journals, synthesise the information, interpret it for key findings and draw conclusions. The limitation of the research is that it is based primarily on the secondary data, and no primary research has been conducted to gather information.

## **FDI Regime in Asian Economies**

The most profound effect of FDI has been seen in developing countries, where yearly FDI flows have increased from an average of less than \$10 billion in the 1970s to a whopping \$208 billion in 1999 (Graham and Spaulding, 2005). This means that the FDI flow increased by more than 20 times in a span of less than 30 years. FDI significantly grew in the last decade as well. According to a UNCTAD data, inward FDI rose from \$481 billion in 1998 to \$636 billion in 2006 (Economy Watch, 2010). Thus, developing economies have experienced systematic and structural economic changes with rapid growth in FDI flows and changes in investment regime since 1970s.

In Asian economies, the FDI regime is more specifically about the inward flow of FDI. The inward flow of FDI is usually from large corporates of developed nations. It benefits the large corporates by furthering their dream to grow globally. In fulfilling this dream, FDI vehicle helps large companies in multiple ways. First, it increases the productive capability of a company. Second, it helps by-pass other trade restrictions imposed by developing countries. Third, it opens up avenues to exploit synergies from joint ventures and co-ownerships. Fourth, it aids classify a sale as local, and circumvent the complications with respect to export sales. Since 1980, the growth of world FDI outflows has overtaken the growth of world exports (Brooks, Fan and Sumulong, 2003). FDI vehicle is advantageous for the developing countries as it provides access to finance, transfer of skills and latest technologies, and increases the productive capacity of the developing nation. It helps better price determination and offers more economic value to customers. Also, FDI appeared to be an attractive alternative for developing countries in the reign of drying commercial bank lending due to debt crises (Brooks, Fan and Sumulong, 2003). Thus, the flow of FDI benefits both the donor as well as the recipient.

In the Asian economies, China leads the FDI growth and is the preferred FDI destination. In 2012, FDI flows to China also reached a record level of \$124 billion (UNCTAD Report, 2012). As per the UNCTAD (2012) report, the top five nations selected as preferred FDI destination are China, United States, India, Indonesia and Brazil. The report also projects that these countries will continue to have high FDI inflow in the next three years as well. Thus, China is the preferred FDI destination across the globe and India has emerged as

another preferred destination.

Dedicated policy reforms have been taken in China and India that have boosted growth in FDI inflow in these countries. In China, policy reforms were made in late 1970s and early 1980s to permit joint ventures using foreign capital, awarded right of autonomy in foreign trade and opened up for FDI (Fung, Iizaka and Tong, 2002). The FDI inflow in Chinese markets was further encouraged through policy reforms in the late 1980s and 1990s. In 1986, more favourable regulations and provisions are used to encourage FDI inflow, especially export-oriented joint ventures and joint ventures using advanced technologies (Fung, Iizaka and Tong, 2002). In 1990s, the government began to focus on key sectors for promoting FDI inflows. The key sectors were identified based on the government's economic objectives during the period. During 1994-1995, proposals to attract FDI into the agriculture, hydropower, communication, energy and raw material sectors were encouraged (Fung, Iizaka and Tong, 2002). These positive reforms contributed to the fast growth of inward FDI in the country. However, China is facing competition from other developing countries as the latter are strengthening their policies to attract FDI (Zhang, 2012).

Similar policy reforms were taken in India to attract foreign investment. The attempt to liberalise Indian economy began in the early 1990s when the economy issued its first set of reforms towards globalisation and free trade. India's liberalised FDI policy allows up to a 100% FDI stake in ventures including the construction sector (Finomenon, 2011). The policy reforms have considerably eliminated foreign investment restrictions and licensing requirements to encourage FDI and transfer of advanced technology.

In spite of these concerted efforts to support the FDI regime, the developing countries have not done away with related restrictions completely. The reason behind this restraint and other challenges being faced by developing countries is being discussed in the next section.

## **FDI Related Challenges Faced by Asian Economies**

The key challenges being faced by Asian economies in promoting FDI are in terms of economic slowdown, rising operational costs, threat to domestic industries, and sensitive sectors and political risks.

### **Economic Slowdown**

The global slowdown of economy is also impacting the FDI inflow in Asian economies. With reduced propensity to save and low consumer confidence, nations are left with lesser financial resources to invest overseas. This coupled with competition from other economies to soften their anti-liberalisation policies affects FDI inflows. Decline in global demand, especially Europe, is also affecting companies and postponing their FDI decisions. According to Xiaoyuan (2012), China's FDI has kept a negative growth for six consecutive months since November 2011. This pattern of growth is also expected in other Asian economies.

### **Rising Operational Costs**

Developing Asian countries provided favourable investment environment to foreign investors also in terms of cheap availability of the factors of production. This scenario is changing in Asian economies. China, for example, is experiencing rising manpower and other operational costs that

makes it probable for foreign companies to relocate factories or withdraw investment in China (Qingfen, 2011).

## **Perceived Threat to Domestic Industries**

Asian economies cannot ignore the apparent detrimental effect of FDI inflows on its domestic industries. Access to advanced technology, best resources, economies of scale and capital provides the multi-national giants with a competitive edge to offer more value to the end consumers. The additional value offered can be in the form of reduced prices or add-on value in the product. FDI in multi-brand retailing is not allowed in India considering the detrimental impact on small and medium enterprises due to predatory pricing (Firstpost, 2012). Multi-national companies in multi-brand retail have been witnessed to offer products at highly reduced prices to the customers that can render the small domestic companies out of business.

## **Sensitive Sectors and Political Risks**

Allowing FDI in sensitive sectors like energy and defence is another challenge of Asian economies. These sensitivities have a potential to become a political agenda for political parties. China's state-owned energy company CNOOC withdrew its bid for Unocal, an American energy company, in 2005 (Tyson, 2012). This withdrawal was made on grounds of threat to national security (Tyson, 2012). Such discriminatory policies can significantly impair FDI inflow in a nation and need to be taken care of.

## Conclusion

FDIs have increased significantly in the past decade due to globalisation and market liberalisation. The paper set out to discuss the policy reforms in Asian economies and understand the challenges faced by them in their attempt to liberalise themselves and allow free flow of funds in the form of FDIs. The paper concludes that significant policy reforms have been taken by Asian economies to boost the growth in FDI inflow. But, there are four key challenges that are faced by Asian economies in this regard. These challenges are with respect to economic slowdown and increasing competition, rising operational cost in Asian economies, perceived threat to domestic industries, and sensitive sectors and political risks. Thus, governments face significant challenges in implementing a FDI friendly policy and attracting FDI inflow. While these challenges do exist, governments can still implement favourable FDI policies without hurting the sentiments of foreign investors.

The research findings are, however, limited given the use of secondary sources alone to conduct analysis and draw conclusions. The paper focuses on only two Asian economies, India and China, which are the most preferred FDI destinations. This focus can also limit the scope of the study conducted.

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