

FDI IN THE BRICS: CHANGING THE INVESTMENT LANDSCAPE

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The economic and financial crisis seems to have altered the global investment landscape considerably. The BRIC economies, in particular, have emerged as the most favoured destination for foreign direct investment (FDI). So, in this paper, attention will be given to one of the key drivers of their economic might – their trade and investment potential, in particular foreign direct investment. Thus, this paper will look at the global scenario in FDI inflows, present a sectoral breakdown of the inward FDI in the BRIC economies, analyse the factors that make the BRIC economies attractive for FDI inflows, examine the relation between economic growth and FDI and also outline relevant policy issues.

INVESTIMENTOS ESTRANGEIROS DIRETOS NAS ECONOMIAS BRIC: MUDANDO O CENÁRIO DE INVESTIMENTO

A crise econômica e financeira parece ter alterado consideravelmente o cenário de investimento global. As economias do bloco Brasil, Rússia, Índia e China (BRIC), em particular, têm surgido como destino preferido para investimentos estrangeiros diretos (IED). Assim, este trabalho analisa um dos principais motores da força econômica destes países – seus potenciais comerciais de investimento, especialmente o investimento estrangeiro direto. Dessa forma, o documento investiga o cenário global de fluxos de entrada de IED, apresenta a distribuição desse fluxo por setores nas economias BRIC, analisa os fatores que tornam as economias BRIC atraentes para o IED, examina a relação entre crescimento econômico e IED e aborda questões relevantes relacionadas a políticas.

1 INTRODUCTION

Geography has made us neighbors. History has made us friends.

Economics has made us partners, and necessity has made us allies.

John Fitzgerald Kennedy

In the context of the BRIC economies, this is so true. It is the combined economic might of Brazil, Russia, India and China that has brought them together to form the BRIC block. Neither of them are part of the developed world and all four have witnessed spectacular economic growth in recent years. Today they constitute 15% of the global GDP and Goldman Sachs has argued that by 2050, the combined income of BRIC economies will exceed the combined income of developed countries.

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The economic and financial crisis seems to have altered the global investment landscape considerably. It is now the developing countries that are taking the lead in attracting investments as well as investing globally (UNCTAD, 2009). The BRIC economies, in particular, have emerged as the most favoured destination for foreign direct investment (FDI). Governments of the BRIC economies are investing heavily in infrastructure, industry, education, healthcare, housing and tourism, with the realisation that they have the opportunity to attract FDI, increase GDP, substantiate growth of import and export trade at the same time as increasing local employment and wealth. As these four states gain importance on the global stage, the international community will increasingly look to the BRIC nations to stabilize the world's economic system. If the BRICs can productively work together today, it should bode well for the future economic order. Together, they will continue to build their economic strength. In this paper, we will look at one of the key drivers of their economic might – their trade and investment potential, in particular foreign direct investment.

The structure of the paper is the following. Section 1 looks at the global scenario in FDI inflows and examines the trends in each of the four BRIC economies in detail. Section 2 presents a sectoral breakdown of the inward FDI in the BRIC economies. Section 3 analyses the factors that make the BRIC economies attractive for FDI inflows. Section 4 examines the relation between economic growth and FDI. Section 5 discusses the rise of outward FDI from BRIC economies. Section 5 outlines the relevant policy issues and Section 6 presents the conclusions.

2 GLOBAL SCENARIO

Amidst a sharpening financial and economic crisis, global FDI inflows fell from a historic high of \$1979 billion in 2007 to \$1697 billion in 2008, a decline of 14%. Importantly, the decline posted globally in 2008 differed among the three major economic groupings i.e. developed countries, developing countries and transition economies - reflecting an initial differential impact of the current crisis. In the first half of 2008, developing countries weathered the global crisis better than developed countries as their financial systems were less closely interlinked with the banking systems of US and Europe. Their economic growth remained robust supported by rising commodity prices. And their FDI inflows continued to grow, though, at a much lower pace than in previous years, posting only a 17% increase to \$621bn in 2008. In a sense, the crisis changed the investment landscape with developing and transition economies share in global FDI flows surging to 43% in 2008.

TABLE 1
Share in FDI inflows

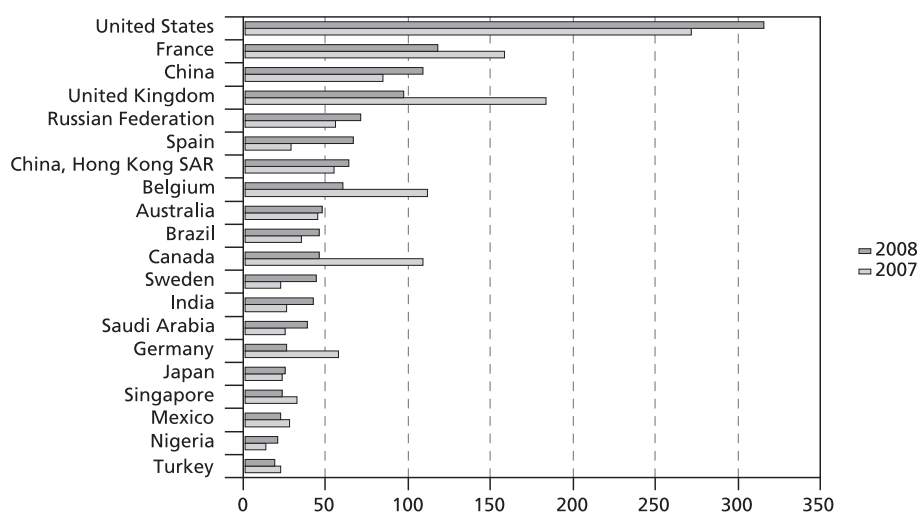
Regions	2003	2004	2005	2006	2007	2008
Developed economies	63.9	56.4	63	66.6	68.7	56.7
Developing Economies	32.6	39.5	33.8	29.7	26.8	36.6
Transition Economies	3.5	4.1	3.2	3.7	4.6	6.7

Source: UNCTAD (2009).

A look at the global FDI inflows into the top 20 economies for the period, 2007-08 indicates that while the United States maintained its position as the largest home country in 2008, many transition and developing economies, in particular the BRIC economies, emerged as large recipients of FDI inflows. A number of European countries saw their rankings slide in terms of FDI inflows. For instance, the United Kingdom lost its position as the largest recipient country of FDI among European countries.

CHART 1
Global FDI inflows

(In US\$ billion)



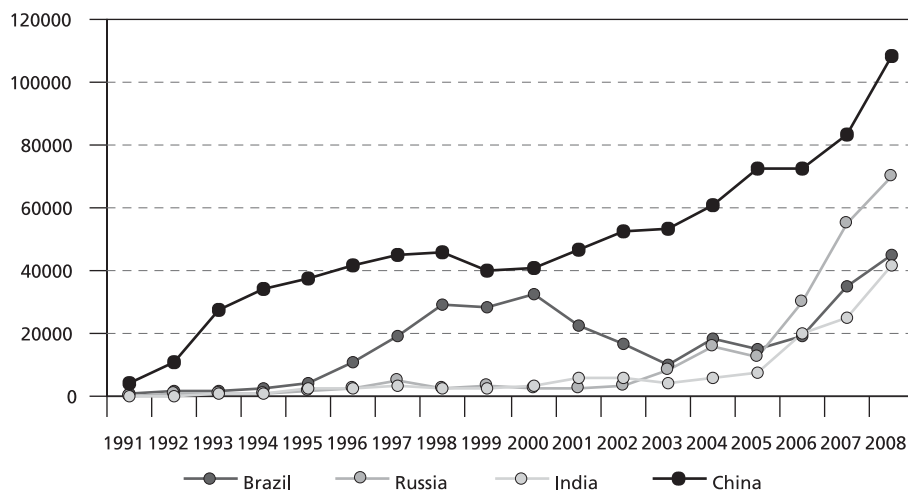
Source: UNCTAD (2009).

In 2008, China emerged as the third largest FDI recipient in the world, with FDI inflows reaching a historic high of \$108 billion. In fact, China has been the fastest growing among the BRICs from 1994-2008. Russia received \$55 billion in FDI in 2007, an 85 % increase over the previous year. Brazil, which traditionally underperformed in the FDI sphere relative to its size and resource endowment, experienced a near doubling of inbound foreign investment between

2006 and 2007 from US \$19 billion to US \$35 billion. India, however, remains the laggard of the BRIC group attracting \$20.3 billion inbound FDI last year. With inflows of \$42 billion in 2008, it ranked the 13th largest FDI recipient in the world.

By the end of 2008 and early 2009, the global economic downturn began to catch up with developing and transition countries as well, adversely affecting their inflows. The slide continued into 2009, with added momentum. Data from the World Investment Report (2009) points to a general decline across all economic groups, with inflows expected to fall below \$1.2 trillion.

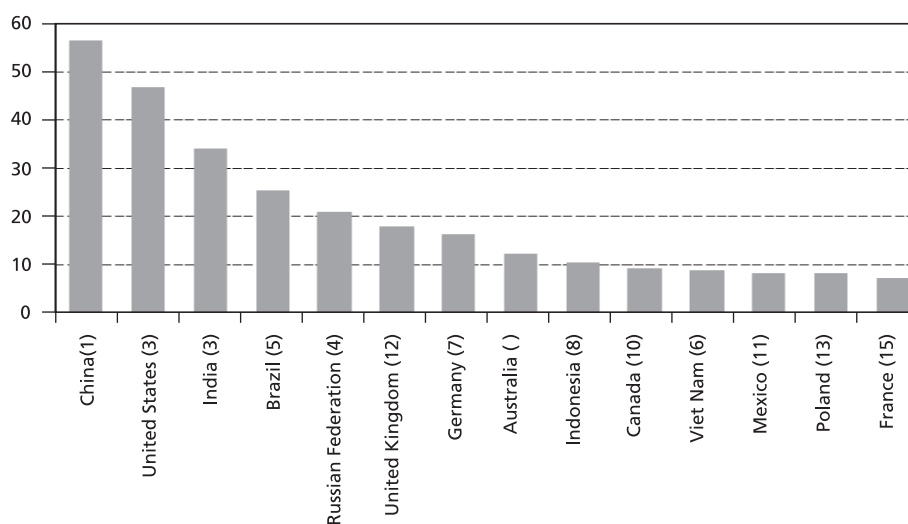
CHART 2
FDI inflows in BRIC
(In US\$ billion)



Source: UNCTAD.

The World Investment Prospects (WIP) Survey predicts that the recovery of these flows is expected to begin slowly in 2010 and reach up to \$1.4 trillion. It is expected to gather further momentum in 2011 when the level could approach an estimated \$1.8 trillion—almost the same as in 2008. Furthermore, the WIP Survey predicts that it is the BRIC economies along with the US that are likely to lead the future FDI recovery. It has ranked China and India as first and third respectively, among the most attractive locations for FDI.

CHART 3
Outlook for 2011: US along with BRIC likely to lead in future FDI recovery
 (In %)



Looking at the global scenario, the main inference we draw is that the investment landscape is changing with the share of developing and transition economies' (in particular BRIC countries) in global FDI increasing. And trends seem to point towards the increasing importance of these economies even in the future.

3 SECTORAL BREAKDOWN

While the preceding section outlined the overall trends in FDI in the BRIC economies, it is imperative that we analyse the sectoral pattern of this inward FDI. Each of the BRIC countries has had different models of economic development. Brazil is a domestically oriented service economy. Russia's economic development is heavily dependent on energy and raw material resources. Indian economy is essentially service-led. And China's economic development is driven by manufacturing exports and investment.

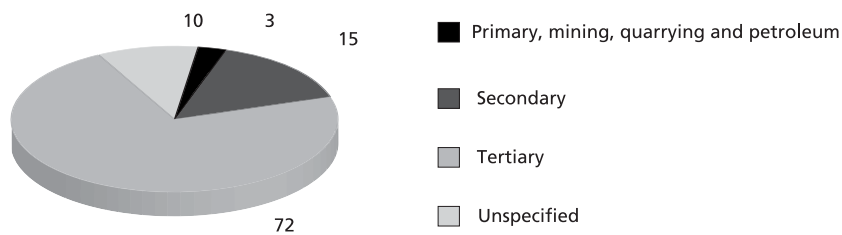
Interestingly, the sectoral distribution of foreign investment roughly mirrors its GDP composition in BRICs. In Brazil, Russia and India; currently the tertiary sector receives the most inward FDI on an average, while the primary sector receives the least and the secondary sector is in the middle. But China, has a special industrial pattern of inward FDI i.e. the secondary sector gets the majority of the inward FDI and the primary and tertiary sectors receive much less.

We will now discuss each of these in detail.

3.1 Brazil

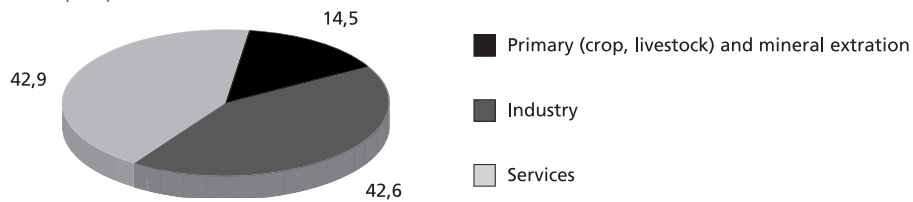
Brazil has performed impressively in attracting FDI inflows and this is mainly because of the open investment regime with no restrictions on remission of profits and repatriation of capital registered with the Central Bank. The efforts of the Brazilian government and the private sector have greatly encouraged foreign investors to consider Brazil as a prime investment option. It's relative attractiveness in relation to other emerging market destinations, like India and Russia comes from its strict adherence to the principles of protection of property rights and free trade. Due to these factors, foreign multinationals own approximately 45% of the 500 largest companies in Brazil and been successful in raising capital locally.

CHART 4
Shares of Sectors in FDI inflows in 2000
(In %)



Source: BCB.

CHART 5
Shares of Sectors in FDI Inflows in 2009
(In %)



Source: BCB.

The sectoral distribution of foreign direct investment in Brazil has changed significantly during the period of 2000 to 2009. In 2000, the tertiary sector was the major recipient of inward FDI as it received 72 percent of the total inward FDI in 2000. However, in 2009, the share of tertiary sector in total inward FDI declined to 43 percent. The tertiary sector's loss in the pie of total inward FDI was compensated by the gain in shares of primary and secondary sectors. The shares of primary and secondary sectors jumped from 3% and 15% respectively in 2000 to 14.5% and 43% in 2009 in the total inward foreign direct investment.

Considering the services sector specifically, which attracts approximately half of the foreign direct investment, most of it is directed towards financial intermediation, retail, electricity, gas and water. In the retail business, the giants like Wal-Mart and Carrefour announced their aggressive expansion plans with later announcing acquisition of supermarket chain Atacadao for US\$ 1.1 bn in 2007. In the primary sector, the dominant segments are hydrocarbons and mining. In the case of industries, whose share is more or less the same as the services sector in total inward FDI, the sub sectors that attract most of the foreign inflows are metallurgy (including iron and steel) , chemicals segments, automotive, cellulose pulp and paper segments. The sectors that are expected to show strong investment growth in future are automotive, telecommunications and mining.

3.2 Russia

The services sector of Russia has been the major destination for the foreign direct investment as it commanded 58 % of the total inward foreign direct investment in 2007, followed by the manufacturing sector, t 25 % and mining & quarrying with a share of 17%. The investment scenario for the sectors has been more or less static since 2003 (Table 2).

As is evident from Table 2, the services sector of the country has attracted most of the foreign direct investment and hence accounts for 50-60% of the flows during 2003-2007. In the case of industries, the natural resources sector and manufacturing are the major players in attracting foreign investment. This is due to the rich natural endowments of the country which consists of deposits of large number of metals and minerals (apart from oil reserves) like iron, copper, nickel, zinc, tin, gold, silver and so on. In case of the energy sector, its contribution to the total foreign investment corresponds to its share in the total earnings of the country. Similarly the foreign direct investment coming into the manufacturing sector reflects its share in the GDP of Russia. However, in order to ensure that the rise in FDI inflow sustains in the long run, Russia needs to reform its legal framework and further has to intensify the reform process for energy related sectors like natural gas. Even though significant liberalization was observed in the energy related areas like the electricity sector, which is currently attracting large FDI inflows from EU companies such as the German E.ON Ruhrgas AG and the Italian Enel (which now owns major parts of the Russia's electricity generation industry), the natural gas sector is still dominated by the state controlled quasi-monopoly Gazprom and, therefore, needs to be reformed. Apart from the natural gas sector, the other outstanding issues and questions that need to be sorted out are investments in 'strategic sectors'. These are the sectors that are strategic to national security of the country and the 'subsoil law'. There are Russian laws pertaining to the use of natural resources of the country

and the lengthy procedures to approve the laws for these two areas (areas strategic to national security and subsoil law) in Russia. The investment climate of the country is also affected by other aspects like protection of property rights and corruption in the country. According to the World Bank's latest global survey of business regulations and their enforcement, Russia performs the worst in areas like licensing requirements, dealing with workers and trading across borders. Therefore, Russia should improve its legal framework and the investment climate. The need is especially stronger in natural resources and energy-linked sectors, if it has to boost the level of foreign direct investment in the economy.

TABLE 2
Destinations of foreign investment inflows into Russia
(In %)

Sectors	2003	2004	2005	2006	2007
Agriculture, hunting and forestry	0.5	0.3	0.2	0.6	0.3
Mining and quarrying	19.3	24.5	11.2	16.6	17.3
Mining and quarrying of energy producing products	17.3	21.6	9.6	14.1	16
Mining and quarrying, except of energy producing products	2	2.9	1.6	2.5	1.3
Manufacturing	22	25.3	33.5	27.5	24.6
Manufacturing of food products	3.4	2.3	2.2	2.5	2.5
Manufacturing of chemicals and chemical products	1.2	1.9	2.7	2.8	1.2
Manufacture of metals and fabricated metal products	10.3	12.6	6.4	6.8	12.6
Manufacture of transport equipment	0.7	2.1	1.8	2.6	0.9
Manufacture of coke and mineral oil	0.6	0.2	15.1	7.2	3.8
Services	58.2	49.9	55.1	55.3	57.8
Construction	0.3	0.6	0.4	1.3	1.2
Wholesale, Retail, Retail Activities	36.1	32.9	38.2	23.7	42.3
Transport and communication	3.8	5	7.2	9.6	6.5
of which communication only	2.3	3.4	6.1	8.5	2.9
Financial intermediation	2.6	2.5	3.4	8.5	2.4

Source: Russian Federal Service of State Statistics.

3.3 India

The sectoral distribution of foreign direct investment for India has undergone significant changes. As is evident from Table 3, the share of secondary sector has declined substantially from 45% in 2000 to 27 % in 2009 in total inward FDI. ¹ The services sector has emerged as the most favored location for the foreign investors as its share in total inward FDI surged from 16.5% in 2000 to 61%

1. See Satyanand and Raghavendran (2010).

in 2009. The primary sector meanwhile has increased its share in the total inward FDI from negligible 0.12 % in 2000 to 9% in 2009. According to the Department of Industrial Promotion and Policy (DIPP), the sectors that attract most of the inward foreign direct investment apart from the services sector are computer software and hardware, telecommunications, housing and real estate and construction activities. The services sector of India has attracted impressive overseas investment interest in the recent years. As per a report by UNCTAD, in 2007, the services sector has become the main destination for off-shoring of most services as back office processes, customer interaction and technical support. However, the Indian services have also started venturing into new territories like reading medical X-rays, analyzing equities, and processing insurance claims.

The significant change in the foreign investment scenario was mainly due to the fact that the industry was the first sector to be opened up for the foreign investors as early as in 1991, while the services sector was opened to foreign investment much later, around the late 1990s. During 1991 policy paradigm shift, industry was the first one to benefit as it resulted in changing the overall system. In the entire process, the procedures for investing in non priority industries were streamlined and at the central level, the Foreign Investment Promotion Board was set up for negotiating with the large multinationals or international firms and for expediting the required clearances. In addition to all this, a large number of government restrictions, licensing requirements and controls on corporate behaviour were eliminated. This benefited the industries in terms of attracting foreign direct investment. But in the subsequent decade of 2000, India's IT success story was making global players take note of this sector's vast potentials. Thus, with the aid of sizeable English speaking IT professionals, this sector emerged as the most favored location for investment to the foreign investors, as is evident from the table above. The manufacturing sector lags behind as a destination for foreign direct investment due to the poor state of the country's infrastructures and acute labour market rigidities.

TABLE 3
India: Sectoral Breakdown of FDI inflows – percent of total inflows

Sectors	2000	2008	2009
Primary	2.8 (0.12%)	1420.9 (4.3%)	2397 (8.86%)
Secondary (manufacturing)	1051.8 (44.8%)	10156.4 (30.8%)	7223.1 (26.7%)
Automobile industry	279.7	1134.1	1338.4
Computer software & hardware	194.4	1828	717
Power	110.7	1339.3	1643.3
Services	388.2 (16.5%)	19812.1 (60%)	16598 (61.4%)

(Continue)

(Continuation)

Sectors	2000	2008	2009
Financial services	43.3	8043.8	1570
Telecom services	79.7	539.3	782.8
Information & broadcasting (including print media)	79.7	539	782.8
Consultancy services	4.9	364.7	420.1
Hotel & tourism	12.2	539	592.9
Housing & real estate		2679	3198.8
Unspecified other sectors	904.2 (38.5%)	1639.8 (5%)	825.5 (3%)

Source: Secretariat for Industrial Assistance, DIPP, GOI.

3.4 China

In China the sector that has always been most lucrative for the foreign investors is the manufacturing sector. This sector had the lion's share of 54.7% in the total inward FDI in 2007, followed by the tertiary sector, 38.7%. And this trend was prevalent in the beginning of this decade, implying that the manufacturing sector has always been the major attraction for the foreign investors. One of the most significant impacts of China's economic reform and opening up of the domestic economy to the world has been the impressive inflow of foreign investment. Since 1979, the FDI restrictions have been gradually liberalized and in addition to this the commitments of the government to further open up the economy have greatly enhanced the investment climate of the country. The prospects of exploiting a huge domestic market, a pool of relatively well educated and low cost labour has made China one of the most favourable locations to the foreign investors. One important development in context of FDI was China's accession to WTO in December 2001. After negotiating for 15 years China agreed to remove restrictions on FDI ,specifically, in services and improve the intellectual property rights apart from the removal of trade related restrictions (tariff and non tariff). This accession of China to WTO provides ample opportunities for foreign investors to invest in country's capital intensive and technology intensive manufacturing industries. If WTO commitments are furthered by China, then it would mean further relaxation of controls on foreign ownership, direct transactions of cross border mergers and acquisitions, particularly, the state owned enterprises and also improvement of the IPRs. Thus, foreign capital will continue to flow increasingly to China's capital and technology intensive manufacturing industries. As is evident from Table 4, the agriculture sector in China attracts a very small percent of the total inward FDI, and this is in line with the sector's contribution to the national economy. China's agricultural land tenure system and the traditional small scale, family based agricultural production pattern have

acted as the main hurdle for foreign investment seeking large scale and technology intensive production. Hence, the country would not be able to attract large amount of foreign investment into agriculture unless it fundamentally changes the land tenure system and reforms the farming pattern. China's services sector, after the manufacturing sector, is most attractive to foreign investors for making direct investment (from the table above). Prior to the accession to WTO, China's services sector was relatively closed to foreign participation for protecting the state monopolies. China has made concrete commitments that gradually it will open up the services sector to foreign investors and so it is expected that with full implementation of such commitments, China would be able to attract more FDI inflows to this sector.

TABLE 4
China: sectoral breakdown of FDI inflows – percent of total
(In US\$ 10,000)

Sectors	2000	2007
Farming, forestry, animal husbandry and fishery	67594 (1.7%)	92407(1.2%)
Manufacturing	2584417(63.5%)	4086482 (54.7%)
Electric power, gas and water production and supply	224212 (5.5%)	107255 (1.4%)
Construction	90542 (2.2%)	43424 (0.6%)
Services	944719 (23.2%)	2897601 (38.7%)

Source: National Bureau of Statistics, China.

4 WHAT MAKES THE BRICS ATTRACTIVE FDI DESTINATIONS?

It is evident from the preceding sections that the BRICs have emerged as a major destination for FDI inflows. There are several factors responsible for this.² The single most important reason for their attracting large capital is their large potential consumer market. Market size is generally measured by Gross Domestic Product (GDP), GDP per capita income and size of the middle class population. For instance, India's 300 million large middle class provides a huge potential market for foreign investors. Furthermore, the stable macroeconomic conditions in these countries coupled with high and sustained growth rates also make them an attractive FDI destination. Investors prefer to invest in more stable economies that reflect a lesser degree of uncertainty. Higher GDP growth rates affect FDI inflows positively. Labor costs are another extremely important determinant of FDI inflows. Higher labor costs result in higher cost of production and are expected to limit the FDI inflows. The low wage rates in BRIC economies make them attractive for FDI. The flexibility of their labour market is also an important determinant in attracting FDI. [This is discussed in detail in the India-China comparison.] The availability of quality infrastructure (electricity,

2. See Vijakumar (2010).

water, transportation and telecommunications) is critical to FDI inflows. The trade openness of these economies is also a key determinant of FDI since much of FDI is export oriented and may also require the import of complementary, intermediate and capital goods. In either case, volume of trade is enhanced and thus trade openness is generally expected to be a positive and significant determinant of FDI. The strength of a currency (exchange rate) is used as proxy for level of inflation and the purchasing power of the investing firm. Devaluation of a currency results in reduced exchange rate risk. As a currency depreciates, the purchasing power of the investors in foreign currency terms is enhanced. Thus, we can expect a positive and significant relationship between the currency value and FDI inflows.

China has emerged as the leader in attracting FDI. There are lessons to be learned from China's strategy and experience by the other BRICs, in particular India, which has been the laggard in attracting FDI. Therefore, it would be appropriate to identify the key features of China and India's strategy before proceeding further.

China and India have adopted very distinct strategies and trajectories of growth. While China embarked into vigorous reform process in 1978, India on the other hand lagged behind in reforming its closed domestic economy and it was not until the decade of 1990 that reforms were initiated. While China adopted liberalisation and modernisation of its socialist, centrally planned and non market economy in 1978; India initiated reform much later. And hence, it was left far behind China in terms of economic performance. Consequently, China became exceedingly successful than India in attracting foreign investment.

China has been successful in attracting foreign direct investment by creating a congenial business climate, providing strategic infrastructure and implementing strategic policy initiatives³. Strategic infrastructure implies location, content and intent to organise economic activity efficiently in an emerging market. The infrastructure should be strategic to reflect on the existing demographic realities. It should be strategic to the extent that sectoral composition complements demographic realities like age, availability and educational skill set of labour force are aptly reflected. It should have connectivity with the hinterland to obtain continuous supply of cheap labour from backward areas. It should have the advantage of proximity to the largest global markets and connectivity with the global shipping network. An example of such strategic infrastructure has been demonstrated with the creation and development of Shenzhen Special Economic Zone. Shenzhen used to be small village and a fishing area (70,000 residents, 325 sq miles area) but due to the reforms initiated over the last twenty five years it is one

3. This discussion is drawn from Sinha et al (2007)

the most modern places in the world. Modern Shenzhen has 7 million population, area of 2020 kilometers, produces \$40 billion in GDP, has 120,000 foreign TNC's in active operation, and is the sixth largest port in the world. Shenzhen is the only city in China that has a land port, sea port, airports, and stock exchange of its own.

Strategic policy initiatives refer to the policy initiatives for supporting the above stated strategic intent – creating economic freedom, facilitating openness, inviting diaspora involvements and formulating flexible labor laws. Strategic policy initiatives taken by the Chinese government provided economic freedom and created openness during the period 1978-2005. The government allowed joint ventures between diaspora and local residents, gave incentives and tax holidays, promoted exports, and wages were kept low allowing free competition. Lease and ownership rights were provided to foreigners. Tax exemption on importing machinery, free movement of goods between SEZ designated areas, rebates on export duty, liberal entry and exit policies were adopted. Foreign currency transactions were allowed in SEZ designated areas. Foreign firms could form Wholly Foreign Owned Enterprise (WFOE) in China from 1986 onwards. Bilateral tax treaty also helped in attracting investment. Cheng and Kwan (2000) found that there is a positive relation between SEZ and regional income in attracting FDI to China. River boat transportation and 'industrial clusters' helped in reducing infrastructural bottlenecks and reducing costs. Share of foreign affiliates increased from 9% in 1989 to more than 50% in 2005. Therefore, freedom and openness adopted by China had a positive impact on FDI inflows into the country.

India, however, needs essential structural changes in the economy to be able to attract foreign direct investment. The piecemeal structural changes that India has adopted so far need to be consolidated and more focussed now. Successful stories like Delhi Metro Rail Corporation Ltd. Expressway Network (Golden Quadrilateral) need to be replicated in other metros and major cities of the country; and expressways need to connect all the parts of the country. Another major concern of the country is power and electricity reform. The successful case of privatisation of Delhi Power board needs to be replicated in all other state capitals. Interestingly, China is expected to face a problem of ageing population and India can take advantage of this to develop its own manufacturing sector and become the next major production hub of the world, since it has the largest young working population in the world. In order to do, not only will it need to overcome the above-mentioned infrastructural bottlenecks, but also eliminate the inherent rigidities in its labour market, which make it difficult for the business constituency to derive maximum benefits from this huge supply of labour. Labour laws should be relaxed to boost the mass production in India. Importantly, India needs to overcome its services sector myopia. The impressive performance of the services sector needs to be complemented with growth in the manufacturing sector as the latter has huge potentials to absorb the idle labour force in India.

5 FDI AND GROWTH

There are two primary channels through which FDI effects growth. The first is that FDI generates an inflow of physical capital to the host country. As the size of the host country's physical capital increases, the productive capacity of the host country also increases. Unfortunately, the growth enhancing effect of an ever growing stock of physical capital is not endless. Even though additional capital has important effects on economies with a low capital-labour ratio, diminishing returns imply that accumulation of physical capital cannot be a permanent source of long run per-capita growth. The second channel through which FDI effects growth is that of technology spillovers. These are an externality that can occur through several different channels including imitation, reverse engineering and supplier linkages. It is argued that it is primarily the positive externalities from technology spillovers that allow FDI to enhance the rate of economic growth. The emergence of theories of endogenous growth provides a framework that show how positive externalities can improve long run economic growth. Positive externalities provide non-diminishing returns to capital and therefore enhance growth in long run. In addition to benefits like capital and technology, FDI brings with it higher wages, access to markets, more competition and cheaper goods and services for consumers.

However it is important to bear in mind that the mode of FDI, i.e. Greenfield FDI (GFDI) or Brownfield FDI (BFDI), plays an important role in determining the growth enhancing ability of FDI inflows. In the case of GFDI, Multinational Enterprises (MNEs) construct new facilities of production, distribution or research in the host country. This results in an increase in the host country stock of physical capital that can be substantial, especially for developing economies that tend to be capital scarce. In the case of BFDI, MNEs acquire existing facilities in the host country; this typically results in a limited increase in the stock of physical capital since there is only a change in ownership. However, Javorcik (2004) argues that BFDI in the form of merger or joint venture maximizes the potential for technology spillovers.

Empirical research has indicated that the impact of FDI on economic growth depends on host country conditions. Borensztein et al (1998) and Bengoa & Sanchez-Robles (2003) find that in developing countries, FDI has a positive effect on growth but magnitude of the effect depends on the amount of human capital available in the host country. Zhang (2001) argues that economic growth is enhanced by FDI, but host country conditions such as trade regimes and macroeconomic stability are important. Olofsdotter (1998) finds that an increase in stock of FDI is positively related to growth and that the effect is stronger for host countries with a higher level of institutional capability as measured by degree of property rights protection and bureaucratic efficiency in the host country.

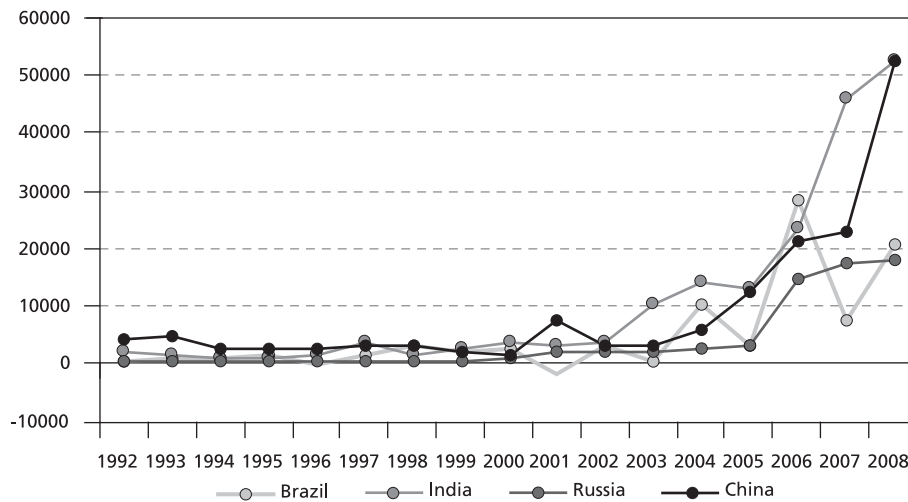
Johnson (2005), using panel data analysis, shows that FDI inflows enhance economic growth in developing economies but not in developed economies. He argues that it is technology spillovers that have the strongest potential to enhance economic growth in host countries.

Importantly, the causality between economic growth and FDI runs in either direction. Not only does FDI bring with it benefits of capital formation and technology, which translate into growth; but FDI also flows into countries with faster economic growth. In a study on BRIC economies, Sridharan et al (2010) find that growth leads FDI bi-directionally for Brazil and Russia, while FDI leads growth unidirectionally for India & China.

6 OUTWARD FDI

The importance of BRICs as FDI destinations is undisputable. But what is particularly interesting is that these economies are emerging as important sources of outward FDI as well. Firms from BRICs are increasingly undertaking direct investment abroad; in developed countries as well as in other emerging markets. This is primarily a consequence of the desire of these firms to increase their competitiveness by acquiring portfolios of locational assets (assets which owe an important part of their value to their location, such as an assembly plant located in a country with lower labor costs than other possible plant locations). OFDI from South, East and South East Asia rose by 7% to \$186bn in 2008, due mainly to large outflows from China. China gained ground as an important source of OFDI. It ranked 13th in the world and 3rd among all developing and transition economies. OFDI from China reached \$52bn in 2008, 132% up from 2007. In early 2009, outflows from the country continued to rise. Indeed, significant exchange rate fluctuations and falling asset prices abroad as a result of the crisis have created M&A opportunities for Chinese companies. India is becoming an important investor, though FDI outflows remained almost at the same level as in 2007. FDI outflows from South America soared in 2008, up by 131%, the strongest increase was registered in Brazil (189%), where outflows reached \$20bn.

CHART 6
FDI outflows from BRIC



6.1 The Chinese experience⁴

The Chinese experience in this context has been particularly interesting. In 2002, a new dimension was added to the Chinese development model by allowing and actively promoting outward direct investment 'Go Global Policy'. In 2008 global FDI fell by around 20 percent, while outward FDI from China nearly doubled. OFDI from China reached \$52bn in 2008, up by 132% from 2007. It is widely believed in the existing literature that China has considerable catch up potential and is set to outpace the other BRICs and emerge as a major source of global FDI⁵.

There are several drivers of China's outward FDI. One of the most commonly cited motivations is China's need to secure natural resources to fuel rapid growth. However, this is actually not the most significant area of China's outward investment. Instead, it is the service industry. While most of China's exports are from foreign-owned enterprises, large domestic firms also export large volumes and for this they need services like shipping and insurance. The latest figures published by China's Ministry of Commerce (MOFCOM) in February 2009 show that the tertiary sector predominated, and accounted for over 70 % of total outward FDI at the end of 2007. The predominance of services is the result of China's export boom and the extension of China's financial services overseas to utilize the wealth of the Chinese diaspora, learn advanced techniques and diversify

4. See Davies (2009).

5. See Jaeger (2009).

earnings sources. Also, China's major enterprises are also acquiring global brands (like Lenovo's acquisition of IBM's personal computer business or the SAIC and Nanjing purchase of MG Rover). Moreover, large state-owned enterprises (SOEs) are losing their monopoly position at home and are diversifying internationally. And finally some enterprises – despite China's ample labour supply are moving their labour intensive operations to cheaper overseas locations like Vietnam and Africa. Interestingly, Africa is emerging as one of the most important destinations of OFDI from China and India. China's OFDI stock in Africa increased from \$49.2 million in 1990 to \$1.6 billion in 2005 and that of India rose from \$296.6 million in 1996 to \$1.96 billion in 2004. This increase is driven not just by an appetite for natural resources but also by the fact that there is a potential consumer market, particularly in South Africa, with a large middle-income group.

6.2 The Indian experience

In the early 1990s, India's share in OFDI from developing economies was the lowest compared to the four large emerging market economies, considered as its competitors (Brazil, China, Mexico, and South Africa). Over the ensuing years, India's share has grown rapidly. India's share in total developing economy FDI outflows remained below 0.5 percent throughout the 1990s, but increased rapidly thereafter, reaching nearly 6.0% in 2007.

Over the past two decades, the government policy in India relating to OFDI has made a palpable transition from the cautious and restrictive approach that prevailed over the first four decades of the post-independence era to one of facilitation and encouragement. Outward FDI is now considered an effective tool of economic advancement through harnessing global technological know-how, building trade support networks for enhancing the international competitiveness of local firms, and opening new market channels for promoting exports (Government of India 2009). The extent to which outward FDI has so far contributed toward these national development goals remains an unexplored empirical issue.

The motives for outward FDI from India differ across industries and over time. However, certain factors stand out as the main drivers. The increasing number of home-grown Indian firms (e.g. Tata Group, Infosys, Ranbaxy) and their improving ownership - specific advantages, including financial capability, are among the key drivers. In addition, the growing competitiveness of Indian firms involved in providing outsourced business and IT services to foreign clients has provided a push for these firms themselves to go offshore to operate near their clients and to expand their growth opportunities in markets abroad. The success of Indian firms as service providers in the outsourcing of IT services, BPO and call centres by developed-country companies has exposed them to knowledge

and methods for conducting international business, and induced outward FDI through demonstration and spillover effects. Indian firms are investing abroad also to access foreign markets, production facilities and international brand names. For instance, Tata Motors Ltd acquired Daewoo Commercial Vehicle Company (Republic of Korea) in 2003 for \$118 million for accessing the South-east Asian market and the Korean firm's production facilities.⁶ Access to technology and knowledge has been a strategic consideration for Indian firms seeking to strengthen their competitiveness and to move up their production value chain. In 2003, WIPRO acquired Nerve Wire Inc (United States) for \$18.7 million to gain deep domain knowledge and other IT related benefits, including access to markets.⁷ Securing natural resources, is also becoming an important driver for Indian outward FDI. For instance, in 2003 Hindalco acquired two copper mines in Australia and Oil and Natural Gas Commission (ONGC) Ltd.

7 POLICY ISSUES

The rising importance of BRICs as a destination and source of FDI is undisputable. However, these economies face some critical policy issues as their investment potential increases. In this section, we will outline two key policy challenges faced by the governments of these countries. The first concerns the establishment of an appropriate OFDI policy regime in emerging markets that face macroeconomic constraint. The second concerns the possibility of a rise in FDI protectionism in the aftermath of the global economic crisis.

7.1 Establishing an appropriate policy regime for OFDI in emerging markets

Governments of emerging markets seeking to establish an appropriate policy regime for OFDI face a dilemma between micro level competitiveness requirements of firms and macro level development constraints of governments (SAUVANT, 2008). At a micro level, OFDI is beneficial for the competitiveness

6. Other instances Infosys Technologies Ltd. acquired Expert Information Services Pty. Ltd (Australia) in 2003 for \$22.9 million to strengthen its presence in the Australian market and to access clients of the acquired company. Similarly, companies such as Daksh eServices, Datamatics Technologies and Hinduja TMT Ltd have been going abroad to expand the markets for their services and exploit growth opportunities in other regions. Ranbaxy Technologies acquired RPG Aventis (France) in 2003 for \$70 million to strengthen its market position in Europe and to access strategic assets (e.g. brand names). Tata Tea acquired Tetley Tea in 2000 for 271 million pounds for access to the Tetley brand name and market. In 2003, Jindal Polyester Ltd acquired Rexor (France) a polyester producer for 10 million Euros; Sundaram Fasteners Ltd bought Dana Spicer Europe Ltd (United Kingdom), a precision forgings business, for 1.5 million pounds; and Dabur India Ltd. acquired Redrock Ltd (United Kingdom) a cosmetic firm for market reasons.

7. Other instances of technology driven OFDI- I-Flex paid \$11.5 million for Supersolutions Corp. (United States) for access to technologies and knowledge; Wockhardt Ltd bought a pharmaceutical company in the United Kingdom for markets, knowledge and strategic reasons; Reliance Infocomm bought Flag Telecom (United Kingdom) for \$211 million to access to the undersea cable network and connect with key regions such as Asia, Europe and the United States. Access to technologies also means setting up R&D centres in key locations. For instance, Ranbaxy Laboratories has R&D activities in various countries, including in China and the United States.

of firms. It allows them to acquire a portfolio of locational assets, which are increasingly important as a source of international competitiveness for firms as it provides access not only to markets but also to the range of resources that are needed for the production process. This is critical in a world economy that is open and in which competition is everywhere, due to the liberalization of trade, FDI and technology regimes.

However, the other side of this dilemma concerns the macro-level. Most emerging markets perceive themselves as importers of capital, not exporters of capital (with the notable exception of China). By virtue of being an emerging market, they typically face a balance of payment constraint. The priority for them is to build a domestic productive capacity and increase domestic employment. Given these domestic priorities, permitting investment abroad - let alone encouraging it - is therefore, not a natural thing. Therefore, not surprisingly, emerging markets have followed a restrictive policy towards OFDI.

Policymakers attempting to resolve this dilemma, need to address a number of issues. Should the OFDI regime be liberalised gradually, for example, by permitting OFDI up to certain ceiling (which can be raised) or by allowing it in certain sectors that are priority for the host country, or on meeting certain criteria (for instance its impact on employment, balance of payments)? What are the risks when liberalizing OFDI in certain sectors and not others-for the country (has it picked the right sectors?) and companies involved (is the competitiveness of companies in non-liberalized sectors compromised?) Should a country aim for a neutral OFDI regime or like virtually all OECD countries do, go all the way and protect and even facilitate OFDI—China ‘Go Global’.

In the Indian context, as outlined in the preceding section, there has been increasing recognition of OFDI as an effective tool of economic advancement and consequently, the government policy in India relating to OFDI has made a transition from a cautious and restrictive approach to one of facilitation and encouragement. The extent to which OFDI has contributed towards development largely remains an unexplored empirical issue. Two studies in this context indicate that outward FDI has a statistically significant positive effect on the degree of export orientation across an entire sample of firms (4,200) and at the level of a number of key industries [(Kumar and Pradhan 2007, Pradhan 2008)].

In interpreting these findings, it is important to take into account that firms with overseas operations are largely concentrated in capital and skill-intensive industries. This will be important in further analysis because the competitive advantage underpinning the observed export success of these industries may not necessarily reflect the intrinsic comparative advantage of the country (Lall 1986). Given the market conditions of the labor-abundant Indian economy, export

growth per se is unlikely to contribute to achieving the employment and equity objectives of national development policy.

The central issue in any assessment of developmental implications of OFDI is the possible trade-off between overseas investment and domestic investment. Much faster growth of overseas FDI relative to domestic investment in the reform era could possibly reflect the fact that domestic investment remains less attractive to Indian firms compared to overseas investment. To the extent that a relatively less attractive domestic environment acts as a push factor in outward investment, some of the investment could take the form of pure capital flight. Of course, this does not make a case for a restrictive policy stance toward outward FDI. Rather, it makes a case for further reforms to improve the domestic investment climate (ATHOKORALA, 2009).

7.2 Rise of protectionism in future?⁸

The current financial and economic crisis has had no major impact on FDI policies so far, since FDI is not the cause of this crisis. However, some national policy measures of a more general scope (national bailout programmes, economic stimulus packages) introduced in response to the crisis are likely to have an impact on FDI flows and TNC operations in an indirect manner. There are two possibilities in this regard. On the one hand, they may have a positive effect on inward FDI, as they could help stabilize, if not improve, the key economic determinants of FDI. On the other hand, there are concerns that country policy measures could result in investment protectionism by favouring domestic over foreign investors, or by introducing obstacles to outward investment in order to keep capital at home.

There are also signs that some countries have begun to discriminate against foreign investors and/or their products in a “hidden” way using gaps in international regulations. Examples of “covert” protectionism include favouring products with high “domestic” content in government procurement (particularly huge public infrastructure projects), de facto preventing banks from lending for foreign operations, invoking “national security” exceptions that stretch the definition of national security, or moving protectionist barriers to subnational levels that are outside the scope of the application of international obligations (e.g. in matters of procurement).

Looking to the future, a crucial question is which FDI policies host countries will apply once the global economy begins to recover. The expected exit of public funds from flagship industries is likely to provide a boost to private investment, including FDI. This could possibly trigger a new wave of economic nationalism

8. See Sauvant (2006).

to protect “national champions” from foreign takeovers. International Investment Agencies (IIAs) have a role to play in ensuring predictability, stability and transparency of national investment regimes. Policymakers should also consider strengthening the investment promotion dimension of IIAs through effective and operational provisions. Investment insurance and other home-country measures that encourage outward investment are cases in point where continued international cooperation can be useful. As there are looming fears of emergence of nationalist policies and state controls, efforts should be made by the countries across the globe to provide the appropriate stimulus to investment and to revive the faith in the belief of an open global economy.

8 CONCLUSIONS

The financial crisis changed the investment landscape of global FDI, with the BRIC economies taking the lead in attracting investments as well as investing globally. The BRICs weathered the crisis better than developed countries as their economic growth remained robust. Importantly, it is predicted that it is these four economies along with the US that will lead the future FDI recovery. However, there are important policy challenges for the BRICs as the global FDI landscape changes. An important policy issue that merits attention is the fear of a possible rise in protectionism in FDI as the world emerges from the global financial crisis. The BRICs with their tremendous clout in the global investment landscape have a key role in ensuring that there isn't a backlash against FDI following decades of liberalization and openness. Also, there is a need to establish an appropriate OFDI regime that can resolve the dilemma between micro level competitiveness requirements of firms and macro level development constraints of governments. OFDI must not be encouraged at the expense of building domestic productive capacity. Given the relation between FDI and economic growth and the benefits FDI brings in the form of greater capital accumulation and technology spillovers, the maxim for these countries should no longer just be “the more FDI, the better” ; rather emphasis should be on targeting FDI that is important for their economic development.

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The Perspective of the World Review is an international periodical sponsored by Ipea (Institute of Applied Economic Research), a body belonging to the Presidency of the Federative Republic of Brazil through the Secretariat for Strategic Affairs (SAE).

The magazine features versions in Portuguese and English and was designed to present and promote contemporary debates, emphasizing the theme of development from a South – South perspective. Its field of action is that of political economy, with plural approaches on the essential dimensions of development such as economic, social and sustainability-related issues.

The goal is to enhance the debate in order to formulate proposals for the development of public policies and, accordingly, to encourage international comparisons and interdisciplinarity – always highlighting the role of planning. The Perspective of the World Review takes the ambition to formulate the questions faced by contemporary civilization, which wants to enjoy comfortable living standards and dignified living conditions, but must simultaneously respect the limits of what the planet can support in terms of environmental exploitation.

It is important to point out the tribute given to Fernand Braudel through the enhancement of his formulation on the *time of the world*, which, together with the *structures of everyday life* and the *games of exchange*, shapes his originality. Braudel always sought to address issues involving the dimensions of development in a historical and long-term perspective. He emphasized that a world dominated by a mode of production based on the accumulation of capital had always had to balance society, market and state. As the master taught us, in places where this task was most successful, there was prosperity, and where difficulties were persistent, results were not as successful. This initiative is not new in Brazil – its great precursor was Celso Furtado, in *The Economic Growth of Brazil*. This seminal work was welcomed by Braudel as innovative under a methodological perspective.

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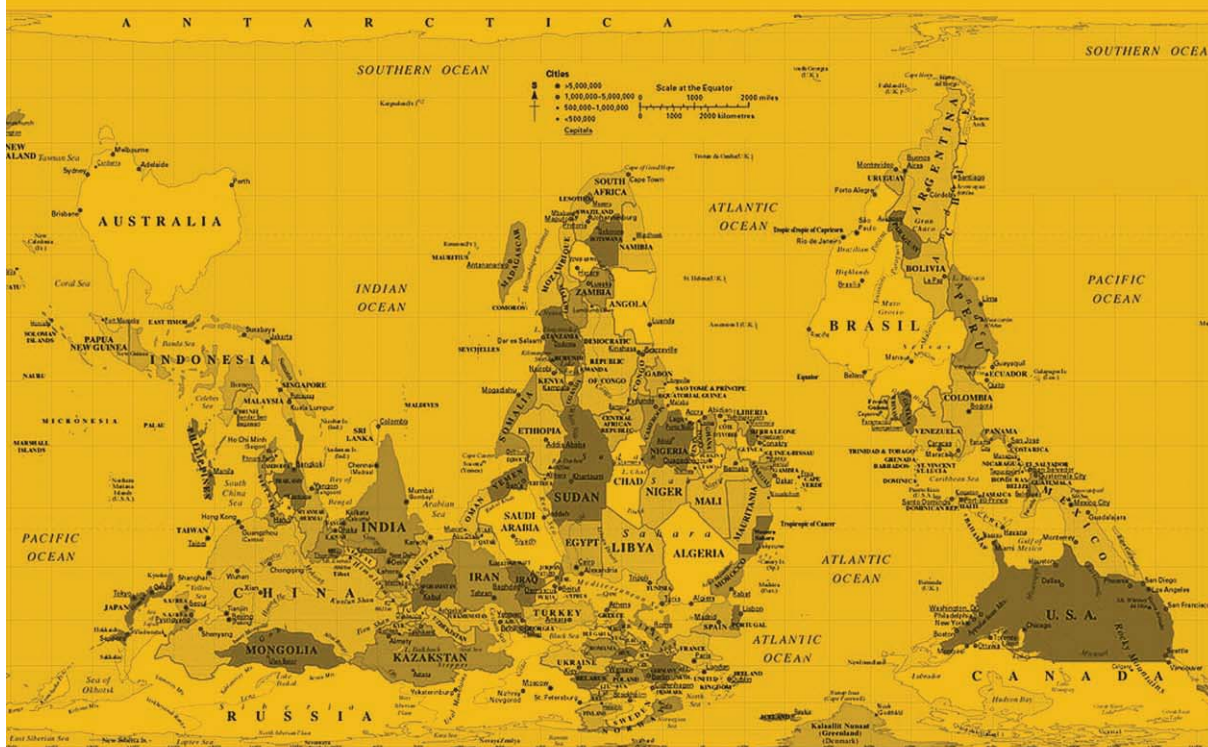
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