

# Chapter 17

## FDI, Urbanization, and Economic Growth Linkages in India and China

**Sudhakar Patra**  
Ravenshaw University, India

### ABSTRACT

*The rapid urbanization and economic growth during new round of globalization is largely due to the flows of Foreign Direct Investment (FDI). In this context the objectives of this chapter is to analyze the causality and linkage among urbanization, GDP and foreign direct investment in China and India with the help of secondary data from 1979 to 2012. It focuses on determinants and pattern of FDI flow in China and India. The study observes a significant positive correlation between urbanization and flow of FDI to a particular region both in China and India. The rate of growth of FDI is significantly influenced by rate of growth of urban population at 10 per cent level of significance and by rate of growth of per capita GDP at 1 percent level of significance. The study also highlights the causality and linkage between urbanization and FDI inflow with evidences from China and India.*

### INTRODUCTION

Foreign direct investment is a direct investment into production or business in a country by an individual or company of another country, either by buying a company in the target country. It has strong linkages with economic growth and urbanization of a country. Urbanization plays a huge role in stimulating growth of a country. China has developed tremendously after the country launched its reforms and adopted its open door policy in 1978. For three decades, China has gained a two-digit annual growth rate on average when it gradually deviated away from the traditional doctrines of a central-planned economy and put into practice the market oriented economy. With the rapid economic development, cities, as centers for economic activities, have been expanding at an unprecedented speed. Urbanization in China has taken on new dimensions as a result of increasing globalization since introduction of economic reforms. The urban growth and other economic activities during new round of globalization can be measured largely

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by the inflows and outflows of Foreign Direct Investment (FDI) which has become one of the driving forces binding countries into closer economic interdependence, and it continues to expand. The rapid increase in FDI flows has generated considerable impact on industrialization and urbanization in China. The role of foreign direct investments in the growth and urbanization of China and India has captured the attention of many researchers and analysts. China has historically attracted more FDI than India as a share of GDP, particularly in the early stage of its economic transformation. China achieved a significant growth rate of over 9 percent per year during 1990 to 2010 which was highest in the world during that period. This achievement was mainly due to adoption of radical changes and huge inflow of FDI to Chinese cities. China used to be one of the most closed economies in terms of policy toward foreign investment and external debt. Starting from virtually no foreign-owned firms on Chinese soil before 1979, China has now become one of the largest developing host countries for foreign investment. The coastal region enjoys more growth than inland region and most of the FDI (84 per cent) in China is invested in coastal region due to higher urbanization (Heid & Ries, 1996). China's need for FDI was related to its export oriented industrial structure – for example, it created special economic zones to attract foreign investment by exempting investors from regulations applicable elsewhere in China. There exist significant positive correlation between urbanization and flow of FDI to a particular region both in china and India. In this context, the objective of the present study is to analyze the causality and linkage between urbanization and FDI inflow with evidences from China and India.

## **REVIEW OF LITERATURE**

There is plethora of literature and research studies on relationship among urbanization, inflow of FDI and GDP growth rates. Henderson (2000) in his study mentioned that cities are becoming the focal points of global and national economies. The evolution of the economic geography of developing countries in the process of urbanization has followed an urban growth pattern that differs from that of earlier industrializing countries, which urbanized much slowly. Yusuf, Altaf, and Nabeshima (2000) stated that the prominent contributors to successful urbanization include specialization in innovative or income elastic economic sectors, favorable national government policies in such areas as investment and infrastructure, economic development leadership from local public or private sectors, flexibility and openness toward new and emerging industrial ensembles. China's urban policy has shifted with the economic boom since 1979. Georgieva (1998) mentioned that the efforts to integrate investment and environmental policies are helped by the growing realization that the environmental and financial crises in developing countries have shared roots and responses. Gentry are an optimistic promoter for FDI; in his conclusion he shows that only FDI can meet the need for environmental infrastructure (Graham, 2000). Chen, Chang and Zhang (1995) study the effect of FDI on China's output and found that the FDI has a positive impact on the output growth between 1978 and 1990. Using cross-country data, Wei (1995b) found that despite the large amount of FDI China has received in recent years, the country still appears to host too little FDI compared to an 'average' host country. Heid and Ries (1996) study 931 joint ventures in 54 cities from 1984 to 1991. They intentionally exclude investments by overseas Chinese (Hong Kong, Macau, Singapore) which probably have a different set of location determinants due to familial, linguistic, and cultural ties. Their conditional logit regression shows that cities with good infrastructure, established industrial base and foreign investment presence are more attractive to investors. Wei (1995a) also looked

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