# Foreign Direct Investment and Economic Growth: A Comparative Econometric Analysis of China and India (1980-2024)

## 2. Abstract

This study conducts a comparative econometric analysis of the relationship between Foreign Direct Investment (FDI) and economic growth in the People's Republic of China and the Republic of India for the period 1980-2024. Employing a Vector Autoregression (VAR) methodology on time-series data, the research investigates the divergent impacts of FDI in two of the world's most significant emerging economies. The principal findings reveal a substantially stronger and more persistent positive effect of FDI on economic growth in China compared to India. This divergence is attributed to China's state-led, manufacturing-centric development model, characterized by early liberalization, strategic industrial policy, and massive infrastructure investment. In contrast, India's gradualist, crisis-driven reforms fostered a service-oriented FDI landscape with a comparatively muted impact on aggregate growth. However, analysis of recent trends, marked by geopolitical shifts and supply chain diversification, indicates a potential structural change, suggesting a future convergence in the FDI-growth nexus as global investment patterns evolve.

## 3. Introduction

### The Global Significance of FDI in Development Economics

In the landscape of modern development economics, Foreign Direct Investment (FDI) has emerged as a paramount force, representing a critical component of private financial flows that substantially outpace official development assistance. Defined by international bodies such as the International Monetary Fund (IMF) and the World Bank as a cross-border investment to acquire a lasting management interest—typically 10 percent or more of voting stock—in an enterprise, FDI is far more than a simple capital transfer. It serves as a vital conduit for the transmission of advanced technology, modern managerial expertise, organizational innovations, and enhanced access to global markets. For developing nations, attracting FDI is often a cornerstone of economic strategy, aimed at augmenting domestic savings, boosting capital formation, creating employment, and ultimately accelerating the pace of economic growth and structural transformation.

### China and India: A Tale of Two Giants

The post-1980 global economic order has been profoundly shaped by the rise of two Asian giants: China and India. In the late 1970s, both nations stood at similar junctures of economic development, characterized by low per capita incomes and largely agrarian, state-controlled economies. However, the paths they subsequently chose for engaging with the global economy were starkly different, creating a compelling natural experiment in development strategy.

China, under the leadership of Deng Xiaoping, initiated its transformative "reform and opening-up" policy in 1978. This was a proactive, state-directed strategy designed to systematically integrate China into the world economy by attracting foreign capital and technology. Through the establishment of Special Economic Zones (SEZs), generous incentives for foreign investors, and a focus on export-oriented manufacturing, China rapidly positioned itself as the "world's factory" and became the largest recipient of FDI among developing countries.

In contrast, India pursued a more cautious, inward-looking policy of import substitution for decades following its independence. Its economic paradigm was characterized by the "Licence Raj," a complex web of regulations that restricted private enterprise and foreign investment. A significant policy shift occurred only in 1991, prompted by a severe balance of payments crisis that necessitated a loan from the IMF. The ensuing reforms were thus more reactive and gradualist, liberalizing the economy in stages rather than through a grand, centrally-planned design. While these reforms successfully opened the Indian economy and spurred growth, the country's approach to FDI remained more circumspect and its institutional environment more complex than China's, leading to a different trajectory of FDI inflows and economic impact.

## The Central Puzzle and Thesis Statement

The divergent paths of these two demographic and economic behemoths present a central puzzle for scholars of international political economy. Despite possessing comparable endowments in terms of large domestic markets and vast labor pools, China has historically attracted significantly higher volumes of FDI and has appeared to leverage this investment more effectively to fuel unprecedented, manufacturing-led economic growth. India, while also achieving impressive growth, has attracted less FDI in both absolute and relative terms, and its growth story has been uniquely characterized by the dominance of the services sector. This raises the fundamental research question: Why has the relationship between FDI and economic growth differed so profoundly between China and India?

This paper argues that the differential impact of FDI on economic growth in China and India is primarily explained by the interplay of three deeply intertwined factors: (1) the timing, pace, and nature of policy liberalization, contrasting China's strategic, state-led model with India's reactive, crisis-driven gradualism; (2) the resulting sectoral concentration of FDI, with investment being channeled into manufacturing in China versus services in India, each with distinct multipliers and linkages to the broader economy; and (3) the underlying institutional frameworks governing investment, where China's authoritarian efficiency in implementing policy and building infrastructure offered a different value proposition to investors than India's democratic, albeit more bureaucratic, system with stronger legal protections. The analysis of this historical divergence is further complicated and enriched by recent global shifts, including geopolitical tensions and supply chain realignments, which may be fundamentally altering this long-standing dynamic.

## Structure of the Paper

This research paper is structured into thirteen sections. Following this introduction, Section 4 provides a comprehensive review of the theoretical and empirical literature on the FDI-growth nexus, with specific attention to studies on China and India. Sections 5 and 6 articulate the research gap and the formal problem statement, respectively, while Section 7 outlines the study's primary objectives. Section 8 details the research methodology, explaining the choice of

a Vector Autoregression (VAR) model, the data sources, and the econometric procedures. Section 9 presents the empirical results through a series of tables and graphs. Section 10 offers an in-depth analysis and discussion of these findings, synthesizing the quantitative results with the qualitative context. Finally, Section 11 provides the conclusion, Section 12 discusses the scope for future research, and Section 13 lists the references cited throughout the study.

# 4. Literature Review

## 4.1. Theoretical Foundations of the FDI-Growth Nexus

The intellectual framework for understanding the relationship between Foreign Direct Investment and economic growth has evolved significantly over the past half-century, moving from classical models emphasizing capital accumulation to more nuanced theories centered on knowledge and productivity.

### Neoclassical Models (Solow-Swan)

Early perspectives on the role of foreign capital were rooted in the neoclassical growth model developed by Solow (1956) and Swan (1956). Within this framework, economic growth is driven by the accumulation of capital and labor, along with an exogenous factor of technological progress. FDI, in this context, contributes to growth primarily by augmenting the domestic capital stock. An inflow of foreign investment increases the capital-labor ratio, leading to a higher level of output per worker. However, due to the assumption of diminishing returns to capital, this effect is transitional. FDI can accelerate a country's convergence to its steady-state level of income but cannot permanently increase its long-run growth rate, which is determined solely by exogenous technological change. While foundational, this model's inability to account for the sustained, high growth rates seen in many FDI-recipient countries highlighted its limitations.

### Endogenous Growth Theory (Romer, Lucas)

The development of endogenous growth theory in the 1980s and 1990s by theorists such as Romer (1990) and Lucas (1988) provided a more powerful lens through which to view the FDI-growth relationship. These models posit that long-run growth is not driven by an external "manna from heaven" but is an endogenous outcome of economic activities that generate knowledge, innovation, and human capital. FDI is no longer seen as just a source of capital but as a primary vehicle for the international transfer of technology, advanced managerial skills, and superior organizational practices.

This perspective suggests several channels through which FDI can permanently increase a host country's growth rate. First, multinational enterprises (MNEs) often bring with them more advanced production technologies than are available domestically. The adoption and diffusion of these technologies can lead to significant increases in total factor productivity (TFP). Second, FDI can generate positive externalities, or "spillovers," for domestic firms through demonstration effects, labor mobility (as trained workers move to domestic firms), and backward and forward linkages in the supply chain. Third, the entry of MNEs often intensifies competition in the host market, compelling domestic firms to become more efficient and innovative to survive. Through these mechanisms, endogenous growth theory establishes a robust theoretical case for FDI as

a potent and sustained driver of economic development.

### The Role of Absorptive Capacity

The empirical record, however, demonstrates that the potential benefits of FDI are not realized automatically or uniformly across all host countries. This observation led to the development of the concept of "absorptive capacity," which posits that the ability of a host economy to benefit from FDI spillovers is contingent upon its own initial conditions. Key components of absorptive capacity include a sufficiently educated workforce (human capital) capable of understanding and adapting new technologies, a well-developed financial system to channel capital effectively, a stable macroeconomic and policy environment, and a minimum level of institutional quality, including the rule of law and protection of property rights. Countries lacking this threshold of domestic capabilities may fail to harness the positive externalities of FDI and, in some cases, may even experience negative effects as domestic firms are crowded out by more efficient foreign competitors. This concept is particularly crucial for a comparative study of China and India, as their differing levels of human capital, infrastructure, and institutional development likely played a significant role in mediating the impact of the FDI they received.

## 4.2. Empirical Evidence: Global and Cross-Country Studies

The vast empirical literature examining the FDI-growth nexus reflects the theoretical ambiguity, yielding a wide spectrum of results. Numerous cross-country panel data studies have found a positive and significant relationship between FDI inflows and economic growth. However, an equally substantial body of research has found the relationship to be insignificant, or even negative in some contexts.

Much of the recent scholarship has focused on identifying the conditions under which FDI is growth-enhancing, largely confirming the importance of absorptive capacity. For instance, Borensztein, De Gregorio, and Lee (1998) found that FDI is more productive than domestic investment only when the host country has a minimum threshold of human capital. Similarly, other studies have shown that the positive effects of FDI are magnified in countries with more developed financial markets, greater trade openness, and stronger institutional quality.

Methodologically, early studies often relied on simple cross-sectional or panel regressions, which were susceptible to issues of endogeneity and omitted variable bias. More recent studies have employed more sophisticated econometric techniques to address these challenges. The use of Vector Autoregression (VAR) models and associated Granger causality tests has become common, as these methods can better capture the dynamic and potentially bidirectional relationship between FDI and growth. Yet even with these advanced techniques, the results remain mixed, often varying based on the sample of countries, the time period studied, and the specific control variables included in the model. This persistent ambiguity in the global literature underscores the necessity of detailed, country-specific case studies to understand the mechanisms at play in particular national contexts.

## 4.3. FDI and Economic Growth in China

The case of China is often presented as the quintessential example of FDI-led development. The literature overwhelmingly credits China's strategic and aggressive pursuit of FDI as a primary engine of its "economic miracle". FDI inflows surged from negligible levels in the late 1970s to over $40 billion per year by the mid-1990s, making China the largest FDI recipient in

the developing world.
A key theme in the literature is the central role of state policy in directing these flows. The "open door" policy began with the creation of SEZs in southern coastal provinces, which acted as laboratories for market reforms and offered foreign investors preferential tax treatment, streamlined regulations, and access to infrastructure. This geographically targeted approach created powerful agglomeration effects, concentrating investment in export-oriented manufacturing. Studies have empirically demonstrated that FDI made a direct and substantial contribution to China's GDP and TFP growth, particularly in the coastal provinces that received the lion's share of investment.
The sectoral impact of FDI in China has been profound. The vast majority of early FDI flowed into the manufacturing sector, transforming China into a global production hub. MNEs not only built factories but also played a crucial role in transferring technological and managerial knowledge and in developing extensive local supplier ecosystems. More recently, however, the literature has noted a structural shift. As China's labor costs have risen and its economy has matured, FDI has increasingly flowed into the services and real estate sectors. Concurrently, manufacturing FDI has faced downward pressure due to rising domestic competition and escalating trade tensions, particularly with the United States.

## 4.4. FDI and Economic Growth in India

India's experience with FDI presents a stark contrast to China's. For decades, its policy framework was restrictive, guided by principles of "technological self-reliance" and protection of domestic industry. The landmark 1991 economic reforms, born out of a crisis, initiated a process of gradual liberalization. The Foreign Exchange Regulation Act (FERA) was replaced by the more liberal Foreign Exchange Management Act (FEMA) in 1999, and industrial licensing was largely abolished.
Despite these reforms, the literature highlights several persistent challenges that have limited India's ability to attract FDI on a scale comparable to China. These include significant infrastructure deficits, bureaucratic complexities and delays (often termed the "Inspector Raj"), and a more rigid regulatory environment.
The most distinctive feature of India's FDI story is its sectoral composition. Unlike China's manufacturing-centric model, FDI in India has been disproportionately concentrated in the services sector. This is particularly true for information technology (IT), business process outsourcing (BPO), telecommunications, and financial services. This path was not necessarily a deliberate policy choice in the same way as China's manufacturing focus, but rather emerged from India's unique comparative advantage: a large, well-educated, English-speaking workforce that was perfectly suited to the global boom in services offshoring that began in the late 1990s.
Empirical studies have documented a strong, positive feedback loop, where FDI inflows have fueled the growth of the services sector, and the success of the services sector has, in turn, attracted more FDI. This services-led growth has been a major contributor to India's overall economic performance.

## 4.5. Direct Comparative Analyses

A number of studies have undertaken direct comparisons of the FDI experience in China and India. A common finding is that FDI exhibits a stronger positive correlation with GDP growth in China than in India. The literature offers several explanations for this divergence.
First, the timing and nature of reforms were critical. China's "early mover" advantage, beginning

its reforms more than a decade before India, allowed it to establish a dominant position in global manufacturing supply chains. Furthermore, China's proactive, state-led approach, characterized by the creation of SEZs and massive infrastructure investment, created a more attractive and efficient environment for large-scale manufacturing investment than India's more incremental and less coordinated reform process.

Second, differences in factor markets and infrastructure are frequently cited. China has historically benefited from more flexible labor markets and superior infrastructure in transport, logistics, and energy, which are critical for an efficient manufacturing sector. India, while possessing a demographic advantage, has been hampered by more restrictive labor laws and persistent infrastructure gaps.

Third, the institutional context differs. While India's democratic framework and independent judiciary offer stronger legal protections for investors, which is a long-term advantage, China's authoritarian system has enabled faster decision-making and policy implementation, reducing short-term uncertainty and transaction costs for investors. The historical trajectory of policy choices thus created a path-dependent development model for each nation. China's early and aggressive promotion of manufacturing in SEZs established a self-reinforcing ecosystem of suppliers, infrastructure, and skilled labor that proved difficult for latecomers to challenge directly. Consequently, India, upon liberalizing in 1991, found a more viable competitive niche by leveraging its distinct endowment of English-speaking, technically proficient human capital, thereby catalyzing a different, service-oriented growth cycle. This explains the divergent sectoral paths and why simply replicating China's model was not a feasible strategy for India.

# 5. Research Gap

While the existing body of literature provides a robust foundation for understanding the historical dynamics of FDI in China and India, a significant research gap has emerged due to the profound global economic and geopolitical shifts of the last decade. Much of the influential comparative econometric work was conducted using data that predates several critical developments. For instance, key studies such as Agrawal (2011) use data only up to 2009 , thereby missing the subsequent period of intense change.

This study identifies four specific temporal and thematic gaps in the current literature:

1. **Post-Crisis Recovery and New Policy Initiatives:** The existing literature does not fully capture the differential impacts of the 2008 global financial crisis on FDI flows to both nations, nor does it assess the effects of major subsequent policy initiatives. A key example is India's "Make in India" campaign, launched in 2014, which was explicitly designed to attract FDI into the manufacturing sector and alter the country's service-led FDI trajectory.
2. **Intensification of Geopolitical Tensions:** The period since 2018 has been characterized by escalating US-China trade and technology competition. This has created significant uncertainty and has been identified as a major driver of declining FDI into China. A long-term analysis is needed to quantify the impact of this new geopolitical environment on the comparative attractiveness of China and India.
3. **The "China Plus One" Strategy:** The COVID-19 pandemic exposed the vulnerabilities of heavily concentrated global supply chains, accelerating the trend of firms seeking to diversify their manufacturing bases beyond China—a strategy often referred to as "China Plus One." Recent data and reports from institutions like the IMF and UNCTAD have documented a notable decline in FDI inflows to China, coupled with a surge in greenfield

investment announcements in other Asian economies, including India. An updated econometric analysis is required to determine if this trend represents a durable structural break from historical patterns.

4. **Lack of a Recent, Long-Term Econometric Comparison:** There is a clear need for a study that applies a consistent econometric methodology, such as a VAR model, to a comprehensive and updated time-series dataset spanning the entire modern era of globalization from 1980 to the most recent available year (2024). Such a study would not only re-evaluate the historical relationships with the benefit of a longer data series but, more importantly, would be able to empirically test for evidence of the structural shifts suggested by recent events.

This research aims to fill this critical gap by providing a rigorous, updated, and long-term comparative analysis that accounts for these recent transformative developments.

# 6. Problem Statement

The relationship between Foreign Direct Investment and economic growth is neither static nor universally applicable; it is deeply contingent on national policy choices, evolving institutional contexts, and the dynamics of the global economy. In the paradigmatic cases of China and India, divergent approaches to economic liberalization have historically produced distinct development outcomes, with China demonstrating a stronger FDI-growth nexus rooted in manufacturing, while India forged a unique path led by services. However, the recent confluence of major global shocks—including intensifying geopolitical rivalry, the COVID-19 pandemic, and a strategic push for supply chain diversification—has fundamentally altered the landscape of international investment. These shifts have called into question the durability of past trends and have potentially initiated a structural realignment in the flow of FDI, with documented evidence of declining investment in China and rising interest in India. Therefore, a rigorous and updated comparative econometric investigation is imperative to first quantify the historical impact and causal dynamics of FDI on economic growth in both nations, and second, to assess the empirical evidence for a structural shift in this long-standing relationship in the contemporary era.

# 7. Objectives

The primary aim of this study is to conduct a comprehensive comparative analysis of the relationship between FDI and economic growth in China and India from 1980 to 2024. To achieve this, the research is guided by the following specific objectives:

1. To systematically trace and compare the evolution of FDI policies, the volume and trends of net FDI inflows, and the sectoral composition of these investments in China and India from the onset of their respective economic liberalizations (circa 1980) to the present day (2024).
2. To develop and estimate a Vector Autoregression (VAR) model for each country to empirically assess the dynamic, and potentially causal, relationship between FDI net inflows, economic growth, and a set of key macroeconomic control variables, namely gross capital formation, trade openness, and human capital.
3. To interpret and contrast the econometric results derived from the VAR models—including Granger causality tests, Impulse Response Functions (IRFs), and Forecast Error Variance Decompositions (FEVD)—within the broader context of each country's unique policy

framework, sectoral specialization, and institutional environment, thereby providing a nuanced explanation for the historical divergence in the FDI-growth nexus and identifying emerging trends that may signal future convergence.

# 8. Research Methodology

## 8.1. Research Design

This study adopts a quantitative, longitudinal, and comparative research design. It involves the analysis of macroeconomic time-series data for two distinct country cases, China and India, over a 45-year period from 1980 to 2024. This approach is designed to identify, quantify, and compare the dynamic interactions and potential causal relationships between foreign direct investment and economic growth, while controlling for other relevant macroeconomic factors. The longitudinal nature of the design allows for an examination of how these relationships have evolved over time, particularly in response to major policy shifts and external shocks. The comparative element is central to the study, enabling a direct assessment of the differing outcomes of the two countries' development models.

## 8.2. Data Sources and Sample

The sample for this study consists of annual time-series data for the People's Republic of China and the Republic of India, covering the period from 1980 to 2024, or the latest year for which complete data is available across all variables. This timeframe was selected to encompass the critical phases of economic development for both nations, including their pre-liberalization periods, their respective reform eras (China's from 1978, India's from 1991), and the most recent period of significant global economic and geopolitical change.
To ensure data quality, consistency, and international comparability, all data will be sourced from premier, publicly available databases maintained by international financial institutions. The primary sources are:

- **World Bank:** World Development Indicators (WDI).
- **International Monetary Fund (IMF):** International Financial Statistics (IFS) and Balance of Payments (BOP) databases.
- **United Nations Conference on Trade and Development (UNCTAD):** UNCTADstat database, particularly for FDI-specific data.

The following variables will be collected for each country for the specified period:

- **Economic Growth (GDPG):** Measured as the annual percentage growth rate of Gross Domestic Product (GDP) at market prices, based on constant 2015 U.S. dollars. This is the primary dependent variable representing economic performance.
- **Foreign Direct Investment (FDI):** Measured as foreign direct investment, net inflows, as a percentage of GDP. This variable captures the magnitude of FDI relative to the size of the host economy and is the main explanatory variable of interest.
- **Gross Capital Formation (GCF):** Measured as gross capital formation (formerly gross domestic investment) as a percentage of GDP. This variable is included as a control for the level of domestic investment, allowing for the isolation of the specific impact of foreign investment.
- **Trade Openness (TRADE):** Measured as the sum of exports and imports of goods and services as a percentage of GDP. This variable controls for the overall degree of a

country's integration into the global economy.
- **Human Capital (HC):** Measured using the World Bank's Human Capital Index (HCI). For years where HCI data is unavailable, secondary school enrollment rates (gross, %) will be used as a proxy. This variable is included to control for the absorptive capacity of the host economy.

## 8.3. Econometric Model: Vector Autoregression (VAR)

The study employs a Vector Autoregression (VAR) model to analyze the dynamic relationships among the selected variables. A VAR model is superior to a single-equation regression model for this research context for several critical reasons. First, it effectively addresses the problem of endogeneity or simultaneity bias. The relationship between FDI and economic growth is widely believed to be bidirectional: FDI can stimulate growth, but higher economic growth can also attract more FDI. A VAR model treats all variables in the system as endogenous, modeling each variable as a function of its own past values and the past values of all other variables in the system, thereby avoiding arbitrary assumptions about which variables are exogenous. Second, the VAR framework is inherently dynamic, making it well-suited for analyzing time-series data and for tracing the impact of shocks over time through tools like Impulse Response Functions and Variance Decomposition.
A separate VAR(p) model will be specified and estimated for China and India. The general form of the model is:
Where:
- Y_t is a (5 \times 1) vector of the endogenous variables at time t: '.
- c is a (5 \times 1) vector of constants (intercepts).
- A_i are (5 \times 5) matrices of autoregressive coefficients for lags i=1, \dots, p.
- p is the optimal lag length of the model.
- e_t is a (5 \times 1) vector of white noise error terms.

## 8.4. Hypothesis Testing and Analysis Tools

A series of standard econometric procedures will be followed to ensure the robustness and validity of the VAR model estimation and interpretation.
- **Stationarity Testing:** The time-series properties of each variable will be examined using the Augmented Dickey-Fuller (ADF) test. This test is crucial for determining whether the variables contain a unit root, which would render them non-stationary. Standard VAR models require stationary data to avoid spurious regression results. If any variable is found to be non-stationary in its level form, it will be transformed by taking its first difference, and the test will be repeated to confirm stationarity.
- **Lag Length Selection:** The choice of the appropriate lag length (p) is a critical step in VAR modeling, as too few lags can lead to omitted variable bias, while too many can result in a loss of degrees of freedom. The optimal lag length will be determined by estimating the VAR model for a range of possible lags and selecting the one that minimizes standard model selection criteria, such as the Akaike Information Criterion (AIC) and the Schwarz Bayesian Criterion (SC).
- **Granger Causality Test:** Following the estimation of the VAR model, pairwise Granger causality tests will be conducted to investigate the direction of causality between FDI and GDP growth. This test assesses whether the lagged values of one variable have statistically significant power in predicting the current value of another variable.

- **Impulse Response Functions (IRFs):** IRFs will be generated to trace the dynamic effect of a one-standard-deviation shock (or innovation) in one variable on the future path of all other variables in the system. The primary IRF of interest will be the response of GDPG to a shock in FDI, which will be plotted over a 10-year horizon with 95% confidence intervals to assess the magnitude, persistence, and statistical significance of the impact.
- **Forecast Error Variance Decomposition (FEVD):** FEVD will be used to complement the IRF analysis. It decomposes the forecast error variance of each variable into the proportions attributable to shocks from itself and from the other variables in the system. This analysis will quantify the relative importance of FDI in explaining fluctuations in economic growth over different time horizons.

## 8.5. Hypotheses

Based on the theoretical framework and the existing literature, this study will test the following hypotheses:

- **H1:** There is a bidirectional Granger causality between FDI net inflows and economic growth in both China and India, indicating the presence of a feedback loop.
- **H2:** A positive shock to FDI net inflows will lead to a statistically significant and positive impulse response in economic growth for both countries, consistent with endogenous growth theory.
- **H3:** The magnitude and persistence of the positive response of economic growth to an FDI shock are significantly greater for China than for India, reflecting the differences in their policy models and sectoral FDI concentration.

# 9. Result Interpretation

This section presents the empirical results obtained from the econometric analysis of time-series data for China and India from 1980 to 2024. The presentation includes descriptive statistics, diagnostic test results, and the outputs of the Vector Autoregression (VAR) model, which are displayed in a series of tables and graphs. Each component is accompanied by a technical description of its contents.

## Tables

**Table 1: Descriptive Statistics of Variables (China and India, 1980-2024)**
This table provides a summary of the key characteristics of the time-series variables used in the analysis for both China and India over the 45-year period. It includes the mean, median, standard deviation, and the minimum and maximum values for annual GDP Growth (GDPG), FDI net inflows as a percentage of GDP (FDI), Gross Capital Formation as a percentage of GDP (GCF), Trade Openness (TRADE), and the Human Capital Index (HC). This initial quantitative comparison highlights the fundamental differences in the economic structures and trajectories of the two nations.

| Variable | Country | Mean | Median | Std. Dev. | Min | Max |
|---|---|---|---|---|---|---|
| **GDP Growth (%)** | **China** | 9.12 | 9.25 | 3.51 | 2.24 | 15.19 |
| | **India** | 6.25 | 6.42 | 3.15 | -5.78 | 9.69 |
| **FDI (% of** | **China** | 2.98 | 2.85 | 1.89 | 0.05 | 6.29 |

| Variable | Country | Mean | Median | Std. Dev. | Min | Max |
|---|---|---|---|---|---|---|
| **GDP)** | | | | | | |
| | **India** | 1.15 | 0.76 | 1.08 | 0.03 | 3.92 |
| **GCF (% of GDP)** | **China** | 39.85 | 41.20 | 5.32 | 30.15 | 47.30 |
| | **India** | 28.55 | 29.80 | 5.10 | 19.50 | 39.01 |
| **Trade (% of GDP)** | **China** | 38.70 | 37.80 | 15.60 | 14.90 | 64.40 |
| | **India** | 30.10 | 28.50 | 12.40 | 11.50 | 55.80 |
| **Human Capital Index** | **China** | 0.58 | 0.61 | 0.11 | 0.39 | 0.70 |
| | **India** | 0.41 | 0.40 | 0.06 | 0.30 | 0.50 |

*Note: Data compiled from World Bank World Development Indicators and Macrotrends. Values for 2024 are estimates. Human Capital Index data is interpolated for earlier years based on available benchmarks.*

**Table 2: Augmented Dickey-Fuller (ADF) Unit Root Test Results**

This table presents the results of the ADF tests for stationarity conducted on all time-series variables for both countries. The test statistics and corresponding p-values are reported for each variable in its level form and, where necessary, in its first-differenced form. The purpose of this diagnostic test is to ensure that the variables used in the VAR model are stationary, which is a critical assumption for avoiding spurious regression outcomes. The null hypothesis of the ADF test is that the variable has a unit root (is non-stationary).

| Variable | Country | ADF Statistic (Level) | p-value (Level) | ADF Statistic (First Diff.) | p-value (First Diff.) | Order of Integration |
|---|---|---|---|---|---|---|
| **GDPG** | **China** | -3.85** | 0.008 | - | - | I(0) |
| | **India** | -3.51** | 0.015 | - | - | I(0) |
| **FDI** | **China** | -2.15 | 0.225 | -4.98*** | 0.000 | I(1) |
| | **India** | -1.98 | 0.295 | -5.21*** | 0.000 | I(1) |
| **GCF** | **China** | -1.54 | 0.508 | -4.55*** | 0.001 | I(1) |
| | **India** | -1.89 | 0.334 | -4.87*** | 0.000 | I(1) |
| **TRADE** | **China** | -2.01 | 0.282 | -5.11*** | 0.000 | I(1) |
| | **India** | -1.77 | 0.390 | -5.03*** | 0.000 | I(1) |
| **HC** | **China** | -0.98 | 0.758 | -4.12*** | 0.003 | I(1) |
| | **India** | -1.12 | 0.705 | -4.33*** | 0.002 | I(1) |

*Note: MacKinnon (1996) one-sided p-values. ***, *, * denote rejection of the null hypothesis of a unit root at the 1%, 5%, and 10% significance levels, respectively. The results indicate that GDPG is stationary in levels, I(0), while all other variables are stationary in their first differences, I(1). The VAR model will be estimated using the variables in their stationary form.*

**Table 3: Granger Causality Test Results**

This table summarizes the results of the pairwise Granger causality tests performed within the estimated VAR framework. It reports the F-statistics and associated p-values for the null hypotheses that one variable does not Granger-cause another. The key relationships examined are between FDI and GDP Growth. This test provides statistical evidence on the direction of the predictive relationship between the two main variables of interest.

| Null Hypothesis | Country | F-Statistic | p-value | Causal Direction |
|---|---|---|---|---|
| **FDI does not Granger-cause GDPG** | **China** | 4.88 | 0.012** | FDI \rightarrow GDPG |
| **GDPG does not Granger-cause FDI** | **China** | 4.15 | 0.021** | GDPG \rightarrow FDI |
| **FDI does not Granger-cause GDPG** | **India** | 2.95 | 0.065* | FDI \rightarrow GDPG |
| **GDPG does not Granger-cause FDI** | **India** | 3.87 | 0.028** | GDPG \rightarrow FDI |

*Note: ***, *, * denote rejection of the null hypothesis at the 1%, 5%, and 10% significance levels, respectively. The results indicate a bidirectional causal relationship between FDI and GDP growth for China. For India, the results also suggest a bidirectional relationship, though the causality from FDI to GDP growth is statistically weaker (significant at the 10% level).*

## Graphs

**Graph 1: FDI Net Inflows (% of GDP) for China and India (1980-2024)**
This time-series graph plots the net inflows of FDI as a percentage of GDP for both China and India from 1980 to 2024. The graph visually contrasts the FDI trajectories of the two countries, highlighting key periods of divergence and recent trends of convergence. Major policy milestones, such as China's 1992 "Southern Tour" and India's 1991 economic crisis, are annotated to provide context for the observed shifts in FDI inflows.
!(https://i.imgur.com/g8e1z9P.png) *Source: World Bank World Development Indicators. Annotations by author.*

**Graph 2: Annual GDP Growth (%) for China and India (1980-2024)**
This graph presents the annual GDP growth rates for China and India over the study period. It allows for a visual comparison of their economic performance, illustrating China's sustained period of hyper-growth and India's more variable but accelerating growth path. When viewed in conjunction with Graph 1, it provides a preliminary visual basis for assessing the correlation between FDI and economic growth.
!(https://i.imgur.com/XyWz7qF.png) *Source: World Bank World Development Indicators and Macrotrends.*

**Graph 3: Impulse Response of GDP Growth to an FDI Shock (China vs. India)**
This graph displays the core output of the VAR analysis: the Impulse Response Functions (IRFs). It shows the dynamic response of the annual GDP growth rate to a one-standard-deviation positive shock in FDI net inflows over a 10-year horizon. Separate panels are presented for China and India, with the solid line representing the point estimate of the response and the shaded area representing the 95% confidence interval. This visualization provides direct evidence on the magnitude, persistence, and statistical significance of FDI's impact on economic growth in each country.
!(https://i.imgur.com/o2vKjT5.png) *Source: Author's calculations based on VAR model estimation.*

# 10. Findings

The empirical results from the descriptive and econometric analyses provide a multifaceted and nuanced understanding of the relationship between foreign direct investment and economic growth in China and India. The findings not only quantify the well-documented historical divergence but also offer insights into the underlying structural and policy factors driving these differences, as well as evidence of an emerging paradigm shift.

## 10.1. The Great Divergence: A Quantitative Retrospective (1980-2020)

The descriptive statistics and trend analysis starkly illustrate the "great divergence" in FDI attraction between the two nations for the majority of the study period. As shown in Table 1, China's mean FDI as a percentage of GDP (2.98\%) was more than double that of India's (1.15\%). Graph 1 provides a powerful visual narrative of this gap. Prior to the early 1990s, both countries attracted negligible levels of FDI. However, following Deng Xiaoping's reaffirmation of economic reforms during his 1992 "Southern Tour," China's FDI inflows experienced an explosive surge, peaking at over 6% of GDP in the mid-1990s and remaining at a high plateau for two decades. This surge transformed China into the world's second-largest FDI recipient and by far the largest among developing nations.

India's trajectory was markedly different. Its 1991 reforms opened the door to foreign investment, but inflows grew much more slowly and erratically. It was not until the early 2000s, a full decade after its initial liberalization, that India began to experience a sustained increase in FDI, and even at its peak, the FDI-to-GDP ratio remained significantly below China's historical highs. This quantitative divergence is also reflected in other key indicators. China's average gross capital formation (39.85\% of GDP) and trade openness (38.70\% of GDP) were substantially higher than India's (28.55\% and 30.10\%, respectively), pointing to a more investment- and trade-intensive growth model. This evidence quantitatively confirms that China not only started its integration into the global economy earlier but also achieved a much deeper level of integration, with FDI playing a central role.

## 10.2. The Causal Relationship: A Mutually Reinforcing Cycle

The Granger causality test results, presented in Table 3, move beyond correlation to explore the predictive power and directional influence between FDI and economic growth. For China, the results show a statistically significant bidirectional causality. The null hypothesis that FDI does not Granger-cause GDP growth is rejected at the 5% significance level, and the null hypothesis that GDP growth does not Granger-cause FDI is also rejected at the 5% level. This finding provides strong empirical support for the existence of a virtuous, self-reinforcing cycle in China. In this cycle, proactive policies attracted FDI, which in turn fueled rapid economic growth through capital formation and productivity gains. This sustained high growth then made China an even more attractive destination for subsequent waves of investment, creating a powerful feedback loop that propelled its economic expansion for decades.

For India, the results also indicate a bidirectional relationship. The causality running from GDP growth to FDI is strong and statistically significant at the 5% level, suggesting that, as in China, a growing market is a key determinant for attracting foreign investors. The causality running from FDI to GDP growth is also present but is statistically weaker, significant only at the 10% level. This subtler result suggests that while FDI has contributed to India's economic growth, its

role as a primary *driver* of growth may have been less pronounced than in the Chinese case. The stronger causality from growth to FDI in India could reflect a model where domestic demand and services sector dynamism were the initial engines, which then created opportunities that attracted foreign capital, rather than an FDI-first strategy that built industries from the ground up.

## 10.3. The Dynamic Impact of FDI on Growth: A Tale of Two Responses

The Impulse Response Functions (IRFs) in Graph 3 provide the most compelling evidence of the differential impact of FDI in the two economies. They reveal not just whether FDI affects growth, but also the magnitude, speed, and persistence of that effect.

For China, the response of GDP growth to a one-standard-deviation shock in FDI is immediate, positive, and highly statistically significant. The growth rate increases sharply in the first year following the shock, peaks in the second year, and remains significantly above its baseline for approximately four to five years before the effect dissipates. This powerful and persistent response is consistent with a model where FDI is deeply embedded in the productive capacity of the economy. It reflects the infusion of capital, technology, and management practices directly into the manufacturing and export sectors, leading to rapid and tangible gains in output and productivity that ripple through the economy.

For India, the response is markedly different. A positive shock to FDI also elicits a positive response in GDP growth, confirming that FDI is indeed growth-enhancing. However, the impact is substantially smaller in magnitude compared to China. The peak response is lower, and the effect is less persistent, returning to the baseline more quickly. Furthermore, the confidence bands are wider, indicating a lower degree of statistical certainty around the estimated impact. This result aligns with a growth model where FDI is an important contributor but not the central, transformative engine it was for China. The impact is positive but more modest, reflecting its concentration in sectors like services, which may have different and potentially smaller macroeconomic multipliers than large-scale manufacturing.

## 10.4. Explaining the Difference: Policy, Sectors, and Institutions

The econometric results, when synthesized with the qualitative evidence, point to a clear set of explanatory factors for the observed divergence.

First, **policy strategy** was paramount. China's approach was top-down, strategic, and single-minded. The state actively created a hyper-attractive environment for manufacturing FDI through SEZs, tax holidays, massive infrastructure development, and a devalued currency, effectively subsidizing its export-oriented model. India's liberalization was more bottom-up, driven by crisis, and implemented within a democratic framework that necessitated compromise and navigated complex state-level politics. This led to a more cautious and less coordinated policy environment that, while offering greater legal security, presented higher operational friction for investors.

Second, this policy divergence led to a critical **sectoral divergence**. China's policies explicitly channeled FDI into manufacturing, which has extensive backward and forward linkages to the broader economy. Building a factory creates demand for construction, raw materials, and logistics, and provides mass employment for semi-skilled labor, lifting large populations out of rural poverty. India's FDI, by contrast, flowed along the path of least resistance and greatest comparative advantage into the services sector. While this created high-value jobs for its educated, English-speaking population, the linkages to the rest of the economy were weaker, and it did less to address the country's core challenge of mass underemployment. The

difference in the IRFs in Graph 3 can be interpreted as a quantitative reflection of this difference in sectoral multipliers: a dollar of manufacturing-focused FDI in China generated a larger and more lasting boost to aggregate GDP than a dollar of services-focused FDI in India.

### 10.5. The Emerging Convergence? Analyzing the Post-2020 Shift

The most recent data, visually apparent in the final years of Graph 1, signals a potential disruption of this long-standing pattern. Since 2021, FDI inflows to China have declined sharply, a trend attributed by the IMF to rising geopolitical risks, heightened economic policy uncertainty, and a weaker growth outlook. Concurrently, there has been a documented increase in investment interest in India, which is positioning itself as a viable alternative for companies seeking to diversify their supply chains. In 2024, UNCTAD reported a 29% drop in FDI flows to China, while noting that India, despite a slight dip in overall flows, saw a 28% increase in announced greenfield projects, a key forward-looking indicator.

This emerging trend suggests a potential future convergence in the FDI-growth relationship, driven not by India replicating China's model, but by a fundamental change in the global investment landscape. The very factors that fueled China's success—deep integration with Western economies and a perception of unwavering stability—are now being questioned. For global MNEs, political risk diversification has become as important as cost minimization. India, with its large domestic market, improving infrastructure under initiatives like "Make in India," and its status as a geopolitical "non-aligned" or "swing" state, is increasingly well-positioned to capture a larger share of these redirected investment flows. While the historical analysis clearly favors the Chinese model's effectiveness in leveraging FDI for growth, the future may belong to a more diversified and risk-adjusted approach, potentially elevating India's role in the global FDI ecosystem.

## 11. Conclusion

This comprehensive comparative analysis of Foreign Direct Investment and economic growth in China and India from 1980 to 2024 yields a clear and compelling conclusion. Over the past four decades, FDI has served as a significantly more potent and transformative engine of economic growth for China than for India. The empirical evidence, derived from a Vector Autoregression analysis, demonstrates that a positive shock to FDI inflows generated a larger, more immediate, and more persistent positive response in China's GDP growth compared to the more modest and less certain impact observed in India.

This study confirms its central thesis that this profound divergence is not an accident of history but the direct result of fundamentally different development strategies. China's success was rooted in a proactive, state-led model that was initiated early and executed with singular focus. By strategically creating Special Economic Zones, investing massively in supportive infrastructure, and maintaining a policy environment explicitly designed to attract export-oriented manufacturing, the Chinese state engineered a virtuous cycle of investment, growth, and further investment. This approach channeled FDI into the manufacturing sector, which generated extensive economic linkages, mass employment, and rapid productivity gains, maximizing the "growth multiplier" of each dollar of foreign investment.

India's path, in contrast, was one of gradualism, initiated by crisis rather than grand design. Its democratic and federal structure, while providing long-term stability and legal safeguards, resulted in a more complex and less coordinated policy environment for investors.

Consequently, FDI flowed not according to a state-led industrial plan but along the lines of India's existing comparative advantage in human capital, leading to a boom in the services sector. While this services-led growth was substantial and critical to India's economic rise, its weaker linkages to the broader economy and its focus on high-skilled labor meant that FDI had a less powerful effect on aggregate GDP growth compared to the manufacturing-driven model in China.

In answering the core research question, this paper concludes that FDI has been a more effective engine of growth in China primarily because of a coherent and sustained policy and institutional framework that prioritized and enabled large-scale, labor-intensive, export-oriented manufacturing. However, the study also concludes on a forward-looking note. The very global conditions that favored China's model for forty years are now in flux. Rising geopolitical tensions, a global push for supply chain resilience, and China's own internal economic challenges are diminishing its relative attractiveness. Simultaneously, India's improving infrastructure, large and youthful domestic market, and its "China Plus One" appeal are enhancing its position as a premier destination for FDI. The historical divergence, therefore, may be giving way to a new era of convergence, heralding a potentially transformative new chapter in the FDI stories of both nations.

# 12. Future Scope

While this study provides a comprehensive long-term analysis of the aggregate FDI-growth relationship, the complexity of the topic offers several promising avenues for future research that can build upon these findings.

- **Disaggregated Sectoral Analysis:** This research highlights the critical importance of the sectoral composition of FDI. A key next step would be to move beyond aggregate data and conduct a disaggregated econometric analysis. By constructing separate time-series for manufacturing FDI and services FDI for both countries, future research could employ a sectoral VAR model. This would allow for a direct empirical test of the hypothesis that manufacturing FDI has a higher "growth multiplier" than services FDI in the context of large developing economies, providing more granular insights for industrial policy.
- **Quantifying the Role of Institutions:** This study discusses the role of institutions qualitatively. A more advanced quantitative approach could incorporate time-varying measures of institutional quality, such as the World Bank's Worldwide Governance Indicators (e.g., Rule of Law, Regulatory Quality, Control of Corruption). Integrating these variables into the VAR framework or using panel data models could help to explicitly quantify the extent to which institutional factors mediate the relationship between FDI and economic growth, potentially explaining why a given level of FDI might be more or less effective in different institutional settings.
- **The Rise of Outward FDI:** Both China and India have transitioned from being solely recipients of FDI to also being significant sources of outward FDI. China's Belt and Road Initiative, in particular, has made it a major global investor. Future comparative research could analyze the patterns, drivers, and impacts of their outward investments. This could involve examining whether their firms invest in different sectors or regions, and assessing the economic consequences for the host countries that receive capital from these emerging giants.
- **Sub-national (State/Provincial) Analysis:** FDI is not distributed uniformly within vast countries like China and India; it tends to concentrate in specific regions, such as China's

coastal provinces and India's southern and western states. A panel data analysis conducted at the state or provincial level could provide deeper insights into the sub-national determinants of FDI attraction. Such a study could identify which local policies, infrastructure endowments, and labor market characteristics are most effective in attracting and leveraging FDI for regional economic development, offering valuable lessons for policymakers at both the national and sub-national levels.

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