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**FDI from Developing and
Transition Economies:
Implications for Development**

**CHAPTER V
IMPACT ON HOME AND
HOST DEVELOPING ECONOMIES**



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IMPACT ON HOME AND HOST DEVELOPING ECONOMIES

Home as well as host economies can benefit from FDI from developing countries, but it may also carry some downside risks. The net outcome depends on various factors such as the level of development of a country, its economic structure and its policies, on the one hand, and the motivations of the TNCs, the industry of the investment and the mode of entry, on the other. The private gains of TNCs and the benefits to home and host countries may converge or diverge, depending on the precise context and on how effectively home- and host-country policy interventions are designed and implemented. This chapter examines the impact on home and host economies, while issues related to home- and host-country policies are analysed in chapter VI.

A. Impact on home economies

Traditionally, analyses of the impacts of FDI and TNC activities on developing economies have focused on their implications for host economies. With more developing and transition economies assuming importance as sources of FDI, it is relevant to pay attention to the implications for home countries as well. Outward FDI can contribute in different ways, directly and indirectly, to a home economy and its development. Arguably, the most important potential home-country gain from outward FDI is the improved competitiveness and performance of the firms and industries involved. Such gains may translate into broader economic benefits and enhanced competitiveness

– defined as the ability to sustain growth in an open setting (*WIR99*, p. 313) – for the home country by contributing to industrial transformation and upgrading of value-added activities, improved export performance, higher national income and better employment opportunities. At the same time, outward FDI may pose several risks for the home economy: outflows of FDI can result in reduced domestic investment and lower additions to capital stock, a “hollowing out” of parts of the economy and loss of jobs. The net outcome for a home economy depends, among other things, on the firms’ underlying motives and strategies for overseas investment and on the characteristics of the home economy.

Any analysis of the impact of outward FDI on home developing economies faces several problems. First and foremost, there are significant data limitations and few research results. Given that the expansion of FDI from developing countries is a fairly recent phenomenon, few studies have systematically assessed the impact of developing-country TNCs on their home economies. Thus any generalization of findings based on developed-country studies has to be interpreted with caution. Secondly, a complete assessment of potential impacts needs to consider the counterfactual (i.e. what would have happened had the investment not taken place). Such counterfactuals are typically hard to establish in practice. Finally, any analysis will partly draw on case studies of how individual firms have performed as a result of FDI. The pitfall of such partial assessments is that they risk leading to unjustified generalizations, and should therefore be interpreted with caution.

Bearing these caveats in mind, it is possible to identify potential benefits and costs for a home country. The starting point for the analysis of these various effects in the discussion below is to consider how internationalization via FDI may affect an investing firm's competitiveness and performance (section 1). The next question is how impacts at the firm level may translate into broader implications for the home economy, in terms of the competitiveness of its industries in general and various aspects of the economy as a whole (sections 2 and 3). Finally, there are a number of non-economic implications, such as those related to socio-economic, environmental and cultural concerns, which are briefly considered in the concluding section.

1. Outward FDI and the competitiveness of developing-country TNCs

The starting point for assessing the impact of outward FDI on the home economy is to examine how and to what extent internationalization via FDI influences an investing firm's competitiveness. Various approaches have been used to define and analyse competitiveness at different levels (firm, industry, region and country level) (Porter 1990, Boltho 1996, Fagerberg 1996).¹ In the context of an open market economy, the competitiveness of firms refers to their ability to survive and grow while attaining their ultimate objective of maximizing profits (and retaining or improving market share), and to adapt to changes in their internal and external environment in a way that guarantees their long-term operation.²

Generally speaking, an outward FDI project can benefit the home economy at large only if it has a positive impact on the overall performance of a parent company.³ However, whether it actually does so will depend on the precise context and the extent to which the interests of the firm coincide with those of the home economy as a whole. For an analysis of the impact of outward FDI on a firm's performance, various aspects of business outcomes need to be considered, including, for instance, a firm's financial results and market position. In addition, it is important to take a long-term perspective, especially on the sustainability of performance.

While outward FDI can contribute to a firm's competitiveness, it is also subject to risks inherent in projects undertaken abroad. First, a newly

established foreign affiliate has the disadvantage of being foreign, compared to established enterprises in the host economy. Second, additional problems related to cultural, social and institutional differences between home and host lead to higher coordination, governance and transaction costs (Hofstede 1980, Jones and Hill 1988, Roth and O'Donnell 1996).⁴ Third, companies face higher levels of complexity as they establish their presence in an increasing number of locations. Additional needs to integrate and coordinate activities, and concomitant organizational and environmental requirements may eventually exhaust managerial capacity (Siddharthan and Lall 1982). Finally, there are specific risks related to outward FDI and overseas operations, including financial risks – such as exchange-rate fluctuations – and political uncertainties.⁵ Some difficulties and risks are also associated with specific strategies adopted by developing-country TNCs in their processes of internationalization, such as entry through cross-border M&As.

In addressing the impact of outward FDI on the competitiveness of firms, it is useful to distinguish between asset-exploiting and asset-augmenting FDI (chapter IV, section A). An asset-exploiting FDI project may directly promote market expansion of a company, thereby contributing to a relatively quick improvement of financial as well as market performance. An asset-augmenting FDI project, on the other hand, will influence a firm's performance indirectly: access to resources and acquisition of strategic assets may help improve its competitiveness and, consequently, its long-term performance. The extent to which a firm benefits from such FDI depends on its ability to absorb and integrate the acquired assets into its activities.

As the contribution of outward FDI to market expansion takes place through various channels, and counterfactuals cannot easily be established, it is difficult to make a quantitative assessment of the contribution of outward FDI to market expansion of developing-country firms. However, results of many case studies and surveys confirm that it has enabled developing-country firms to enter new markets and expand their businesses in existing ones (Monkiewicz 1986, Yeung 1994, Hobday 1997, Hoesel 1999, Sachwald 2001, Mathews 2002, UNCTAD 2005). In a range of industries, such as white goods (box V.1) and personal computers (box V.2), a number of Asian TNCs have successfully expanded their market access through FDI and grown into global players. Some companies from other developing regions

have also ventured beyond their borders and become successful players in regional and even global markets (chapter III, section B). For instance, CEMEX (Mexico) has become the third largest cement-making company in the world, with more than two thirds of its sales in developed countries in 2005. Cross-border M&As have contributed significantly to its market expansion in developed countries since 2000 (ECLAC 2006a). The UNCTAD global survey (box IV.4) also indicates that the most frequently mentioned benefit developing-country TNCs perceived from their projects abroad, was market expansion in a broad sense (including market diversification) (about 40% of the responses; figure V.1).

Through efficiency-seeking FDI, firms can improve their competitiveness by accessing cheaper inputs of production or achieving economies of scale through vertical and horizontal integration. Rising costs in the home economy have been among the prime forces driving the growth of outward FDI by firms from some developing economies, in particular the East and South-East Asian NIEs since the 1980s (chapters III and IV). By relocating to neighbouring countries with lower labour costs, TNCs from Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China have enhanced their competitiveness in manufacturing (Tuan and Ng 1995, Nicolas 2001). In these economies rapidly rising labour costs have

Box V.1. How does outward FDI promote the market expansion of developing-country TNCs?

The case of white goods

The global white goods industry is characterized by mature technologies and rapid relocation of production to developing countries where input costs are lower and growth rates of demand are higher, giving latecomer advantages to developing-country TNCs in the industry (Goldstein et al. 2006). In addition to global players from the Republic of Korea, such as LG and Samsung, Haier (China) (chapter III, section B.3.a) and Arçelik (Turkey) are emerging as important developing country TNCs in this industry, with noticeable internationalization of their business operations (box table V.1.1). The two firms are still in their early stages of international expansion, but their reach has become increasingly global through accelerated FDI.

company changed its technological orientation in 2000, when it bought a minority stake in the United States company Ubicom, which produces chips for smart household devices. The company then adopted an internationalization strategy based on M&As, mainly in Europe. In 2002, it acquired Arctic (Romania's only refrigerator maker), and Blomberg (Germany), Elektra Brengesz and Tirolija (Austria), and Flavel and Leisure (United Kingdom). By June 2006, it had 12 foreign affiliates and 9 foreign plants.

Haier. After establishing a leading position for consumer electronics in the Chinese market, Haier made the decision to exploit foreign markets by gaining brand recognition and establishing local manufacturing facilities abroad.^b Since the mid-1990s, it has established 10 information centres and 6 design units abroad. It has also set up 13 factories in a wide range of countries, including Indonesia, the Islamic Republic of Iran, Malaysia, the Philippines and the United States. The establishment of a refrigerator plant in South Carolina and a design centre in Los Angeles in 1999 helped Haier bypass non-tariff barriers, reorganize its production structure and expand its market share in the United States. In 2005, it attempted to acquire Maytag (United States) for furthering its market expansion in that country, but eventually dropped its bid.

Box table V.1.1. Internationalization of Arçelik and Haier, 2004
(Millions of dollars and number of employees)

Firm	Country	Assets		Sales		Employment	
		Foreign	Total	Foreign	Total	Foreign	Total
Arçelik	Turkey	434	2 593	1 499	3 442	..	10 841
Haier	China	561	5 220	1 463	12 305	3 200	52 835

Source: UNCTAD, based on firm reports.

Arçelik. Part of the Koç Group – which also includes the electronics firm, Beko – Arçelik is Turkey's largest household appliances producer. It started its internationalization process through original equipment manufacturing (OEM).^a The

Source: UNCTAD, based on Akçaoglu 2005, Goldstein et al. 2006, and information from companies.

^a In 1998, it secured a contract in the United States to supply refrigerators under the Kenmore brand, followed nine years later by a European deal with Whirlpool for dishwashers (Root and Quelch 1997).

^b The company was transformed from an ailing enterprise controlled by the Qingdao Municipal Government in the mid-1980s.

Box V.2. How does outward FDI promote the market expansion of developing-country TNCs? The case of personal computers

Lenovo (China) and Acer (Taiwan Province of China) are the two largest personal computer (PC) makers from developing economies and the third and fourth largest, respectively, in the global PC market.^a Both companies are highly globalized, and their international market expansion has been driven by outward FDI. However, they have experienced different processes of global expansion and adopted different internationalization strategies.

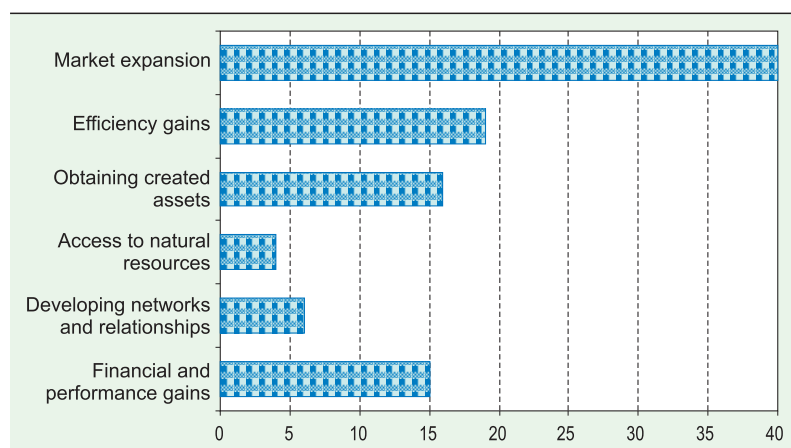
Acer's international expansion has been by far the most successful in Europe, which accounts for 60% of its sales. It established its first European affiliate in 1985. Since then, it has invested intensively in a distribution network

in Europe. The company now ranks third in the European PC market and has become the largest supplier in the laptop segment of that market. In comparison, the international market expansion of Lenovo started much later, but has entered a much faster track based on an ambitious M&A strategy. In December 2004, Lenovo acquired IBM's PC business, which accounted for about two thirds of its revenue in 2005. This deal has provided it with valuable strategic assets, such as brands and distribution networks. More importantly, it has helped the company rapidly extend its market reach and become a global company. Since early 2006, Lenovo has begun to promote its own brand in the United States and other developed countries.

Source: UNCTAD, based on press reports.

^a According to an estimate of the International Data Corporation, the global market shares of Lenovo and Acer were 7% and 4% respectively, following Dell (17%) and HP (15%) in 2005.

Figure V.1. Main benefits gained by developing-country TNCs from investing abroad: results of the UNCTAD global survey, 2006
(Per cent)



Source: UNCTAD global survey.

Note: Question: What are the three main benefits that conducting overseas operations have brought to your company? Responses were received from 41 companies. The figure gives the share of total responses for each type of benefit.

made outward FDI a necessity for companies in several industries during the past two decades. Many of them have successfully reduced production costs and maintained competitiveness by relocating part of their production abroad. According to one study, about 75% of the TNCs from the Republic of Korea surveyed for the study reduced their production costs by more than 20% through outward FDI (KCCI 2002). Similarly, electrical and

electronic equipment manufacturers in Taiwan Province of China have improved their competitiveness by investing in mainland China since the mid-1990s. For example, Hon Hai Precision Industry (chapter III, section B.3.a) has become the world's leading electronics manufacturing company by leveraging a cheap, 100,000-plus workforce in China.⁶ In the UNCTAD global survey, efficiency gains were reported to be an appreciable proportion of benefits (19% of responses, figure V.1) that developing-country TNCs obtained from FDI.⁷

Natural-resource-seeking FDI can also contribute to firms' competitiveness, a strategy increasingly adopted by developing-country TNCs in selected primary industries in recent years (chapters III and IV). Outward FDI allows developing-country TNCs to access resources beyond their national borders, and even on a global scale (chapter IV).⁸ In oil and gas and other mining industries, it is also an effective way for them to expand their production and reserves and sustain competitiveness. The largest oil and gas companies from developing and transition economies have

Table V.1. Top 10 cross-border M&A deals in the oil and gas industry by companies from developing and transition economies, ranked by the value of sales, 1987-2005

Target company (country)	Acquiring company	Value of sales (Millions of dollars)	Equity shares acquired (%)	Reserves added (Millions of barrels)	Year
PetroKazakhstan (Canada)	CNPC (China)	4 141	100.0	503	2005
Nelson Resources (Canada)	Lukoil (Russian Federation)	2 000	100.0	..	2005
Maxus Energy (United States)	YPF SA (Argentina)	1 844	100.0	209	1995
Egyptian LNG (Egypt)	Petronas (Malaysia)	1 766	35.0	..	2003
Sakhalin-1 consortium (Russian Federation)	ONGC (India)	1 700	20.0	460 ^a	2001
Gallo Oil Ltd (United States)	BT Bumi Modern (Indonesia)	1 311	97.5	..	2000
Perez Compans SA (Argentina)	Petrobras (Brazil)	1 028	58.6	730	2003
Greater Nile Petroleum (Sudan)	ONGC (India)	768	25.0	281 ^b	2003
Repsol-YPF's oil fields in Indonesia	CNOOC (China)	592	100.0	360	2002
Mangistau Oil & Gas (Kazakhstan)	Central Asia Petroleum (Indonesia)	576	70.0	..	1997

Source: UNCTAD, cross-border M&A database (www.unctad.org/fdistatistics). Reserves added are based on various newspaper accounts and company websites.

^a Total reserves (2,300 million barrels) adjusted by equity shares acquired (20%).

^b Total reserves (1,124 million barrels) adjusted by equity shares acquired (25%).

significantly increased their reserves through FDI, including through cross-border M&As (table V.1).

Part of outward FDI from developing countries is related to strategic-asset-seeking activities by their TNCs in developed countries (chapter IV, section B). Acquisition of assets such as technologies, skills, R&D facilities, brand names and distribution networks can permit leapfrogging by developing-country TNCs for the production of high-value products and services to enhance their competitiveness.⁹ This helps them move up the value chain (from manufacturing to R&D, branding and distribution) and establish a reputation in international markets. TNCs from developing economies such as China, the Republic of Korea, Taiwan Province of China and Turkey have indeed aimed at technological catch-up through overseas investment (Lee 2001, Li 2003, Sigurdson 2005 and *WIR05*) (see also box V.1). In the UNCTAD global survey, too, a significant number of TNCs regarded the obtaining of created assets as an important benefit from FDI (16% of responses, figure V.1). Another 6% of responses referred to the benefit of establishing or expanding networks and relationships, which can be regarded as created assets.

FDI can be used by developing-country TNCs as a means of technology-sourcing and learning in addition to other forms of partnership with developed-country companies (chapter IV, section B). Organizational learning, for instance, usually accompanies the internationalization process of TNCs (Sullivan 1994a, Hitt et al. 1997, Ruigrok and Wagner 2003). For example, Korean TNCs invested actively in the United States during

the 1990s and successfully tapped into technological resources in that country through minority shares in joint ventures (Kim 1997, Miotti and Sachwald 2001).

Firms' performances can be conceptualized on two dimensions: financial (e.g. return on assets and profitability) and operational (e.g. efficiency and market share).¹⁰ Early studies in the 1970s and 1980s hypothesized a linear and positive relationship between internationalization¹¹ and firms' performance, but yielded ambiguous results in empirical investigations due mainly to the omission of internationalization costs in the conceptual framework (Sullivan 1994a, Gomes and Ramaswamy 1999, Ruigrok and Wagner 2003). The findings of more recent studies indicate that the relationship exhibits a non-linear form, but they disagree on the shape of the curve.¹² Some studies, for instance (Lu and Beamish 2001), suggest a U-shaped relationship, which implies that a firm's performance declines in the early stages of internationalization, but improves later with more FDI.

Most of the empirical evidence in the literature on the performance of internationalization relates to TNCs from developed countries. Results of a few studies that focus on developing-country TNCs seem to support a positive impact of outward FDI on a firm's performance (Lecraw 1993, Pangarkar 2003, Chen and Chang 2005). For instance, Indonesian firms that invested abroad were found to have improved their performance dramatically after their investment, in terms of management expertise, exports, quality and assets, relative to their past performance and to the performance of firms in the sample that did not

make such investments (Lecraw 1993). A study on 100 business groups based in Taiwan Province of China generally supports a positive relationship between the degree of internationalization and financial performance, although the effect of internationalization on market value is not significant (Chen and Chang 2005). These findings are supported partly by the results of the UNCTAD global survey, with 15% of responses mentioning financial and performance gains as major benefits arising from FDI (figure V.1).

Case studies on latecomer TNCs from the East Asian NIEs provide additional evidence on the contribution of internationalization to the competitiveness and performance of firms (Hobday 1997, Oh et al. 1998, Hoesel 1999, Sachwald 2001, Mathews 2002, Sim and Pandian 2002, Li 2003). For example, a case study on Acer (Li 2003) shows that the company initially developed its ownership advantages through outward FDI, and its performance is positively correlated with its intensive use of strategic alliances in the process of internationalization. Another case study on Acer (Mathews 2002, chapter 3) shows that the company has leapfrogged its more traditional rivals through internationalization, expanding in developing countries in the mid-1980s (before tackling the Triad markets) and through global integration in the late 1990s. Some country studies suggest that

outward investing firms are more profitable than their domestically oriented peers, and others demonstrate that companies' profits increase as a result of FDI (Jaklic and Svetlicic 2005, Rumney 2005, UNCTAD 2005c). Furthermore, a recent survey of Chinese TNCs found that foreign operations tended to be more profitable than domestic operations (Yao and He 2005). For example, the profitability of China State Construction Engineering Corporation (CSCEC), one of the largest Chinese TNCs (chapter III.B), is much higher abroad than at home (box V.3). However, other evidence from China shows that rapid internationalization jeopardized the profitability of some investing firms. For example, TCL Multimedia Technology and TCL Communication Technology,¹³ two foreign affiliates of TCL Corp., reported greater losses due to difficulties in integrating their acquired overseas operations, including the television business of Thomson (France).¹⁴ And, in a recent survey by the Foreign Investment Advisory Service (FIAS) of outward-investing firms from China (box IV.4), one third of the firms reported that their FDI performance did not meet their expectations (Yao and He 2005). Another study focusing on cross-border M&As by Chinese firms found that, while nearly two thirds of the deals created value in the first year after announcement of the transactions, there was considerable divergence in performance,

Box V.3. Internationalization and profitability: the case of CSCEC

China State Construction Engineering Corporation (CSCEC) is one of China's largest construction companies and by far the most internationalized. It was established in the 1950s as a State-owned enterprise, and assumed its current name in 1982. With foreign assets of \$4.4 billion (37% of its total assets), the company is the third largest Chinese TNC (annex table A.I.12). Its profitability is much higher abroad than at home (box table V.3.1): for instance in 2005, foreign sales accounted for one quarter of its total sales, while foreign profits accounted for three quarters of its total profits. Thus internationalization has contributed significantly to the company's financial performance.

The high profitability of CSCEC's overseas operations can be attributed to a set of locational and organizational competitive factors. Most importantly, the experience gained in its overseas operations has helped the company control risks and costs in its further international expansion. As in the case of many Chinese companies, CSCEC's first stop in going global, its operations in Hong Kong (China) played an important role in giving it international experience and training its management team for further internationalization.

Box table V.3.1. Financial results of CSCEC, 2000 and 2005
(Millions of dollars)

		2000	2005
Value of contracts	Total	6 660	19 311
	Foreign	1 757	4 447
Sales	Total	5 853	14 163
	Foreign	1 889	3 359
Profits	Total	45	364
	Foreign	50	300
Assets	Total	8 256	13 083
	Foreign	2 985	5 578

Source: UNCTAD, based on information provided by CSCEC.

Source: UNCTAD, based on Sun 2006.

depending on the degree to which the deal required the integration of the two operations. Those that required comparatively low integration – either strategic investments in which the Chinese company bought a minority share and the foreign owner remained in control of operations, or acquisitions to gain access to natural resources or stand-alone assets – performed considerably better than the high integration deals including outright (100%) acquisitions (Boston Consulting Group 2006).¹⁵

To sum up, outward FDI can help firms achieve various strategic objectives, such as expanding market access, enhancing efficiency and acquiring natural resources and strategic assets. It also creates channels through which firms can move up the value chain, enter into higher value-added activities and improve their competitiveness. However, outward FDI is subject to various risks and difficulties, which can entail costs. Thus sound corporate strategies and adequate managerial capabilities are crucial for firms to maximize their net benefits from internationalization. Government policy can play a role in creating an environment conducive to investment, thereby helping firms take advantage of opportunities for internationalization and strengthen their competitiveness in a globalizing world economy (chapter VI).

2. Outward FDI and the competitiveness and restructuring of home-country industries

In developing as in developed countries, the interactions between the foreign and domestic operations of TNCs and the connections between their home-base operations and other domestic businesses will by and large determine the impact on the home economy. However, a positive contribution of an FDI project to a firm's competitiveness is not a sufficient condition for the project to be of net benefit to the economy at large. Due to the possible divergence of private and public interests, as well as the possibility of market or government failures, what is good for a company may not necessarily be good for its home economy.

Outward FDI affects a home economy through its direct effects on that country's economic activity, as well as indirect effects through various channels by which the improved competitiveness of outward investing firms can be transmitted to

the rest of the economy. A key area of impact relates to effects on the competitiveness of industries (in terms of efficiency and productivity), and the consequent upgrading and restructuring of industries in the home economy – an issue examined in this section.

a. Industrial competitiveness

The enhancement of industrial competitiveness in an economy involves four interrelated types of upgrading of industries in general: process upgrading, product upgrading, functional upgrading (expanding activities in the value chain) and chain upgrading (moving to a new value chain) (Kaplinsky and Morris 2001, *WIR05*). Outward FDI can help promote competitiveness of all these types. In developing countries, a number of cases suggest that it has played a role in strengthening competitiveness of particular industries, for instance, IT services and software in India, telecom equipment manufacturing in China, PC peripherals and semiconductors in Taiwan Province of China and biotech in Singapore, and a range of manufacturing and service industries in Hong Kong, China.

As discussed above (section A.1), under appropriate conditions, international production through FDI can improve the competitiveness of developing-country firms. To the extent that outward-investor firms are an important part of particular industries, those industries are directly affected. More importantly, this improvement can be transmitted to other firms and economic agents in home countries – within the industries concerned as well as outside – through various channels, resulting in a wider influence on the performance of various industries. The channels include:

- Linkages with local firms;
- Spillovers to local firms;
- Competitive effects on local business (including crowding in/out);
- Linkages and interactions with institutions such as universities and research centres (i.e. the national innovation system in general).

In all economies, whether developed, developing or transition, the interaction of outward investing TNCs with home-country enterprises and other economic agents is one of the key determinants of the economic impact. For instance, the more supplier linkages parent companies have with businesses at home, the more likely it is that

the home base will share with the TNC the benefits of outward expansion. In Hong Kong (China), for example, over the past decade, the expansion of outward FDI to newer and higher technology industries (using “soft” technology) has produced important forward and backward linkages with home-based firms and activities (Chen and Lin 2005). Over time, these developments have led to the emergence of a cluster of producer services (supply chain management, customer relationship management, transportation and storage, product design and promotion), especially in support of enterprises based in Hong Kong (China) and operating in China.

The impact of developing-country TNCs on industrial competitiveness in their home economies through linkages with other firms depends to some extent on the internationalization path that the TNCs take (Yeung 2006). Differences in the degree of development of industries in developing countries are likely to result in an uneven internationalization of firms from an economy, led by the more advanced sectors/industries. That may have major implications for the development and competitiveness of less advanced industries. Again, much depends on the extent, nature and scope of linkages that exist between the internationalized and primarily domestic industries and between firms in the more and the less advanced groups of industries.

Spillovers from TNC parents to other domestic firms are often a function of the existence of industry clusters in the home economy. Such clusters tend to be the main venue for effective spillovers from firms engaged in outward FDI (Zander 1999, De Propris and Driffield 2006). In terms of competition effects, a key issue is whether the improved competitive strength of outward investing firms in the home base – a typical consequence of outward FDI – leads to efficiency-enhancing or anti-competitive behaviours on the part of TNCs. Which of the two effects dominates depends partly on the structure of the domestic market (to what degree domestic firms are competitive) and on a possible policy intervention by competition authorities (chapter VI). In terms of linkages with the national innovation system,¹⁶ these will depend largely on the extent of clustering of private and public agents of technological progress located in the home territory, including partnering between TNCs and other firms, and between TNCs and universities, public research institutions and other public entities (UNCTAD 2005k). As TNCs have privileged access to sources

of knowledge abroad, their contribution to such partnering can be crucial (Reddy 2000).

The impact of outward FDI on the technological base of the home country is of particular importance in the context of the industrial competitiveness of developing countries. Gains for the home economy include feedbacks in technology resulting from the FDI (particularly important where the investment is in a technologically more advanced economy); extra business for technology suppliers in the home country; and (unique to FDI compared with other forms of technology export) control over the use of the technology. Outward FDI can augment technological capabilities in the home economy through the provision of training and technology spillovers from operations abroad (Globerman et al. 2000). On the other hand, there is also scope for a spillover of knowledge to competing firms in the host countries (Zander 1991). Here, the motivation of TNCs is likely to be a determining factor. For example, in strategic-asset-seeking projects, which are gaining importance in developing-country FDI in developed countries, the net balance of technology flows can be expected to be positive for the home economy, while efficiency-seeking projects are more likely to have the opposite effect.

In general, the impact of FDI on the technological capacity of the home country depends on various factors such as the type of FDI, the conditions under which it occurs, the home and host countries involved and the time horizon being considered (Dunning and Lundan forthcoming). Moreover, a cost-benefit analysis of the technological implications of outward FDI has to take into account the alternative costs of other scenarios of technology links, such as the costs of not exporting technology, as well as the benefits of outward FDI in terms of a restructuring of domestic technological activities.

Reverse transfer of technology (Hobday 1995), whereby knowledge acquired by foreign affiliates is channelled back to the home country, is one of the most important ways of mitigating the risks and concerns about the potential erosion of the home country’s technological edge. Furthermore, with the globalization of knowledge, technology flows are increasingly a two-way phenomenon, so that inflows and outflows may mutually reinforce each other. This makes it more difficult to base an evaluation of the impact on technology and skills simply on the balance of knowledge flows.

Reverse transfer and two-way flows of technology are particularly relevant issues for home developing economies, and they are likely to have a significant impact if the host country is relatively advanced technologically and the home country has sufficient absorptive capacity for effective use of the imported technologies (*WIR05*). Such technologies can be applied in the home country to develop new products and processes for global markets. In 2003, 21 of the 289 affiliates of TNCs from developing Asia in Japan were engaged in R&D. Moreover, their R&D expenditure per affiliate (238 million yen) came relatively close to that of United States affiliates (332 million yen) (Japan, METI 2006).

Concerning outward FDI as a means for strengthening technological capacity, the priorities of developed and developing home countries are expected to be similar. However, there may be strategic differences between TNCs from the two groups of countries: developed-country TNCs may focus more on controlling knowledge creation (Cantwell and Janne 1999, Kuemmerle 1999, Le Bas and Sierra 2002, Patel and Vega 1999, Roberts 2001) and developing-country TNCs more on accessing technologies abroad. Developing-country TNCs and their home countries in general tend to give considerable importance to technology monitoring units (*WIR05*), which shows that they rely heavily on outward FDI as a channel to acquire or upgrade technology. For example, a study of large Chinese TNCs in the mid-1990s found that the strategies of these firms were “strongly internationally oriented” (Young et al. 1996, p. 304), with an increasing emphasis on investment for technological progress, resulting in faster technological improvement than in their domestic (non-TNC) peers.

In the area of managerial expertise and knowledge, outward FDI has been found to be an important channel for example for Chinese TNCs to acquire marketing skills from abroad (Young et al. 1996, p. 312). It can also have a positive impact on managerial practices and affect the skills composition of employment in the home country, increasing the share of management jobs and reducing that of blue-collar jobs (Blomström et al. 1997 and Lipsey 2002b, for the United States). There are also large differences between industries. More mature and less technology-intensive industries typically provide less room for exchange of skills and knowledge than technology-intensive industries.

b. Industrial restructuring

To improve the competitiveness of their industries and indeed, their economies generally, countries need continuously to restructure their economies; that is, they need to change the composition of output, employment and exports, across sectors, industries or types of activities as they grow (*WIR95*). This can be accomplished by the successful transmission of TNCs’ competitiveness to domestic business through the channels discussed above (subsection a). If the resources released due to improved performance or the relocation of low value-added activities are utilized in high value-added activities, this reflects an upgrading of the value chain, which suggests a stronger competitive position of the economy.

Restructuring and upgrading are particularly important areas for developing economies seeking to sustain economic growth and move towards higher value-added activities. Outward FDI is, of course, only one of several international channels for accessing the resources, markets and capabilities needed for industrial upgrading and restructuring in an open economy. Other channels include inward FDI, imports, contractual arrangements and alliances between domestic and foreign firms. Generally, a combination of various channels is involved. The link between outward FDI and home-country restructuring is not necessarily straightforward or automatic; for instance, in the case of efficiency-seeking FDI, new lines of production at home following relocation of activities to foreign sites may not be more productive than the ones replaced. Moreover, the economic gains from restructuring may involve high social costs, for example in the form of structural unemployment resulting from higher capital or skill intensity that may persist for an extended period (*WIR95*).

One area of concern regarding the impact of outward FDI on restructuring relates to the possible “hollowing out” of the domestic production base, leading to a loss of related skills. As “hollowing out” often denotes the loss of manufacturing capabilities, and not of capabilities in services, part of this concern may be a perception problem, where service activities are considered less valuable than manufacturing. Indeed, hollowing out, relocation and deindustrialization are terms usually used together (Chen and Lin 2005). However, to the extent that manufacturing carries unique knowledge and processes that service industries cannot

provide, concern about hollowing out, in the sense of loss of manufacturing industries, has some basis.

When large-scale relocation of manufacturing occurs, the creation of jobs and knowledge in services may well be more limited than the losses in manufacturing. Such a scenario is more probable in efficiency-seeking projects than in others, and more likely to occur in small high-income countries than in larger and lower income home countries. In the developing world, for instance, Hong Kong (China), Singapore and Taiwan Province of China are the most prominent cases of relatively important and rapid structural change in the home base and a massive transfer of manufacturing jobs.

Empirical evidence on outward FDI and restructuring in developing countries is limited and relates mainly to the East and South-East Asian NIEs.¹⁷ In the case of Hong Kong (China), for instance, a massive transfer of labour-intensive manufacturing operations, mainly to China, since the 1980s has changed the nature of the home economy (Chen and Lin 2005), with the physical and human resources released from relocation shifting successfully to services. According to the Hong Kong Labour Department, from 1987 to 1992, almost 400,000 manufacturing jobs were lost in the territory, whereas 450,000 jobs in the services sector were created. The challenge was to help displaced manufacturing workers with retraining in vocational skills, with special emphasis on middle-aged workers. Retraining proved to be crucial as parent firms located in Hong Kong (China) moved quickly towards high-value-added activities, such as design, management and consumer-oriented production. Taiwan Province of China's experience with managing hollowing out has been somewhat different, reflecting the differences in the structure and size of the home economy (Schive and Chen 2004): it specialized more in electronics production, and its upgrading resulted in higher-value added manufacturing more than services.

The restructuring of the first group of NIEs in developing Asia – Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China – through outward FDI has been viewed as the continuation and extension of the “flying geese” phenomenon. This phenomenon started in the 1960s when outward FDI from Japanese labour-intensive industries such as food, beverages, tobacco, textiles, apparel and leather (*WIR95*, p. 241) contributed to the industrial upgrading of the first-tier NIEs and their emergence as outward

investors. Their successful restructuring helped create new home countries, and, combined with the liberalization of inward FDI policies in the region, their investments in turn helped in the restructuring of a second tier of NIEs (such as Malaysia, the Philippines and Thailand). This second group has since then also become a source of outward investment targeting lower income countries (such as China and Viet Nam). Increasingly, the restructuring has involved not so much a movement from lower technology industries to higher technology ones as much as from lower value-added activities along the value chain to higher ones (UN Millennium Project 2005).

The flying geese pattern of the division of labour through outward and inward FDI and trade, observed in East and South-East Asia, while not easily replicable in other regions, offers a notable example of continued and relatively smooth redeployment of economic activities between countries at different levels of development (Ozawa 1979). The efficiency-seeking strategies of Japanese and NIE-based TNCs that led to the emergence of this pattern have been complemented, as highlighted above, by outward FDI strategies aimed at acquiring assets and knowledge abroad, which helped reinforce the emerging comparative advantages in higher value activities. A similar pattern is emerging with respect to FDI from newer outward-investor economies from Asia that are investing within and beyond their region. There are also signs that countries in other regions are embarking on outward FDI in lower segments of industries built up with the help of inward FDI. One example is outward FDI and outsourcing of lower value segments of clothing production by firms from Mauritius, while they retain higher value activities in that country (UNCTAD 2005j).¹⁸

3. Macroeconomic, trade and employment effects in the home economy

While enterprise and industrial competitiveness is probably the most important development effect of outward FDI on the home economy, and an overriding concern guiding national and international policies in this respect (chapter VI), the implications of outward FDI for development go beyond industrial competitiveness. The discussion in the sections that follow looks at the potential impact of outward FDI on home-county financial flows and balance of payments,

investment and capital formation, employment and trade (especially exports), and reviews empirical evidence on these various aspects, all of which have implications for the sustainability of industrial competitiveness as well as economic growth generally.

a. Financial resource flows and balance of payments

Financial flows related to outward FDI include outflows of capital from the home country and a wide range of directly or indirectly related inflows such as investment income, royalties, fees and service charges associated with the FDI (*WIR95*, p. 220). Outward FDI projects tend to result in net financial outflows in the balance of payments of the home country in an initial phase. But this gradually changes to net inflows once the direct investment yields returns in the form of income and other payments (cf. Rodriguez 1980, UNCTC 1993, Whichard and Lowe 1998, *WIR99*). These can be quite important in countries with relatively large FDI outflows; for instance, in 2005 alone, Singapore derived almost 20% of its gross national income from factor income from abroad, predominantly in the form of overseas investment income (Toh 2006). However, the relationship between inflows and outflows can vary over time; subsequent investments or reinvested earnings can tilt the balance again towards increased net financial outflows.

Data for selected developing economies with a longer history of outward FDI in the United States show that balance-of-payments inflows directly associated with outward FDI tend to be significantly higher than the direct balance-of-payments outflows resulting from outward FDI (taking into account intra-firm trade, among others) (table V.2). For the Republic of Korea, that difference exceeded \$16 billion while it was negative in Kuwait in 1992 and 1997, in Brazil in 1997 and in the United Arab Emirates in 1992.

Aside from the question of the balance of inflows and outflows, a major concern for some home countries relates to the potential for capital flight in a broad sense. The business environment of developing home countries tends to be less stable than that of developed home countries, hence there may be an incentive for some firms to create “safety nests” by investing abroad, even in situations where investment at home would be more profitable.¹⁹ Furthermore, as highlighted in chapter III, some developing-country TNCs invest large

amounts of FDI in offshore financial centres such as Bermuda, the British Virgin Islands and the Cayman Islands, or engage in round-tripping investment (e.g. Chinese TNCs – see box I.1). Such transactions are often less transparent than other FDI deals, requiring special care in their management.

Financial flows related to outward FDI could contribute potentially to either a gain or a loss of financial capital for investment in the home economy. Some developing-country TNCs invest abroad explicitly to gain access to developed-country financial markets in order to reduce reliance on or supplement funding from the home base. An example is South African TNCs investing in the United Kingdom in order to get listed on the London Stock Exchange (chapter III, section B.2). Although no comprehensive statistics are available to compare the extent of financing raised in host or third countries by developing-country versus developed-country TNCs, the relatively underdeveloped financial markets in the home bases of many of the former would suggest their greater dependence on foreign sources and earnings of affiliates abroad for financing foreign expansion.²⁰

Moreover, in some developing home economies, outward FDI financed from domestic sources could be viewed as a loss of financial capital that could have been used for investment

Table V.2. Balance-of-payments impact^a of FDI in the United States, selected developing home economies, 1992-2002
(Millions of dollars)

Economy	1992	1997	2002
Brazil	530	-296	1 762
Mexico	365	3 110	1 539
Venezuela	3 165	2 745	..
South Africa	..	120	7
Kuwait	-208	-167	..
United Arab Emirates	-12	9	..
Hong Kong, China	621	2 027	528
Korea, Republic of	1 978	4 564	16 787
Malaysia	380	761	296
Philippines	199	257	..
Singapore	1 207	18	1 046
Taiwan Province of China	179	1 855	1 719

Source: UNCTAD.

^a Calculated by subtracting FDI outflows as reported in the balance of payments from the sum of all positive items associated with FDI outflows. The positive items include repatriated profits from affiliates in the United States; trade effects (exports less imports associated with FDI outflows, in this case between parent firms and their affiliates in the United States); and royalty and licence fee payments to the parent company.

at home (de Mooij and Ederveen 2003). This may be the case, for instance, when outward FDI occurs because certain developing-country firms (or State-owned TNCs) accumulate large financial resources – that may be derived, for example, from export revenues or high prices of natural resources – and envisage using them abroad for various reasons. From the TNCs' point of view there may be limited investment opportunities in the home country, but from the home country's perspective there may be many socially desirable projects that require additional investment, implying a divergence of TNC and country interests. Another reason may be the aspiration of firms to leapfrog to global status, prompting them to move to developed economies (chapter IV, section B.3.d).²¹ In addition, TNCs from natural-resource-poor countries may invest abroad in a rush to secure the supply of those resources. Past experience, such as that of Japanese FDI in finance and real estate in the early 1990s (Farrell 2002), suggests that part of these outflows indeed result in losses, although the degree of net losses has not been quantified. Moreover, the counterfactual – investing at home – is difficult to quantify, especially where deficiencies in the domestic business environment are the main push factor for outward FDI (chapter IV).

The financial impact of outward FDI on the home-country's economy can also be influenced by the interactions between outward investing TNCs and the home-country's public finances. On the one hand, the government may subsidize the outward investment of firms, as in the case of the Chinese Government's support to the Lenovo-IBM and CNPC-PetroKazakhstan deals (chapter VI); and on the other, the government may use budget revenues to acquire control over outward investing TNCs as happened in 2004 and 2005 in the oil and gas industry in the Russian Federation. In both cases, the opportunity costs of these expenditures raises questions. Support or resources devoted to large companies can raise concerns generally about their implications for competition and welfare. For example, the close to \$20 billion spent on the three main purchases in the Russian Federation (Locatelli 2006) could perhaps have been used for other, more welfare-enhancing purposes.

b. Domestic investment

From the perspective of development and growth, what happens to domestic investment or capital formation is perhaps the most common benchmark of the impact of outward FDI. This is

so not only because domestic investment is a major source of GDP growth, but also because it allows measuring to what degree the allocation of resources to projects abroad leads to a fall or rise in domestic investment. It thereby throws light on complementarity versus substitution between foreign and domestic investment (Dunning and Lundan forthcoming).

Evidence of the impact of FDI from developed countries on domestic capital formation tends to support, with some exceptions, the hypothesis that it has a positive impact on home-country investment.²² In most of the developing home economies, the impact may be expected to be similar to that observed in developed countries.²³ In the case of Singapore, a high-income developing country with one of the highest ratios of FDI outflows to GFCF (22% in 2005) (annex table B.3), outward FDI flows have been observed to have a delayed but marginally positive impact on GFCF with a two-year lag (Wu et al. 2003).²⁴ However, differences in impact can be expected due, for example, to differences in motivations or the stage of outward FDI, or to differences in domestic resource endowments. For instance, Chinese and Indian TNCs are, at least for the time being, less motivated by the search for more efficient locations (chapter IV), as their home countries offer efficient production bases. This pattern is different from that of the early internationalization of firms from Taiwan Province of China and Hong Kong (China), which started locating labour-intensive activities abroad much earlier. The motivation to access technologies abroad again can be interpreted as a factor leading to the elimination of an important bottleneck to development, and hence enhancing domestic investment.

c. International trade

The relationship between outward FDI and home-country trade depends to a large extent on the motivations of a country's TNCs. If the TNCs seek natural resources, outward FDI could enhance the imports of those resources and exports of the inputs required for extraction. Market-seeking FDI can be expected to boost exports of intermediate products and capital goods from the home to the host country. If the motivation is efficiency or cost-reduction, as in the case of some FDI from the Asian NIEs, outward FDI would be expected to enhance exports as well as imports, especially intra-firm trade, their extent and pattern depending on

the geography of the TNCs' integrated international production activities. The relationship between outward FDI and trade also depends on industry characteristics such as the tradability of the goods and services produced by that industry. If tradability is limited or non-existent, as in the case of many services, there will obviously be few, if any, measurable direct trade effects. It is only in tradable goods and services that the question of whether outward FDI enhances or displaces the exports of the home country assumes relevance, although it is important to note that FDI in tradable services – an important area for FDI from developing countries – can contribute to increased exports of tradable products from home countries.

Empirical evidence from developed countries, notably the United States and Sweden, has generally found FDI and home-country exports to be complements rather than substitutes, with a positive relationship between the two (Dunning and Lundan forthcoming). At the same time, evidence of substitution has been found in studies at a more disaggregated industry or product level (see, for example, Frank and Freeman 1978 for the United States, and Svensson 1996 for Sweden). In high-income developing home economies, outward FDI, especially when located in other developing countries, was found to be a contributory factor for enhancing exports (Lim and Moon 2001 for the Republic of Korea, Liu and Lin 2001 for Taiwan Province of China, Ellingsen et al. 2006 for Singapore). In the Republic of Korea, the intra-firm trade of outward investing TNCs was reported to create a trade surplus of \$6.8 billion in 2003 alone (Moon 2005, p. 17). On trade in intermediate goods, the 1992 survey of the Hong Kong Census and Statistics Department found that 72% of total imports from China and 74% of total exports to China were related to outward FDI in processing in China (Chen and Lin 2005). Apparently, parent companies from those countries and their foreign affiliates maintain close ties via intra-firm trade. This intra-firm trade has forward linkages affecting other industries of the Hong Kong (China) economy and its export potential. In the case of Singapore, a model of the growth of non-oil exports from 1995 to 2000 found a clear-cut positive correlation with the growth of outward FDI stocks in both the manufacturing and non-manufacturing sectors (Wu et al. 2003). Singapore's non-oil exports to China and Taiwan Province of China grew robustly, at more than 6% per annum over the period of observation, in line with the strong growth of outward FDI between these economies.

Data for 1992, 1997 and 2002 on intra-firm trade by United States affiliates of TNCs from a number of developing countries indicate that, in the majority of cases, affiliates' imports from the foreign parent group exceeded their exports to the foreign parent group (United States, Department of Commerce, various issues).²⁵ For foreign affiliates of all the countries combined, the value of intra-firm imports was well over twice that of exports in all three years. Evidence on the activities of affiliates of developing-country TNCs in Japan also suggest that most of their FDI is trade supporting. In 2003, 178 of their 358 affiliates were engaged in wholesale or retail trade (Japan, METI 2006). Their imports from their parent firms based in South, East and South-East Asia alone amounted to 634 billion yen (\$5.5 billion), accounting for 3% of Japan's total imports from the region.

When applying the past experience of developed-country TNCs to the current situation of emerging developing-country TNCs today, it is important to consider major changes in the world economy that have taken place since the 1960s and 1970s. There has been a shift in the world economy, and in global FDI, towards services. In services (other than trading) the potential replacement or generation of exports by FDI is limited by the fact that in many cases such investment is the only way to serve foreign markets (*WIR04*). The implications of greater trade liberalization and globalization are also worth noting. For instance, in global competition, the need for a quick reaction has resulted in "truncated" product cycles. In order to capture and retain foreign markets, TNCs from both developed and developing countries often need to engage in exports and FDI simultaneously, and sometimes FDI may even need to precede trade (see Aizenman and Noy forthcoming, Blonigen 2001, Markusen 2002, Markusen and Venables 1998). This development, as highlighted by the evidence above, is related not only to globalization but also to the growing importance of intra-firm transactions in TNC networks.

d. Employment

Employment is one area of impact where the interests of outward investing TNCs and their home governments may diverge. While a TNC may be interested in optimizing the use of labour or human resources within its global corporate network, the home government may be interested in maximizing the employment in its home base. A summary of evidence from various developed home countries

in the late 1980s and early 1990s (Agarwal 1997), however, concluded that the divergence of interests may be relatively small: on balance, the impact of outward FDI on employment in the home economy was small; it was only efficiency-seeking outward FDI that raised questions about job relocation.²⁶

While most empirical evidence suggests a small and marginally positive impact of outward FDI on aggregate employment, certain activities and groups of employees could be seriously hurt (WIR95, p. 221), calling for active labour market policies (chapter VI). In particular, there is a perception in developed countries that outward FDI increases the insecurity and risk of loss of home-country employment and reduced wage levels (Scheve and Slaughter 2001).

Whether outward FDI reduces or increases employment in the home base depends on the kind of investment undertaken, the complementarity/substitutability of the activity abroad in comparison to the home country, and the degree to which inputs are sourced from the home country (Dunning and Lundan forthcoming). Efficiency-seeking FDI is likely to have a greater impact on home-country employment, especially when it involves relocation of activities at the lower end of the value chain. Under a best-case scenario for the home economy, investment abroad can boost demand for high-level skills and managerial services and exports of intermediate goods from the home country, leading to structural change, and not necessarily reduced employment, in the home economy. Under a less favourable scenario, investment abroad can substitute for activities in the home base. The latter is more likely to occur if the cost (or other business) conditions of the home country are unfavourable, at least in the initial phase of the investment.

Evidence on the employment effects of outward FDI on home developing countries is limited, but what little exists suggests that they are probably similar to those in developed countries. In the case of high-income developing economies such as Taiwan Province of China, outward FDI to all countries was found to generate additional jobs for technical workers and managers over the period 1993-2000, while employment of unskilled labour was adversely affected to a small degree by outward FDI directed to China (Chen and Ku 2003, p. 22). On balance, the job-creating effect of outward FDI exceeded its job-substituting effect. In the case of Singapore, the growth of outward FDI was estimated to create 33,600 jobs

in the manufacturing sector between 1995 and 2000 (Wu et al. 2003). Another recent study concluded that concerns regarding adverse effects of outward FDI on Singapore's labour market are unfounded, in particular because there is no evidence that outward FDI has replaced exports (Ellingsen et al. 2006).

A survey of industrial firms in Brazil in 2000 throws light on the qualitative impact of outward investment on that middle-income country's employment. Compared to uniquely domestic firms, Brazilian TNCs with investments abroad employed people with higher levels of education, offered them more stable employment, and paid them almost three times the wages paid by their domestic counterparts (De Negri et al. 2005). In this respect, Brazilian TNCs with FDI abroad behaved in a manner similar to that of foreign affiliates located in Brazil. There is also some evidence of upgrading of human resources through professional training in the home base of some developing-country TNCs following their outward FDI (see Young et al. 1996 for China).

Some of the impacts of outward FDI from lower-income developing countries on home-country employment may be different from those of outward FDI from NIEs and other developing countries due to the nature of their home economies. For example, their manufacturing TNCs may continue to find the most cost-efficient locations for production at home, and their foreign affiliates may specialize in other activities such as sales or product development. In those cases, there may be limited, if any, export of jobs. On the other hand, there may be instances of management opportunities being limited in the home country, especially when developing-country TNCs invest in developed markets, as these TNCs may prefer to hire managers from the developed host countries.

4. Concluding remarks

The impact of outward FDI on the home economy arises from the improvement of competitiveness of outward investing firms, and depends on whether that leads to improved competitiveness for industries in general and the economy as a whole. The latter depends, in turn, on the improved competitiveness of a country's TNCs being diffused to other enterprises. It also depends on the effects of outward FDI on key economic variables such as the availability of financial resources for investment, exports and employment. In most of the cases observed (related

mainly to developed home countries), there appears to have been a net positive impact. Although evidence specific to FDI by developing-country TNCs is limited, given its relatively recent emergence, in many respects, it can be expected to have a similar impact on the home economy to FDI by TNCs from developed countries. Moreover, studies indicate that outward FDI from developing countries has a positive effect on the investor firms' performance and that in some developing countries, mostly in South-East and East Asia, outward FDI has been one of the factors of successful industrial restructuring, alongside sustained economic growth.

The effects of outward FDI on developing home countries go beyond its economic impact to include the political, social and environmental consequences for those countries. Rigorous analysis of those issues is scarce. Thus only certain concerns or considerations can be highlighted. For example, the political implications of outward FDI in a developing home country may be significant, as suggested by the fairly frequent intervention of the government in FDI-related decisions. In the area of environmental protection and corporate governance, global presence and investment in countries with stricter standards can have important demonstration effects on developing-country TNCs and their conduct of business in their home base. In matters such as transparency of corporate activities, for instance, the requirements for revealing information to stakeholders abroad spills over frequently to the home country.²⁷

For policymakers, the fact that competitiveness is a key issue for the home economy has major implications (chapter VI). Moreover, as the impact is contextual, and depends on circumstances, policies can play a major role in maximizing the benefits and minimizing the negative impacts of outward FDI for the home economy. Policymakers have to weigh the potential social costs and benefits of allowing or supporting outward FDI in areas such as local production capabilities, productivity, employment and capacity for innovation. This is especially true with respect to policies dealing with the general economic conditions surrounding outward FDI. Moreover, to the extent that the difference between perceived social and private benefits of outward FDI outweigh the cost of measures to support it, such policies may be justified in the context of broader industrial development strategies. These issues are discussed in chapter VI.

B. Impact on host economies

FDI, whatever its source, affects the economic welfare, growth and development of host countries in a number of ways (*WIR93*, *WIR99*). First of all, in any host country, FDI manifests itself in the form of TNCs establishing local operations, usually through one or more affiliates each. These foreign affiliates interact with the local economy by building production facilities and hiring workers, many of whom will require training. Second, since the affiliates are constituent elements of the TNCs involved, they are parts of the TNCs' respective value chains, both within the host country and internationally. They establish backward (with suppliers) and forward linkages (with distributors and sales organizations), which can stimulate production in supplier and distributor firms and organizations in the host country and constitute a channel for the transfer of technology. To that extent, FDI has an amplified effect on the local economy beyond the initial direct effect of affiliates' operations. Third, the affiliates might have a variety of indirect, spillover effects on local firms, for example through the impact of competition that might spur local firms to improve their performance; or, conversely, they might induce failures because of affiliates' greater efficiency. Finally, potential increases in employment and income due to the entry of FDI projects might result in multiplier effects on the entire host economy while, at the same time, potential crowding out of that economy's domestic enterprises by FDI might have the opposite impact.

The extent and nature of these effects and the net outcome for a host economy depend, among other factors, on the scale of the initial FDI, the technology used, the number of people employed and the training and wages offered, the market orientation of foreign affiliates in the economy, the degree to which the affiliates procure goods and service inputs locally, and the proportion of profits reinvested, as well as the conditions prevailing in the host economy.

This section examines the impact that FDI from developing countries can have on host economies, focusing almost entirely on host developing economies. Section 1 below briefly outlines the potential areas of impact of FDI and problems related to its assessment. It also considers whether the distinction between FDI from

developed and developing countries matters when it comes to host-country impact. Section 2 reviews various areas of impact of developing-country FDI on host developing economies, drawing on relevant data and research findings. It focuses, to the extent possible, on whether the impact of FDI by developing-country TNCs differs from that of TNCs from developed countries. The concluding section highlights the main findings and their limitations, as well as the need for further work, and touches briefly on the implications of developing-country FDI for host developed economies.

1. Assessing host-country impact

FDI comprises a bundle of assets, some of which are proprietary and others are not. Key assets include, for instance, capital, technology, management techniques, skills and market access. Non-proprietary assets (e.g. finance, capital goods and intermediate inputs) can be obtained, at least in part, from international markets, but proprietary assets can be obtained only from the firms that create and possess them. Of the proprietary assets that TNCs make available to their affiliates in host countries, with direct effects on production quantity and quality and possible indirect effects and spillovers to the host economy, the most important is probably technology. But there are others such as brand names, skills, the ability to organize and integrate production across countries, and privileged access to markets (*WIR99*, p. 316). Taken together, these advantages mean that FDI can contribute to the economic performance of host countries and, in particular, to the development objectives of host developing countries. On the other hand, FDI entails risks for host developing countries when the objectives of TNCs and those of the host countries do not match.²⁸

The economic impact of FDI is difficult to measure with precision. The FDI package varies from one host country to another, and is difficult to separate and quantify. Where FDI entry has large (non-marginal) effects, measurement is even more difficult: there is no precise method of specifying a counterfactual (i.e. what would have happened if a TNC or TNCs had not made a particular investment or investments). The assessment of the development effects of FDI generally resorts to one of two approaches. One is an econometric analysis of the relationships between inward FDI and various measures of economic performance. The second is a qualitative analysis of various aspects

of TNCs' impacts, without any attempt at calculating a precise relationship or rate of return. The latter approach, which is the one adopted in the discussion of host-country impact below, includes, in particular, a consideration of the ways in which the unique characteristics of TNCs interact with the unique characteristics of countries (Dunning 1993, p. 284).

The above observations with respect to the impact of FDI and its assessment apply to FDI in general as well as to FDI from developing countries. However, as the analysis in the preceding chapters shows, developing-country FDI tends to differ in several respects from FDI from developed countries:

- It is located more in developing countries than in developed countries, and over the years South-South FDI has been increasing significantly in value (chapter III);
- It accounts for a larger share of inward FDI in developing countries, especially LDCs (chapter III); and
- The motivations, locational advantages sought, and competitive strengths or ownership-specific advantages of developing-country TNCs differ in several respects from those of TNCs from developed countries (chapter IV).

These differences have implications for the role and impact of developing-country FDI on host economies, and in particular, its role in development.

2. Impact on host developing economies

The entry of developing-country TNCs into host developing countries presents benefits as well as risks for the host economies. The main beneficial impacts are derived from the access to resources and markets that their foreign affiliates secure as a result of being part of the international production systems of the respective TNCs. The financial capital generated, mobilized and invested by developing-country TNCs can be important in terms of supplementing domestic savings and investment for output and productivity growth in the host economies. Advanced technologies that can be transmitted to local firms can also make important contributions, although perhaps to a lesser extent than those that developed-country firms can provide. Large developing-country TNCs have

established their own systems for generating new knowledge through R&D. Some TNCs from the Republic of Korea, such as Samsung Electronic, Hyundai Motor and LG Electronics, already figure prominently on the list of the 700 largest R&D-spending companies in the world (*WIR05*, pp. 150-151). The leading software firms of India, such as Infosys, Wipro, Birlasoft (part of Aditya Birla Group) and HCL Technologies, are also globalizing their R&D, focusing mainly on serving their customers in specific markets. In China, two electronics TNCs, Huawei and Haier, are illustrative of the trend of R&D units being located mainly in developed countries. Similarly, the IT company, Ingenuity Solutions (Malaysia), and the pharmaceutical firms, Bionova (Mexico) and Cordlife (Singapore), have targeted the knowledge base of the United States when investing in R&D abroad.

If the technological gaps between host-country firms and foreign affiliates of developing-country TNCs are smaller than those with affiliates of developed-country TNCs (as is likely to be the case), that may facilitate the transfer, absorption and diffusion of knowledge or competencies. Moreover, the production activities of developing-country TNCs can generate jobs that add to the level and quality of host-country employment. Furthermore, the privileged access of foreign affiliates to intra-firm markets within TNC-systems, and their advantageous access to the wider marketing networks established by the respective TNCs, provide opportunities for promoting host-country trade through exports by foreign affiliates as well as by other host-country firms.

The main advantage of developing-country FDI, compared to developed-country FDI, for host developing economies is in the similarity of the economic conditions between the home and host countries. To begin with, this means that it may be easier for the host countries to attract developing-country TNCs as the latter may be more comfortable operating in similar economies, even when their firm-specific competitive advantages are relatively less well-developed. Moreover, while developing-country TNCs often lag behind their developed-country counterparts in terms of technological assets and capabilities, their specific business models and competencies may make them more adept at operating in developing host countries. The greater tendency of developing-country TNCs to concentrate on labour-intensive industries and the higher likelihood of their using more labour-intensive manufacturing technologies,

suggest that their potential for employment generation may also be greater than that of FDI from developed countries. Furthermore, some of the main source developing countries of South-South FDI, such as Brazil, China and India, are also fast growing markets, and therefore establishing trade links through hosting their TNCs can yield substantial benefits in terms of exports.

However, FDI from developing countries, like FDI generally, can also impose costs and create concerns for host developing economies. It can result in crowding out of domestic firms if the latter are less competitive or if the foreign affiliates operate in oligopolistic markets with weak regulatory frameworks. Foreign affiliates of developing-country TNCs may not establish strong linkages with domestic enterprises, and therefore the opportunities they offer for the dissemination of technologies and knowledge in host economies may be limited. The employment conditions and practices in foreign affiliates established by developing-country TNCs may fall short of norms and standards followed by other firms. These risks highlight the need for adequate and effective policies for maximizing the net benefits of FDI from developing countries, as with FDI from developed countries.

a. Financial resource flows and investment

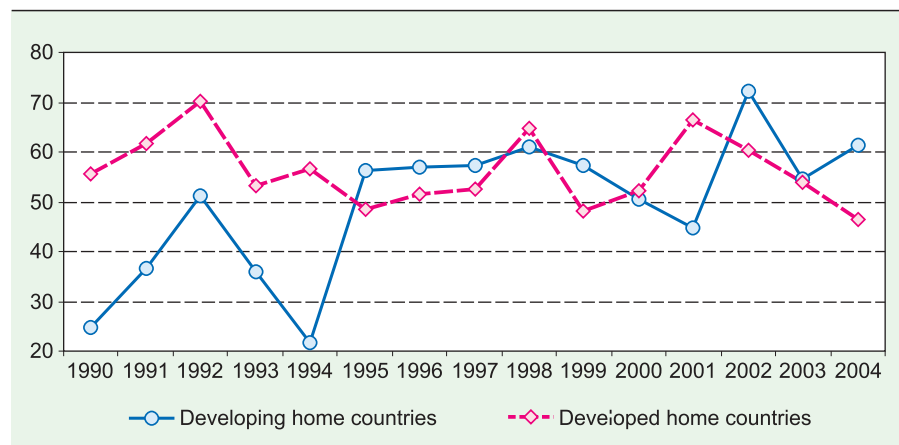
As noted in chapter III, FDI from developing countries accounts for a larger share of FDI flows to developing countries than of flows worldwide. It constitutes a large part of FDI in many host developing countries, especially LDCs. Except in extractive industries, developed-country TNCs are less likely to invest in poorer economies with small markets, whereas developing-country TNCs tend to invest in neighbouring developing countries with a similar or lower level of development than their home country (chapter III). The latter also appear to have somewhat different priorities in selecting a location (chapter IV), and they are increasingly investing in poorer, riskier and more remote countries that are not necessarily the preferred locations of developed-country TNCs. The share of FDI from developing economies therefore tends to be greater in countries with lower real GDP per capita, and in some LDCs its share exceeds 50% (figure III.10 and table III.9). Thus, developing-country FDI flows, though modest in global terms, may be significant for many developing countries especially LDCs that are trying to supplement

domestic savings with external financial inflows, raise investment rates, and accelerate income and employment growth. And, as TNCs from developing countries are expected to invest increasing amounts in other developing countries, their importance in this respect could intensify. In the UNCTAD global survey (box IV.4), 70% of TNC responses to a question on favoured locations for new affiliates over the next five years cited developing countries. This is 15% higher than the share of developing locations in existing foreign affiliates.

Like FDI from developed countries, FDI inflows from developing countries are generally likely to be more stable than foreign commercial debt or portfolio investment. Moreover, balance-of-payments data show that, compared with TNCs from developed countries, developing-country TNCs repatriated less of their income on FDI to their home countries in the first half of the 1990s (figure V.2). This suggests that they spent a higher share of profits for reinvestment than developed-country TNCs. However, since the mid-1990s, there has not been much difference between the two in terms of the propensity to repatriate profits and this share in total FDI income fluctuated at 50%-60% (figure V.2).

In the short run, the impact of FDI on investment or the establishment of new production facilities in host countries varies according to whether FDI is in the form of greenfield investments or cross-border M&As. Greenfield projects may be the only option in many LDCs, but where the choice exists, developing-country TNCs also engage in cross-border M&As. In general, however, developing-country TNCs use cross-border M&As less as a mode of investment than do developed-country TNCs (*WIR00*). This is also confirmed by UNCTAD's global survey of developing-country TNCs (figure V.3). But when it comes to host developed countries, they often use M&As, because, given their technological position vis-à-vis developed-country firms, in those countries it is easier for them to take over existing

Figure V.2. Share of repatriated profits in total income on outward FDI flows, 1990-2004
(Per cent)



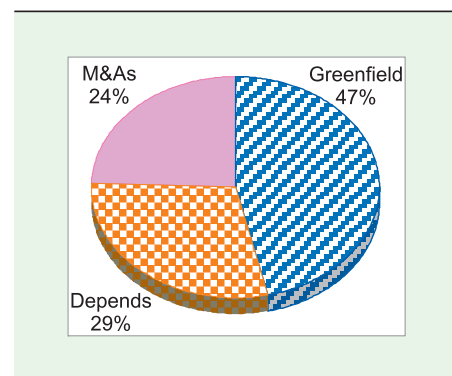
Source: UNCTAD, based on the April 2006 *IMF Balance of Payments Statistics*.

Note: Data for "developing home countries" cover 43 developing economies and South-East Europe and CIS, and those for developed countries cover 33 developed economies. Only economies for which data on both FDI flows and repatriated earnings are available are included.

plants and adapt them for their own production purposes.

FDI from developing countries adds directly to investment and production capacity – immediately in the case of greenfield FDI, and through frequently occurring sequential investments in the case of cross-border M&As. Data on sales

Figure V.3. Preferred mode of establishment of overseas affiliates by developing-country TNCs, 2006
(Percentage of response from TNCs)



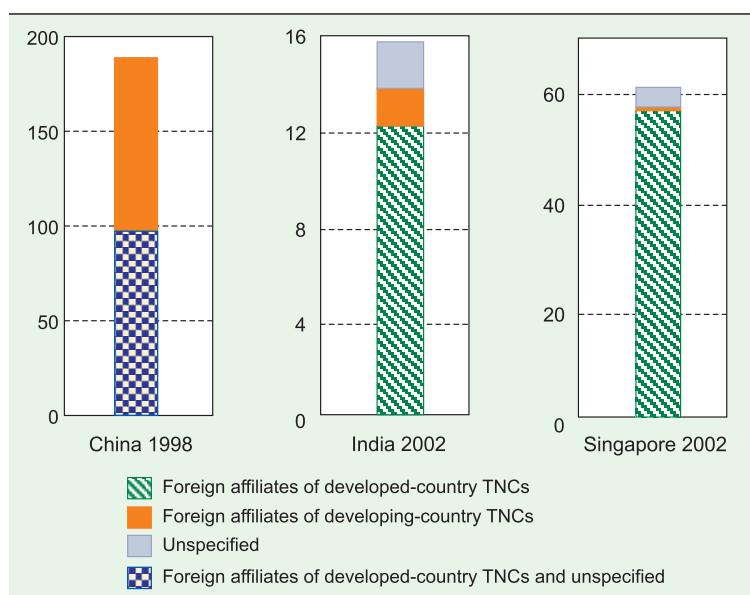
Source: UNCTAD, based on the global survey described in box IV.3.

Note: Based on 41 TNCs. Question: When establishing an overseas affiliate, do you prefer to establish a new company (greenfield) or buy an existing one (M&A)? Depends means that it depends on the individual investment case.

by foreign affiliates, albeit limited to a few countries, provide an idea of its relative importance in production: for example, affiliates established by TNCs from developing countries and transition economies accounted for a half and one tenth of total sales of all foreign affiliates in China (1998) and India (2002) respectively (figure V.4).

Figure V.4. Sales of foreign affiliates established by developed- and developing-country TNCs, various years

(Billions of dollars)



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

Besides the activities that developing-country TNCs themselves undertake, the linkages and spillovers that they generate can catalyze domestic investment, enterprise development and supply capacity in host developing countries. This depends significantly on the extent of linkages that foreign affiliates establish with domestic firms, especially for sourcing supplies. Sourcing behaviour in turn depends on the motivations and strategies of TNCs, whether from developed or developing countries: efficiency-seeking FDI (in production of goods and services for international markets) can generally be expected to have fewer linkages with host-country firms for supplies. In general, certain attributes of developing-country TNCs suggest that they may establish strong linkages with domestic firms in host developing countries, at least in manufacturing.²⁹ The most important of these are their technologies and the markets in which they

operate: foreign affiliates of developing-country TNCs are more likely to be engaged in producing standardized products with mature, non-proprietary technologies that are more conducive to the use of externalized, arm's length procurement of supplies. Thus, not only are developing country TNC affiliates less likely to need associate firms from home countries with special supplier capabilities but they are also less likely to have associate firms with sufficient capabilities to undertake investment abroad. Therefore, local firms can be expected to stand a better chance of becoming suppliers of affiliates of developing-country TNCs than suppliers of affiliates of developed-country TNCs.

However, finding new suppliers and forming relationships with them is not necessarily a simple task. Developing-country TNCs, many of which are newly expanding firms, may find it difficult to forge such linkages. Evidence from some surveys suggests that developing-country TNC may lag behind their developed-country counterparts with respect to local sourcing. For example a UNIDO survey of foreign firms in 15 sub-Saharan African host countries found that local sourcing (purchasing of materials) by affiliates of firms from developed countries accounted for an average of 43% of sales, while that by developing-country TNC affiliates accounted for an average of 34% (UNIDO 2006, p. x).³⁰ The lower ratio of local sourcing by developing-country TNC affiliates may be related to differences in date of entry and length of experience of the two groups of firms in the African host countries covered: older established firms in the sample were mainly from developed countries and newcomer firms, mainly from developing countries (UNIDO 2006, p. 52). Results of another, smaller survey of foreign affiliates in the ASEAN-5 countries³¹ also showed that the share of locally sourced input was much larger (33%) for affiliates of developed-country TNCs than for those of developing-country TNCs (19%).³² However, this difference was probably largely due to the predominance of the garments industry among the developing-country foreign affiliates in the sample surveyed, which rely heavily on imported inputs.

b. Technology and skills

Technology generation is concentrated in the more advanced developed countries and takes place mainly in large TNCs based in those countries, which in turn are among the main sources of new technology to developing countries. However, while technological advantage is a powerful determinant of outward FDI from developed countries, it plays a smaller role in the internationalization of production by developing-country firms. This limits the role of developing-country TNCs in the transfer and dissemination of technology to host developing countries. On the other hand, the technologies used by developing-country TNCs are likely to be more suitable for developing countries and, to the extent that the technologies are more advanced than those available domestically, FDI from developing countries may better contribute to technological upgrading in host developing countries than FDI from developed countries.

The tendency of developing-country TNCs to establish joint ventures with host-country enterprises may also enhance the prospects for technology transfer and dissemination. The UNCTAD global survey (box IV.4) has found that more than half of the 41 respondents to the question on the mode of entry to foreign markets³³ had some form of joint ventures abroad. For almost a quarter of respondents, joint ventures accounted for more than 40% of their foreign affiliates. A relatively high share (30%) of joint ventures is in primary activities. Given their limited experience, developing-country TNCs are more apt to involve a local partner who is familiar with host-country bureaucracy and the business environment in general. The advantage of forming a joint venture from the perspective of technology diffusion within the host economy is that the local partners and the affiliate, which would be vested with a certain amount of technological and managerial expertise transferred from the parent firm, are likely to have close contacts and exchanges of personnel. Forming a joint venture is therefore the most obvious - and possibly the most effective - means by which local firms can acquire knowledge from TNCs.

Another condition that appears to encourage spillovers of technology in the case of developing-country FDI in developing countries is that the gap in the levels of technology between foreign affiliates and local firms is sufficiently small. Studies on the impact of FDI from developed countries draw similar conclusions and suggest that

positive spillovers are greatest in industries in which the technology gap between host and home countries and between foreign affiliates and local firms is small (Kokko 1996, for Mexican manufacturing and Liu et al 2000, for United Kingdom manufacturing). A study on spillover effects of FDI on Turkish manufacturing concluded that where the initial technology gap was sufficiently small, domestic firms were able to close the gap, whereas where the gap was larger than a critical level, it would widen even further in subsequent years (Aslanoglu 2000).

These findings suggest that there is a greater advantage for host developing countries of entry by developing-country TNCs than entry by developed-country TNCs in terms of spillover effects for technology diffusion. A developing-country TNC might be able to make an investment project succeed precisely because it uses an alternative technology and a business model that are more suited to the absorptive capacity of the host economy. And, since their technologies can be demonstrated to work in such conditions, it would be easier for local firms to acquire and absorb the technologies used by developing-country TNCs.

The turnover of employees is a channel through which knowledge can be diffused from foreign affiliates to the rest of the economy. From the firm's point of view, however, the departure of trained workers is a loss. Thus, the more the workers who are trained (and hence valuable to the rest of the economy), the harder the firms will try to retain them. The findings of the above-mentioned survey of foreign affiliates in the ASEAN-5³⁴ indicate a higher turnover ratio of labour in affiliates of developing-country TNCs (5.0%) than in those of developed-country TNCs (3.6%). The difference between the two groups of TNCs can perhaps be explained by the differences in skill requirements as indicated by foreign affiliates' expenditures on human resource development: on average, developed-country TNCs devoted an amount equivalent to 2.6% of the foreign affiliates' payroll to human resource development while the corresponding figure for developing-country TNCs was 0.5%. However, as noted above in the context of local sourcing, the results of this survey may be biased by the fact that a majority of the developing-country affiliates were from the textile and garments industry. In Africa, according to the UNIDO survey, developing-country TNC affiliates spent more on training than those of developed-country TNCs. As discussed

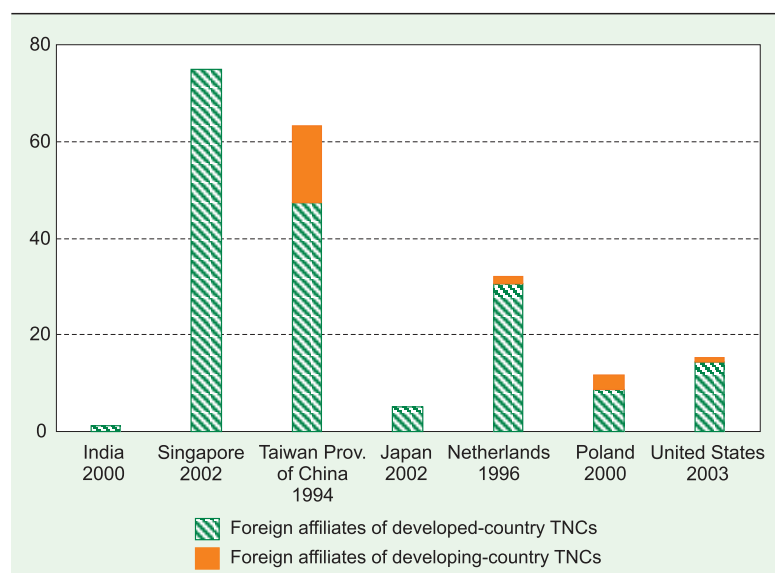
below (subsection B.2.d), the difference is due to significantly higher training expenditures by large affiliates of developing-country TNCs than those of similar size from developed countries. Other evidence, related to FDI in textiles and clothing in the export processing zone in Mauritius, in which Asian FDI plays an important role, also suggests that developing-country TNCs attach significant importance to training (Susanne and Pearce 2006).

The creation of linkages with host-country firms provides another channel for the transfer and diffusion of technology to host developing countries. In general, efficiency-seeking FDI and market-seeking FDI are often associated with the creation of linkages, while resource-seeking FDI and asset-seeking FDI tend to offer few such opportunities. In forming backward linkages, developing-country TNCs may provide technical assistance to local suppliers with a view to improving the quality (e.g. fewer defects) of the intermediate goods supplied to them and widening the range of products (e.g. products matching the specific requirements of the foreign affiliates). One example of such assistance involving a developing-country TNC is the cooperation between the Indian affiliate of LG Electronics (Republic of Korea) and its local suppliers (*WIR00*, p. 144). In another case, Tata Motors (India), which has assembly operations in Bangladesh, Malaysia, and South Africa was reported to be carrying out an SME upgrading support programme in these developing host locations, which included “technical support for development as well as quality, project guidance, tooling support, financial support, training support, guaranteed business and raw materials support in special nature” (UNCTAD 2005n, p. 14). To the extent that developing-country TNCs possess characteristics better suited to linkages with local suppliers than do developed-country TNCs (see subsection B.2.a above) their potential development impacts may be greater than those of developed-country TNCs.

In addition to the transfer and dissemination of technology, foreign affiliates can contribute towards strengthening host-country technological capabilities by locating R&D activities in host economies. Data on R&D expenditures by foreign affiliates in India show that developing-country

foreign affiliates contributed about 15% of total R&D expenditures of all foreign affiliates in the country and to a low of 0.1% of total gross domestic expenditures on R&D (figure V.5). In the case of Taiwan Province of China where foreign affiliates contribute more than 60% of the country’s business enterprise R&D expenditures, developing-country affiliates alone accounted for 16% of the total in 1994 (the most recent year for which the data are available) (figure V.5).

Figure V.5. Share of R&D expenditures of foreign affiliates of developed- and developing-country TNCs in total gross domestic R&D expenditure, selected host countries, various years
(Per cent)



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

Note: Data for the Netherlands and Poland refer to majority-owned affiliates only.

c. International trade

The impact of FDI on host-country international trade will differ, depending on its motive – whether it is efficiency-seeking, market-seeking, resource-seeking or strategic asset-seeking. Output resulting from efficiency-seeking FDI is typically intended for export, and therefore the impact of such FDI is likely to be an increase in exports from the host country. If local firms supply inputs to affiliates producing goods for export, the local content of value-added exported would be that much greater. In cases where intermediate goods are imported from outside the host economy, efficiency-seeking FDI will increase exports as well as imports. Nevertheless, since certain value-adding processes take place within

the host economy, the overall impact will be an improvement in the trade balance in the long run.³⁵

Given the differences in the motivation and characteristics of FDI from developing countries as compared with that from developed countries, it can be expected to differ somewhat from the latter in terms of impact on host-country trade. As noted in chapter IV, efficiency-seeking is a relatively less important motive for FDI from developing-countries than for FDI from developed countries. However, it is growing, and plays an important role in generating exports from developing countries – including LDCs – in specific industries, the most important of which is textiles and garments. In particular, TNCs from Asian NIEs have built up competitive advantages in the course of their export-oriented industrialization process. As wage levels at home have risen, they have extended their production activities to foreign locations in their quest for lower cost labour, especially for the manufacture of garments and some electrical and electronic products. In the garments industry, beginning with locations in Asia, their reach now extends to numerous host countries in all developing regions. The pattern of their geographic spread has also been influenced by the textile quotas and preferential market access offered under arrangements such as the African Growth and Opportunity Act (AGOA) of the United States. For example, Lesotho, a small African country, has attracted FDI into export-oriented manufacture of clothing (box V.4).

In the case of market-seeking FDI that is oriented primarily to the host-country market (rather than the regional market), the impact on trade will be mostly on imports, because foreign affiliates are likely to purchase some intermediate products from outside the host country, while their output is intended for the domestic market. The direction of the impact would, however, depend on whether, pre-FDI, the goods or services foreign affiliates produce were being imported into the host economy. Market-seeking FDI can reduce a host country's imports if FDI results in local production that replaces imports. If, however, the host economy is a completely new market for the TNC, it could result in an increase in imports of intermediate inputs. A substantial part of FDI by developing-country TNCs, especially in host developing countries is market-seeking in nature, much of it in trade-supporting and financial services. In manufacturing, it is often geared to

producing goods more suited to the level of economic development of host countries – such as \$50 television sets produced by TCL in Viet Nam and \$2,000 cars produced by Maruti Suzuki in India (Battat and Aykut 2005). At least a part of such manufacturing FDI is likely to replace imports, or potential imports, of similar products by host countries.

Resource-seeking FDI, almost by definition, results in exports from the host economy. Such investment has been rising in importance in FDI from developing countries, including in host African and Latin American countries (chapters III and IV). In this context, the impact of developing-country FDI in oil and gas extraction in other developing countries is noteworthy. Since large oil and gas TNCs have traditionally originated from a handful of developed countries, recent resource-seeking investment by developing-country TNCs would allow the host economies to diversify their markets. However, much depends on the access of developing-country TNCs to the technology needed for exploiting challenging opportunities in oil and gas extraction.

In the case of asset-seeking FDI, the impact on trade will depend on the nature of the acquired assets. For example, when a TNC seeks a distribution network or the production of a brand name known to consumers in the host economy, its impact may primarily be to increase imports. On the other hand, if a foreign firm sets up an R&D facility to serve the regional or even the global market, such an affiliate would, in effect, be exporting R&D services abroad. However, asset-seeking FDI, although important for developing-country TNCs operating in developed countries, is a relatively unimportant motive for developing-country FDI in host developing countries.

Overall, foreign affiliates account for a significant share of trade in many countries (*WIR02*). But the extent to which developing-country affiliates contribute to trade varies. In host developing countries, the share of these affiliates in total exports was, for example, 0.6% in India (in 2000) and 11% in China (in 2002) (figure V.6). According to the survey of foreign affiliates in the ASEAN-5 countries, mentioned earlier, developing-country TNCs had a higher propensity to export from the host countries than did affiliates of developed-country TNCs: the former exported 77% of output, while the latter exported 67%.³⁶ In host countries of sub-Saharan Africa, on average, the export propensity of the foreign affiliates of

Box V.4. Impact of developing-country FDI in a small LDC: The experience of Lesotho

Lesotho is a small landlocked LDC, entirely surrounded by South Africa, with a population of less than two million, mostly engaged in subsistence agriculture. Unemployment is estimated at one third to one half of the working population. Gross domestic product per capita was \$764 in 2004.^a

Despite its paucity of locational advantages, since the mid-1990s, Lesotho has been quite successful in attracting increased inflows of FDI, as a result of government efforts combined with trade privileges (UNCTAD 2003, p. 3). FDI inflows in recent years have increased, from \$27 million in 2002 to \$52 million in 2005, and they go mainly into manufacturing, in particular apparel, mostly aimed at markets in industrialized countries.

The flows of FDI into the apparel industry in Lesotho are almost entirely from East Asia, led by TNCs based in Taiwan Province of China. Inflows started in the late 1980s: clothing firms of Taiwan Province of China began shifting their production facilities in South Africa to Lesotho, following the imposition of economic sanctions against the apartheid regime. The main attraction of Lesotho at that time was that it maintained its diplomatic relations with Taiwan Province of China and enjoyed quota and duty-free access to Europe under the Lomé Convention (Lall 2003). The introduction by the United States of the AGOA in 2000, which offered import concessions to poorer African countries, gave a new impetus to FDI inflows into Lesotho. The fact that some apparel TNCs from Taiwan Province of China had already operated there for over 10 years helped attract more investment.^b In 2002, of the 41 largest foreign affiliates in the country, 26 were from Taiwan Province of China, one each from Fiji, Hong Kong (China) and Singapore and 12 from South Africa (UNCTAD 2003, p. 16).

FDI in apparel in Lesotho clearly succeeded in increasing the country's manufacturing exports. Around 87% of its total exports were in textiles

and apparel.^c In 2004, Lesotho's exports to the United States amounted to \$467 million, of which \$448 million worth were the direct result of preferential treatment under AGOA.

Textiles and clothing became Lesotho's main manufacturing industry, employing 56,000 workers at its peak and accounting for nearly all jobs in the manufacturing sector of the country (Gumisai 2006). However, its impacts in terms of creating linkages and fostering local skills development appear to have been limited. East Asian firms in Lesotho were apparently reluctant to train local workers or giving them high skilled or managerial tasks (Lall 2003).

In 2005, the system of quotas under the Multi-Fibre Arrangement was fully removed, and the AGOA entered its second phase, making conditions with regard to procurement tighter. In the same year, Lesotho's total exports fell by 14%, almost entirely accounted for by the decline of exports in textiles and apparel. By the end of 2004, 6 of the country's 50 clothing factories closed with a loss of 6,600 jobs. Other firms placed 10,000 workers on short-term work in response to declines in export orders (Gumisai 2006).

The experience of Lesotho illustrates both the benefits and potential costs of export-oriented FDI in manufacturing – in its case, mainly from developing countries. The benefits include employment generation, increased exports, industrial experience and some institutional development. The costs are related to low local value added, lack of local linkages, insufficient local participation at higher levels, inadequate training and productivity improvement and poor integration with the local population – all of which signify that the investments have not taken root and will vanish in the long term (Lall 2003). The balance between the benefits and costs depends to a large extent on effective policies to upgrade local capabilities and tap FDI potential.

Source: UNCTAD, based on Cobbe 2004; Lall 2003; Gumisai 2006 and UNCTAD 2003.

^a UNCTAD Handbook of Statistics 2005 on-line.

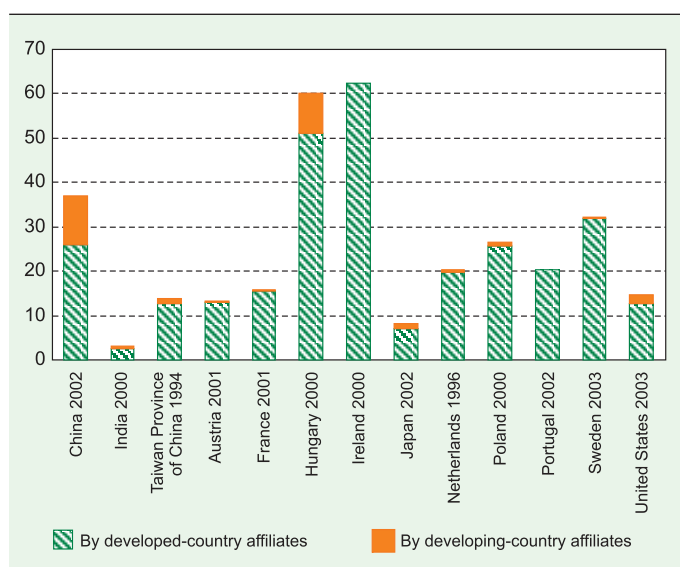
^b "Textile companies turn to Africa for US access", *Taipei Times*, 18 July 2001 (www.taipeitimes.com/News/worldbiz/archives/2001/07/18/94706).

^c Figures from the website of the United States International Trade Commission (reportweb.usitc.gov/africa/by_country.jsp).

developed-country TNCs was found to be slightly higher than that of the affiliates of developing-country TNCs in 2005 (17.6% versus 15.8%) (table V.3). The results however varied by industry: for instance, the affiliates of developed-country TNCs

clearly showed higher export propensity in food and beverages, paper and automobile, while affiliates of developing-country TNCs exported relatively more in garments, textiles and non-metallic mineral products (UNIDO 2006).

Figure V.6. Share of exports of foreign affiliates of developed- and developing-country TNCs in total exports, selected countries, various years
(Per cent)



Source: UNCTAD, based on annex table A.V.1.

Note: Data for the Netherlands, Poland, Portugal and Sweden refer to majority-owned affiliates only.

Table V.3. Exports per unit of sales of affiliates of TNCs from developing and developed countries in 15 sub-Saharan African countries, by industry, 2005
(Per cent)

Sector/industry	Developing-country TNCs	Developed-country TNCs
Primary	57.9	61.2
Secondary		
Food and beverages	11.0	25.7
Textile	78.1	65.6
Garment	78.9	62.8
Paper	2.9	15.8
Publishing and media	...	3.0
Chemicals, plastics and rubber	8.2	14.0
Non-metallic mineral products	17.8	7.0
Basic and fabricated metals	12.4	9.4
Automobile, machinery and equipment	10.6	17.5
Wood products and furniture	...	30.4
Tertiary	38.4	23.9
Electricity, gas and water	...	6.8
Construction	0.1	1.7
Trade	10.4	12.0
Hotels	4.4	4.1
Transport and communication	13.5	19.7
Financial intermediation	1.8	1.8
Business services	11.8	7.9
Total	15.8	17.6

Source: UNCTAD, based on UNIDO 2006.

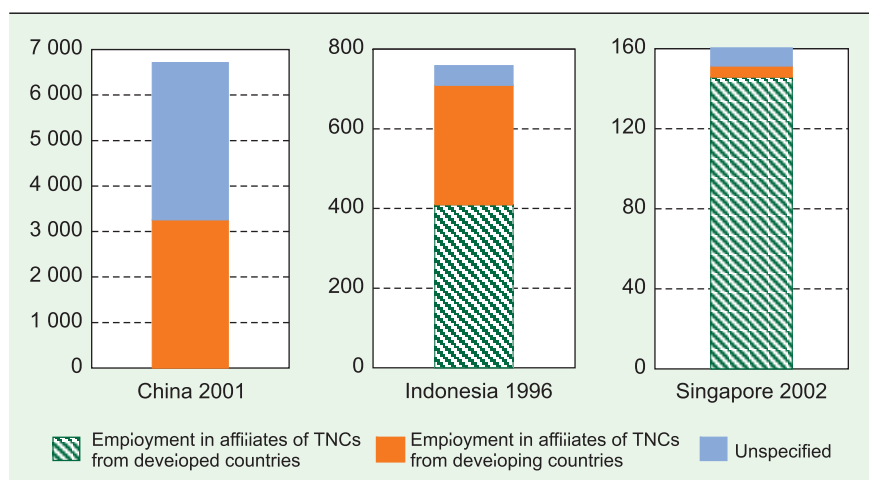
d. Employment

The employment effects of FDI are of considerable interest to host developing countries: in many of them, a key requirement for sustainable growth is the ability to absorb the human resources released from agriculture into manufacturing and services industries. The quantitative effects of FDI on employment globally have been found to be modest, but somewhat larger in host developing than host developed countries, and especially so in the manufacturing sector (*WIR94*, *WIR99*, chapter IX). The potential of FDI by developing-country TNCs to generate employment may be greater than that from developed-country TNCs, owing to certain basic characteristics such as its greater orientation towards labour-intensive industries or activities.

Job-creation as a result of developing-country FDI can be of considerable significance for low- and middle-income countries that attract sizeable amounts of such FDI. For instance, in China, where foreign affiliates employed 23.5 million people, accounting for 10% of the total workforce in 2003 (according to unpublished data of MOFCOM), half of the employment generated by foreign affiliates was associated with TNCs from developing countries (figure V.7). In Indonesia, that share exceeded 40%.

In terms of average employment per affiliate, some survey findings suggest that developing-country TNC affiliates hire more people than do affiliates of developed-country TNCs in host developing countries. In sub-Saharan Africa, according to data from a UNIDO survey, labour-intensity in 2005 was higher in the majority of the industries covered. Foreign affiliates of developing-country TNCs created, on average, more jobs per million dollars of assets than did foreign affiliates of developed-country TNCs in 10 of the 18 industries covered by the sample (table V.4). Their employment generation was similar to that of developed-country TNCs in one industry (non-metallic mineral products). The difference in terms of greater employment generated by developing-country TNCs was significant in some typically labour-intensive activities such as construction, textiles and wood products, and in six out of ten manufacturing industries. However, there were some notable exceptions such as the garments industry, in which TNCs from Hong Kong (China), India and Mauritius were less labour- and more

Figure V.7. Employment in foreign affiliates of TNCs from developing and developed countries, various years
(Thousands of employees)



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

capital-intensive than their counterparts from developed countries (UNIDO 2006, p. 54). There were also exceptions in tertiary activities such as trade, hotels and telecommunications.³⁷ Because of this, the labour intensity of the affiliates of developed-country TNCs taken as a whole turned out to be slightly higher than that of the affiliates of TNCs from developing countries.

For developing host economies, the qualitative aspects of employment in foreign affiliates of developing-country TNCs, in terms of wages, working conditions and industrial relations, can be as important as the quantitative impacts. Evidence on TNC operations worldwide suggests that, in general, workers directly employed by foreign affiliates enjoy better wages, working conditions and social security benefits than those employed by domestic firms (*WIR94*).³⁸

There are hardly any studies that analyse separately the impact of affiliates of developing-country TNCs on host-country wages. However, in some host countries, such as African countries and Indonesia, developing-country TNCs are important investors. Moreover, the wage differential observed among skilled labour is so large that there is a high probability that developing-country TNCs also pay higher wages than domestic firms. The situation may be more mixed in the case of low-skilled labour, for which the wage differentials observed between foreign affiliates and domestic firms is small. Survey data for sub-Saharan Africa indicate that affiliates of TNCs from developed countries paid higher wages

than affiliates of TNCs from developing countries in 15 of the 18 industries analysed (table V.4). There was a large variation in some industries in which technological differences between TNCs from the two groups of firms may be expected to be high, such as electricity, gas and water, non-metallic mineral products and chemicals, plastics and rubber, but minimal in textiles, hotels and telecommunications. One exception was the garments industry where affiliates of developing-Asia-based capital-intensive garments TNCs paid higher wages than their developed-country rivals. Wage differentials were closely related to the skill-intensity of individual industries. In the majority of the industries in which developed-country TNCs paid higher wages, they also employed a relatively larger number of skilled workers (table V.4). In skill intensity as well, the exceptional case of developing-country TNCs in the garments industry of the host countries was further confirmed: they were not just more capital-intensive than their developed-country peers, and paid higher wages, but also employed relatively more skilled workers.

These findings suggest that the pattern of wages in foreign affiliates of developing-country TNCs in developing countries could be explained by factors such as the size of the foreign affiliate – larger firms tend to offer higher wages and better working conditions – and the capital- and skill-intensity of the industries or activities in which they are concentrated. TNCs in capital- and skill-intensive industries tend to employ more skilled labour and pay higher wages. Wages, skills and training are closely related and mutually reinforce each other. In the sub-Saharan African host economies, affiliates of large developing-country TNCs spent at least nine times more on training than affiliates of small or medium-sized developing country- TNCs (table V.5). Even more importantly, they spent twice as much on training than large TNCs from developed countries. As a result, on average, affiliates of all TNCs from developing countries combined spent more on training than affiliates of TNCs from developed countries.

Table V.4. Selected indicators of employment by affiliates of TNCs from developing and developed countries in 15 sub-Saharan African countries, 2005
(Averages)

Sector/industry	Workers per \$ million of assets		Wages per month (\$ thousand)		Ratio of skilled to unskilled workers (%)	
	Developing- country TNCs	Developed- country TNCs	Developing- country TNCs	Developed- country TNCs	Developing- country TNCs	Developed- country TNCs
Primary	59.2	61.6	1 764	1 966	58.1	61.8
Secondary						
Food and beverages	33.6	19.8	1 078	2 234	96.6	96.9
Textiles	60.3	21.8	1 812	1 922	164.5	175.4
Garments	61.0	137.5	985	489	208.9	116.2
Paper	10.6	41.6	502	472	75.6	131.1
Publishing and media	4.8	45.7	498	338	140.0	189.1
Chemicals, plastics and rubber	41.4	18.3	244	1 555	91.7	118.4
Non-metallic mineral products	11.8	11.9	203	3 096	186.1	100.8
Basic and fabricated metals	31.0	13.8	239	319	127.2	201.0
Automobiles, machinery and equipment	29.0	13.1	250	973	104.4	251.2
Wood products and furniture	57.0	37.1	61	359	120.1	105.9
Tertiary						
Electricity, gas and water	71.0	8.6	277	6 035	134.5	132.8
Construction	78.7	56.8	661	1 523	76.3	141.8
Trade	10.1	15.8	193	679	112.8	218.9
Hotels	16.2	41.4	603	667	265.4	135.9
Transport and communications	6.8	18.3	1 982	2 571	201.7	181.2
Financial intermediation	3.4	3.1	1 133	3 402	408.1	514.7
Business services	41.7	25.7	210	1 243	250.4	200.5
Total	12.7	14.0	649	1 716	128.7	150.5

Source: UNCTAD, based on UNIDO 2006.

From a dynamic perspective, the higher wage levels in foreign affiliates in developing host economies are likely to influence wage growth, at least for certain kinds of labour, in host developing economies. Regarding other work-related conditions, TNCs generally adopt standards that are not less favourable than those of comparable national employers and are sometimes above the national average. In an opinion survey of employees in a South African-owned retail firm in Zambia, workers considered their wages too low

and their working hours too long, but had relatively good job satisfaction and a positive opinion of skills upgrading (Miller 2005).

While it is a relatively well-established fact that foreign affiliates pay higher wages than domestic firms, workers and their representatives in developing host economies can still question whether those salaries are above or below the minimum wage. Foreign affiliates may pay less than the perceived minimum, for example in high-unemployment areas in which no alternative jobs exist. In host countries with minimum-wage legislation, it is also an issue for law enforcement (how to make sure that foreign affiliates comply with the relevant legislation). In countries where no minimum wages are set, it is not easy to establish whether salaries are below the subsistence level of survival or not. The Zambian study mentioned earlier, based on interviews with workers in an affiliate of a South African retail chain, notes the prevalence of the perception that the affiliate paid "starvation wages" (less than the perceived local minimum for survival) (Miller 2005).

Table V.5. Training expenditure per foreign affiliate in 15 sub-Saharan African countries, by size and origin of affiliate, 2005
(Thousands of dollars)

Criterion	Size	Affiliates of	
		developing- country TNCs	developed- country TNCs
Sales	Small (<\$1 million)	10.3	13.8
	Medium (\$1-5 million)	21.2	15.5
	Large (>\$5 million)	187.5	97.7
Assets	Small (<\$1 million)	6.7	13.7
	Medium (\$1-5 million)	13.3	24.4
	Large (>\$5 million)	220.2	91.8
Total		57.9	43.2

Source: UNCTAD, based on UNIDO 2006.

In affiliates of developing-country TNCs, as in affiliates of developed-country TNCs, the level and quality of employment are influenced by the interaction between the human resource management of the TNC and the industrial relations framework of the host economy, covering such areas as union organization and action, access of workers to decision-making, and information disclosure and consultation (*WIR94*). Evidence on practices of developing-country TNCs is very limited. One case study (Baboo et al. 2005) suggests that the industrial relations of their affiliates are in part influenced by the common practices of their home country: if unions and collective action are accepted in the parent firm's home country, so are they in their foreign affiliates. For instance, the fact that South Africa has relatively advanced labour legislation – a Labour Relations Act (1995), a Basic Conditions of Employment Act (1997), an Employment Equity Act (1998) and a Skills Development Act (1999) – and enforcement affects the behaviour and practices of South African TNCs in sub-Saharan Africa. Moreover, TNCs tend to adapt their own practices to host-country norms (*WIR94*).

e. Other impacts

Although the injection of resources to poorer countries with few sources of external resources carries a number of potential benefits as discussed above, FDI from developing countries, like FDI generally, could present certain risks to the host economy. One such risk is that the entry of a TNC could result in the creation of a dominant monopoly in the host-country market. Such a situation might arise if the productivity of domestic firms is low and the market is perceived to be too small to entice other TNCs to enter it. Clearly, the likelihood of such a situation arising is greater in poorer and more remote countries where developing-country FDI has been seen to play an important role.

Furthermore, if a large share of FDI originates from one particular country, it may create a perception in the host economy that it has become too dependent on and dominated by the home economy concerned. Such fears are exacerbated by the fact that net inflows of capital may sometimes be accompanied by current-account deficits, including trade deficits. Consequently, it may lead to a concern in the host economy that large inflows of capital are buying up the country's assets while it is "suffering" from trade deficit. Such concerns have been expressed, for example,

with regard to investment by South African TNCs in its poorer neighbouring countries (Naidu 2006). South Africa is the largest or second largest source of FDI in most of the SADC countries and has large trade surpluses with them (Rumney and Pingo 2004).

The political and social aspects of TNCs' activities can also give rise to controversies, partly due to the size of their operations and partly to their transnational character. This can apply to developing-country FDI as well as to that from developed countries. In developing host economies, problems have often been exacerbated by the absence of an adequate regulatory framework and by disparity in the allocation of the economic benefits. In economies where domestic industries are underdeveloped, governments may not have the capabilities to ensure proper adherence to acceptable labour and environmental standards, for example, when foreign firms introduce new production processes or working methods. In other cases, tension can arise when vast amounts of wealth are created, for example through oil and gas extraction, where the local community not only receives little benefit, but also suffers as a result of damage to the environment.

In such situations, developing-country TNCs investing in developing host countries may have certain advantages. The strength of developing-country TNCs lies in their familiarity and experience with operating in underdeveloped economies, which may give them a better chance of avoiding problems.

Corporate governance is another frequently discussed issue. Typically the legal requirements concerning corporate governance in developing countries are more lax than in developed countries. Similarly, the pressure on TNCs to conform to a standard of "good conduct" and fulfil what has come to be known as corporate social responsibility (CSR) has not reached the same level as in developed countries, and this may have implications for the standards followed by developing-country TNCs. However, broad generalizations cannot be made regarding the CSR of developing-country TNCs.

There is also the issue of political influence on corporate strategy. Many of the leading developing-country firms investing abroad are State-owned. One of the implications is that the financing of the corporate activities has the support of the TNC's home country, at least implicitly. Similarly, the operation of State-owned companies

cannot completely be separated from the political aspirations of the home-country government. This may be particularly relevant with respect to emerging FDI by major State-owned oil TNCs in war-torn developing countries, where such companies dominate the oil industry. While many profit-seeking TNCs from developed countries have withdrawn their oil investments following accusations of their negative impacts on peace-making processes, as well as the mounting pressure in the context of human rights abuses by host governments, some major State-owned TNCs from developing countries have increased their presence in such conflict-ridden countries (chapter IV), despite the risk of insecurity and instability. They have done so partly by strengthening their political and economic relationships with host-country governments,³⁹ while some also demonstrate their commitment to the host economy and the host country's welfare and development through contributions to public and social welfare projects (e.g. building local hospitals and providing ambulance services for villages) (Patey 2006).

FDI might also entail certain risks for the host country – especially when it involves taking over control of infrastructure industries – resulting in creating a leverage with which the home-country government can exert political pressure on the host economy. For example, in recent years, the Government of the Russian Federation has tightened its control over some large energy TNCs or affiliates (Gazprom, Sibneft, Yuganskneftegas). There is concern that the strategies of these firms may thus have a political dimension, illustrated by Gazprom's changing approach to the pricing of its natural gas deliveries in some CIS countries at the end of 2005 (Vahtra 2006, Vahtra and Liuhto 2004). In another example, an acquisition of a stake in Hutchison Telecommunications International Limited (HTIL), an Indian telecom company, by Egypt's Orascom, which entitled the latter to a board seat on Hutch Essar (a joint venture between HTIL and the Essar Group) faced obstacles on security grounds.⁴⁰

3. Concluding remarks

The discussion on host-country impact in the preceding sections has focused on host developing economies both because they are the principal recipients of FDI from developing countries and because it is the development impact of such FDI

that matters the most. The impact of FDI from developing countries on host developed economies is likely to be much less significant than that on host developing economies, because of its much smaller size relative to total FDI (chapter IV) and GFCF in host developed countries.⁴¹ Moreover, access to proprietary assets, particularly technology, and to markets that developing-country TNCs offer is likely to be relatively limited in comparison with what developed countries' own firms can provide. Nevertheless, the economic implication of developing-country FDI, especially in terms of additions to investible financial resources and to income and employment generation may not be negligible even in some developed economies,⁴² as is evident from the promotion of such FDI by some host developed countries (chapter VI).⁴³ At the same time, specific developing-country FDI may cause concern in some developed host countries, for economic as well as non-economic reasons. For example, national security and related concerns have been expressed, particularly in the United States, regarding the entry into some business activities by TNCs from certain developing countries, such as DP World from the United Arab Emirates and Lenovo from China (chapter VI, section B.3).

Although modest in size relative to global FDI flows, FDI from developing countries assumes considerable importance for host developing countries. The direct and indirect effects of the FDI package on financial resource flows and investment, transfer and diffusion of technology, export activity and employment can usefully supplement domestic efforts of host developing countries in those areas. The industrial distribution of developing-country FDI and the technological attributes of developing-country TNCs suggest that developing-country foreign affiliates may be able to interact more effectively with domestic firms in host developing countries than affiliates of TNCs from developed countries.

However, apart from the potential economic benefits of FDI from developing countries – as also in the case of FDI from developed countries – there may also be a number of risks, economic as well as non-economic, for host developing economies. The challenge for host developing economies is to minimize the risks, and benefit to the maximum extent possible from these new sources of FDI. In that context, national and international policies matter.

C. Conclusions

As developing countries expand beyond their traditional involvement in international production as recipients of FDI to that of rising sources of FDI, the impact of their outward FDI on the home countries as well as on host countries, especially host developing countries, assumes increasing significance. For the home countries, questions arise as to whether the exports of capital, technology and other resources by their TNCs bring benefits to the firms undertaking them, as well as to the economy at large, and contribute to the development process. For the host developing countries of FDI from other developing countries, the main issues are to what extent such FDI adds to capital and other resources available for development, and whether the benefits and costs of such FDI differ in any way from those of FDI from developed countries.

Exploring how FDI and related production decisions by TNCs from developing countries affect the home countries is not a simple exercise, since the characteristics of FDI vary across TNCs, industries and countries, influencing both the behaviour of TNCs and the effects on home countries. Furthermore, data and research on the home-country impact of developing-country FDI are as yet limited. At the firm level, although it cannot be taken for granted that outward FDI necessarily contributes to enhancing competitiveness and performance, evidence from studies and surveys, related mainly to outward FDI from some East and South-East Asian economies, suggests that in a majority of cases, developing-country firms do attain their objectives: they expand markets, improve efficiency, acquire natural resources, or augment created and strategic assets, thus improving their performance by investing in foreign locations.

Under appropriate home-country conditions, including, in particular, adequate technological capacity and absorptive capabilities conducive to the formation of linkages between outward-investing firms and other firms and institutions, and to spillovers from the former to the latter, the improved competitiveness of outward investing firms can contribute towards enhancing industrial competitiveness in the home economy as a whole. Beginning with the industries in which outward FDI occurs, such effects can spread to other industries and, depending on the motivation or type of FDI, can help accelerate industrial upgrading

and restructuring in the home economy. The scope for such dynamic transformation is illustrated by the experiences of East and South-East Asian NIEs and some other East and South-East Asian economies where firms have engaged in outward FDI, not only for market-seeking but also efficiency-seeking reasons. In addition, while strengthened competitiveness of firms due to outward FDI, especially in manufacturing and services, can benefit home industries and the home economy in general through linkages and spillovers, it can also raise concerns relating to monopoly power and competition, as the relative size of the investing firms can be large relative to that of other firms in the home developing countries.

Outward FDI may raise a number of concerns in home countries, mainly stemming from the outflow of finance and other resources in the FDI package. The most common ones relate to balance-of-payments problems that may arise due to the size of the financial outflows involved, diversion of investment activity from home to host economies and shifting of jobs from home to host economies. As regards the first, the limited evidence available (on direct effects of selected developing-countries' FDI in the United States through FDI flows, repatriated earnings and intra-firm trade) shows that outward FDI has contributed positively to the balance of payments of the home economies concerned, reflecting the fact that developing-country TNCs engage substantially in trade-supporting activities. It is relevant in this context to note that developing countries' focus on the balance-of-payments impact of outward (or for that matter, inward) FDI per se has diminished somewhat, partly due to an improved overall balance-of-payments situation in many outward-investing developing countries, and partly because of a growing tendency to look at the balance of payments as a whole and manage it through an appropriate exchange-rate policy.

Whether outward FDI leads to a reduction in the financing available for domestic investment is a question that is difficult to answer definitively. Some indirect evidence seems to indicate that developing-country firms tend to rely more on external funding than on home-country finance for their investment activities abroad. On the other hand, if developing-country firms engage in FDI mainly because they have accumulated large financial resources or because their outward FDI is subsidized by the government, there may be grounds for concern over the diversion of resources from more welfare- or development-enhancing uses

at home. With regard to the impact of outward FDI on domestic investment or capital formation itself, evidence for developing countries specifically is limited, but what little there is suggests that outward FDI and domestic investment are likely to be, with some exceptions, complements rather than substitutes, as has been found to be the case for several home developed countries.

The trade and employment effects of outward FDI on home economies depend considerably on the motivations and type of investments abroad, and this applies to developing-country FDI as well. To the extent that market-seeking motivations drive the greater part of FDI from developing countries, and such FDI has been found to be generally complementary to home-country exports (excepting where host countries pursue import-substitution policies), a positive impact on home-country exports may be expected. Results of some studies on Asian NIEs as home economies and data on trade by affiliates of developing-country TNCs in the United States and Japan suggest a positive relationship, but more evidence is needed to confirm complementarity between outward FDI and home-country exports.

The effects of outward FDI on home-country employment have been a matter of concern for developed countries, especially in the context of relocation of activities by efficiency (or cost-reduction)-seeking TNCs, and can equally be a concern for developing countries. Evidence related to some Asian NIEs suggests that, as in some developed countries, under appropriate conditions outward FDI can generate additional jobs in higher-skilled technical and managerial categories and reduce those in unskilled ones; on balance, the job-creating effects of outward FDI may exceed its job-reducing effects. To a large extent, this would depend on the capacities of the human resources in the home country to adapt to changes in the structure of production. For some developing countries with large low-cost labour supplies (such as China and India), the possibilities of job losses at home due to outward FDI may be expected to be limited, at least for the present.

For host economies, especially developing ones, FDI from developing countries can add to inflows of other external financial resources, including FDI from developed countries, commercial bank lending, portfolio investment and ODA. For poorer developing countries, it can be significant, accounting for over half of total FDI inflows into several LDCs. Furthermore, because

the motivations and competitive strengths of developing-country TNCs and the locational advantages sought by these firms differ in several respects from those of TNCs from developed countries, its impact on various aspects of host developing economies may differ somewhat from developed-country FDI, in some instances bringing greater benefits.

In general, developing-country TNCs tend to use the greenfield mode of entry more often than do developed-country TNCs, which show a greater preference for cross-border M&As, especially for investment in developing host countries. Thus developing-country investments are more likely to add immediately to investment in production capacity in developing countries, compared with FDI by developed countries.

Certain attributes of developing-country TNCs, especially in manufacturing, suggest that they may establish stronger linkages with domestic firms in developing countries than developed-country TNCs, and therefore they could have larger indirect effects on investment as well as technological capacity-building in those host countries. The main differentiating attributes are that they tend to be engaged in standardized production activities with non-proprietary technologies that are more conducive to the external procurement of supplies, and that the technological gap between foreign affiliates of developing countries and host-country firms is likely to be smaller, facilitating the transfer and dissemination of technology. Although data for selected African and ASEAN economies indicate a lower rate of local sourcing by developing-country firms as compared with those from developed countries, it seems likely that this is due to the relatively younger age of foreign affiliates of developing-country TNCs, since establishing local linkages takes time.

A key advantage for host developing-countries of FDI from developing countries compared with that from developed countries is the greater employment-generating potential that the former may have due to its greater orientation towards labour-intensive industries and the likely use of simpler and more labour-intensive technologies by developing-country TNCs, especially in manufacturing. Survey findings on African host countries, for example, indicate that foreign affiliates of TNCs from developing countries, on average, created more jobs per unit of assets in the majority of manufacturing industries

surveyed than did those of TNCs from developed countries. To the extent that firms from developing countries invest appreciable amounts in other developing countries, outward FDI provides a potential avenue for closer economic cooperation among them and greater gains therefrom.

While the limited evidence presented in this chapter suggests that for home as well as host developing countries, the positive effects of FDI from developing countries may outweigh the negative ones, it is important to emphasize the contextual nature of the impacts observed and the limitations of the information available. Further research and understanding is necessary of the benefits as well as risks, both economic and non-economic, for home and host countries. That would assist home-country policymakers to weigh the potential costs and benefits of allowing and, where appropriate, supporting outward FDI, and of host-developing country policymakers to consider how best to attract and benefit from developing-country FDI. The following chapter deals with some of the policies issues raised in that respect.

Notes

- 1 See Lall 2001 and Musik and Murillo 2003 for a discussion on the definition of competitiveness.
- 2 *WIR95*, p. 126.
- 3 Under certain circumstances of market failure and externalities, the underperformance of a firm due to an outward FDI project might lead to the coexistence of costs to the firm and net benefits to the home economy. However, these situations are likely to be rare.
- 4 For instance, communication and coordination problems may stem from cultural diversity within an organization.
- 5 See e.g. Reeb et al. 1998 for a systematic analysis of the risks.
- 6 “The Asian Businessweek 50 – Leaders: No. 12: Hon Hai Precision Industry”, *Business Week* on-line, 24 October 2005 (www.businessweek.com/magazine/content/05_43/b3956417.htm).
- 7 Related benefits mentioned by firms include financial and performance gains (15% of responses), but these do not derive solely from greater efficiency.
- 8 See Xiang 2006 for a discussion on Chinese companies in this respect.
- 9 However, the related costs, risks and difficulties should not be overlooked (see later discussion and chapter VI).
- 10 See for instance Venkatraman and Ramanujam 1986 for a discussion.
- 11 Researchers typically use measures such as the ratio of foreign to total sales, foreign to total assets and foreign to total employment as indicators of internationalization.
- 12 See, for instance, Ramaswamy 1992, Sullivan 1994b, Annavarjula and Beldona 2000, and Ruigrok and Wagner 2003 for reviews of the literature.
- 13 They are two consumer electronics makers listed on the Hong Kong Stock Exchange (Hong Kong, China).
- 14 “TCL losses triple in third quarter”, *The Standard* (www.thestandard.com.hk), 29 October 2005.

- 15 The study analysed 16 M&A transactions that took place since 2001. All the acquirers were listed in the Hong Kong (China), Shanghai and Shenzhen stock exchanges. None had completed any other transactions in the period under study.
- 16 Defined as a “network of institutions in the public and private sectors whose activities and interactions initiate, import, modify and diffuse new technologies” (Freeman 1987, p. 1).
- 17 Evidence on developed home countries suggests a positive impact on restructuring overall. In the United States, Japan and 11 European countries, total factor productivity – one of the possible benchmarks for success in upgrading domestic value added – reacted positively to outward FDI and imports, while inward FDI flows did not seem to contribute to (or detract from) productivity during the period 1971-1990 (Pottelsberghe de la Potterie and Lichtenberg 2001). In Australia, the reaction of TNC parent firms to external factors such as imports was found to be significantly stronger than in unisonal firms (Williamson 1986). In Slovenia, one of the former economies in transition (now a high-income country) the majority of managers (52%) attributed a major role to outward FDI in the transformation of the home economy (Jaklic and Svetlicic 2003, p. 174).
- 18 In Mauritius, the textiles and apparel industry was created in the 1970s and 1980s mainly by TNCs from Hong Kong (China), and was largely taken over by Mauritians in the 1990s. One of the largest Mauritian-owned TNCs, Ciel Textile, closed seven factories in Mauritius in 2004 and formed a cluster of higher end clothing units with the remaining three (with finishing located in Reunion). Meanwhile, lower-end production has been expanded to Madagascar (Saminaden 2005, p. 1).
- 19 See Young et al. 1996, p. 310 for a discussion related to China, and Bulatov 1998 for the Russian Federation.
- 20 Anecdotal evidence suggests that TNCs from developing countries rely significantly on funds raised from stock markets and international banks in developed countries. For example, in 2003, in the case of foreign affiliates in Japan, those established by Asian TNCs raised 62% of total funds locally (through corporate bonds and/or commercial loans as well as own funds) compared to 50% for affiliates of United States TNCs and 72% of European TNCs (Japan, METI 2006).
- 21 This development is reminiscent of Japanese outward FDI in the 1970s (cf. Caves 1993, Pak and Park 2005, Wilkins 1990).
- 22 For instance, a recent study of the Canadian experience (Hejazi and Pauly 2003) concluded that the impact of outward FDI depended on the motivation of TNCs: market-seeking, natural-resource-seeking and strategic-asset-seeking FDI tended to have positive or no effect on GFCF over the period 1970-1998, while efficiency-seeking FDI had a slightly negative impact. Similarly, a summary of various studies (Lipsey 2002a) concluded that outward FDI did not result in any large movement of aggregate production capacity from the home country, although there may be important differences depending on the type of investment project (vertical or horizontal), industry (goods or services), target country (industrialized or developing), or technology (plant level or firm level economies of scale). Other studies (e.g. by Stevens and Lipsey 1992 for the United States and Bayoumi and Lipworth 1997 for Japan) reached similar conclusions regarding effects at the aggregate level. Empirical evidence indicating investment substitution is usually limited to selected industries or activities (Belderbos 1992 for food, metals and electronics industries in the

- Netherlands, and Braunerhjelm and Oxelheim 2000 for R&D-intensive industries in Sweden).
- 23 Moreover, the fact that outward FDI is still relatively small in developing countries (on average, annual outflows of developing countries were less than 4% of GFCF during the period 1998-2005 as compared with about 13% for developed countries) (annex table B.3) may make this area of impact less important for those countries, at least for the present.
- 24 The approach of that study followed that of Hejazi and Pauly 2003.
- 25 Economies covered included Brazil, Mexico, Panama, South Africa, Hong Kong (China), the Republic of Korea, Malaysia, Singapore, Taiwan Province of China and the Philippines for 2002, and somewhat different groups of countries from 1997 and 1992.
- 26 In the case of the United States, the propensity of affiliates abroad to substitute for the employment of their parent firms was found to be low in the mid-1990s (Brainard and Riker 1997a and b); studies on TNCs from Italy (Mariotti et al. 2003), Slovenia (Jaklic and Svetlicic 2003, p. 165) and Sweden (Hatzius 1997, Hakkala and Kokko 2000, Fors and Kokko 2001) also tend to support the findings of a limited impact in terms of a reduced level of employment at home, with, however, some differentiation by industry.
- 27 Opinion polls of developing-country managers suggest that there may be important differences between individual home developing economies. In one survey, nearly 90% of the Indian managers interviewed endorsed the importance of the "public good" dimension of their business dealings, whereas "Chinese managers were more lukewarm, with 25% saying that investors should be the sole focus of corporate activity" (McKinsey 2006).
- 28 For a discussion of the impact of FDI on development, see *WIR99*, Part Two.
- 29 For a discussion of factors determining backward linkages of foreign affiliates with domestic firms in host economies, see *WIR01*, chapter IV.
- 30 Local purchase figures were provided by 436 manufacturing firms in the survey.
- 31 The ASEAN-5 consists of Indonesia, Malaysia, the Philippines, Singapore and Thailand.
- 32 The Bradford University School of Management survey, described in box IV.4.
- 33 The question was: What proportion of your overseas affiliates are joint ventures?
- 34 Bradford University Survey (see end-note 32 above).
- 35 In the short run, a worsening of the trade balance may occur if FDI is accompanied by the import of capital goods needed for establishing a production unit in the host economy.
- 36 Bradford University Survey, described in end-note 32. The difference in export propensities is largely accounted for by the industrial composition of the affiliates surveyed. Both developed and developing-country TNCs in the garments industry of the host countries export nearly all of their output, and nearly half of developing-country TNCs surveyed were in this industry. In addition, it must be noted that governments may require them to export a specific amount of output: for example, the required share of output required to be exported in ASEAN countries ranged from 15% to 100% (or an average of 76%).
- 37 It is also possible that there was underreporting of employment by some developing-country TNC affiliates (due, for example, to the undocumented status of some workers). However, there is no information to support this conjecture.
- 38 Various studies on the impact of foreign affiliates in general on wages in developing host countries have found that they tend to pay higher wages than comparable domestic firms (Aitken and Lipsey 1996 for Mexico and Venezuela, Lipsey and Sjöholm 2001 for Indonesia; te Velde and Morrissey 2001 for Cameroon, Ghana, Kenya, Zambia and Zimbabwe; Udomsaph 2002 for skilled workers in Thailand). A recent analysis utilizing Indonesian manufacturing census data for 1990-1999 (Harrison and Scorse 2005) found that foreign affiliates (of TNCs from all countries) paid 5%-10% higher wages to their unskilled workers, and 20%-35% higher wages to their skilled workers than domestic firms. These wage premiums were found to be robust in various industries and across various indicators, and to be related to differences in worker productivity between the two groups of firms. There are however some studies (e.g. Ramstetter 1999 for Hong Kong (China), Indonesia, Malaysia, Singapore, and Taiwan Province of China) that have found no systematic links between the higher productivity of foreign affiliates and employees' wages.
- 39 The major example is that of oil TNCs in the Sudan (Chapter II, box II.5).
- 40 When Orascom, the Egyptian telecom TNC, bought a 19.3% equity stake in HTIL, which has a 42% holding in Hutch Essar, it entitled Orascom to a board seat and about 10% indirect interest in Hutch Essar. The Essar group, apparently upset over the entry of Orascom, alleged that Orascom's acquisition of equity in HTIL was a threat to national security as Orascom was a dominant mobile operator in Pakistan and Bangladesh. Subsequently, the national security adviser of India wrote to the Department of Telecommunications agreeing to the national security concern raised by the Essar group. "Orascom-Hutch deal: a security risk", *The Economic Times* (<http://economictimes.indiatimes.com>), 8 March 2006. In July 2006, the case was still pending: while the Foreign Investment Promotion Board (and earlier the Department of Telecommunications) cleared the transaction, the National Security Council was still examining the security concerns. "Orascom's purchase in Hutch has got the final nod", *Moneycontrol India* (<http://news.moneycontrol.com/india/>), 15 July 2006.
- 41 FDI from developing countries accounts for less than 1% of GFCF in developed countries (annex table B.3).
- 42 In sales and employment by affiliates established by TNCs, developing-country TNCs account for a marginal share, but in some countries such as the United States their share amounts to 10% (UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics)).
- 43 A case in point relates to Chinese FDI in Canada, which has been growing in recent years; it is actively promoted by Canada, which has been losing its share in global FDI inflows in recent years (Lituchy and Lizhan Du 2006).