The results of McKinsey's latest study of the pros and cons of emerging market foreign investment.

The Case for Globalization

B Y D I A N A F A R R E L L

Few topics are more intensely debated or generate more contrasting emotions than the merits and costs of globalization, particularly foreign direct investment (FDI) by multinational companies in emerging markets.

To bring new facts to this heated debate, the McKinsey Global Institute studied the impact of FDI on local industries in China, India, Brazil, and Mexico. The industries included manufacturing and service sectors: automotive, consumer electronics, banking, food retailing, and information technology and business process outsourcing. In each of fourteen industry studies, we looked at the change in industry dynamics, sector productivity, output, employment, and prices before and after foreign players entered the market, and we conducted interviews with foreign and local executives. The complete collection of fourteen in-depth case studies is likely the broadest ever evaluated in a single research project and provides a strong base for our conclusions.

The research shows that FDI is indeed good for the economic health of developing nations—regardless of the policy regime, industry, or time period studied. In thirteen out of fourteen case studies, FDI improved productivity and output in the sector, raising national income while lowering prices and improving quality and selection for consumers.

And contrary to what critics charge, our case studies showed that foreign companies paid higher wages and were more likely to follow local labor laws than domestic companies in the same sector.

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The McKinsey Global Institute also found that FDI impact on host countries differed depending on whether investors were seeking lower costs or new markets. Investment by companies seeking lower costs—so called "efficiency-seeking" investment—consistently improved sector productivity, output, employment, and standards of living in the host countries, with few negative consequences. This type of export-oriented FDI also posed little threat to domestic producers, who instead often benefit as foreign companies look for local distributors and suppliers. They can also benefit by copying and building on what the foreign players are doing, as seen in the domestic Chinese consumer electronics and high tech industries, or the formidable Indian outsourcing players.

Companies that sought to expand their markets in the host countries also had a positive economic impact. In these "market-seeking" cases, however, the impact on employment was mixed and the benefits often came at a cost to incumbent, less productive companies, as seen in the case of Wal-Mart's entry into the Mexican food market, which drove down average margins for companies in the industry.

The impact on domestic living standards is the great success story of FDI and one that is seldom discussed. In nearly every one of our case studies, we saw lower prices and better selection after foreign players arrived. The reason? Foreign players improve the efficiency and productivity of the sector by bringing new capital, technology, and management skills and forcing less efficient domestic companies to either improve their operations or exit. Although some incumbent companies stand to lose, consumers benefit. In many cases, lower prices then led to an increase in demand and industry growth.

In market-seeking FDI cases, prices to consumers declined in seven out of ten cases, and product selection increased in all but the retail banking cases. The impact on prices was very large in some cases: for example, Chinese consumers saw passenger car prices drop by more than 30 percent between 1995 and 2001, though consumer prices more broadly grew by 10 percent during the same time period.

We found efficiency-seeking FDI cases to have a more limited impact on host country consumers as most production is for export and benefits global consumers. But even in these cases, the presence of foreign players benefited domestic consumers—either in the form of broader selection enabled by local production, or as in the case of the Mexican auto sector, by FDI players introducing innovative financing options in the Mexican market.

Indirectly, we also found that national income grew through improved productivity and output in many sectors and their suppliers.

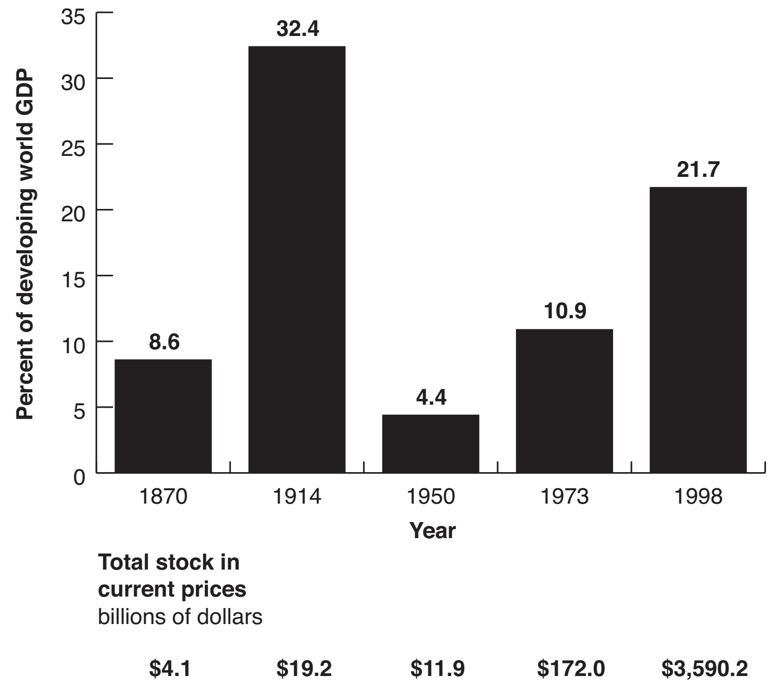
These results suggest that many of the criticisms directed at foreign companies today are not broadly warranted. Rather than being beneficial in only select circumstances, it appears that foreign investment nearly always generates positive spillovers to the rest of the economy.

THE FOLLY OF INCENTIVES

Given its salutary economic effects, most governments around the world actively woo FDI by offering a smorgasbord of tax holidays, import duty exemptions, subsidized land and power, and other enticements—policies every bit as popular in Iowa and New Jersey as they are in Brazil and India. However, our case evidence suggests that they are costly and largely ineffective.

In most cases, governments are giving away substantial sums of money for investments that would have been

Foreign capital is once again playing an increasingly important role in developing countries
Gross value of foreign capital stock in developing countries



Source: *The World Economy: A Millennial Perspective* by Angus Maddison (OECD, 2001).

made anyway. India, for instance, waived the 35 percent tax on corporate profits for companies moving back office processing and information technology jobs there (following similar concessions by the Philippines). This is worth roughly $6,000 annually for every full-time information technology employee and $2,000 for every processing one. While such measures might have been needed to offset perceived risk when the industry was in its infancy, they are almost certainly irrelevant today, when India commands more than a quarter of the global market. Our survey of thirty foreign executives who have moved jobs to India reveals that financial incentives were the least important factor in their decision. Most told us they would rather see the government spend its money upgrading local infrastructure.

When incentives do succeed in attracting foreign investment, there are sometimes unintended consequences. Government costs can escalate as incentives are extended to local players. Generous incentives can encourage too much investment, as seen in Brazil's automotive industry. Responding to subsidies worth roughly $100,000 per employee, we estimate that foreign carmakers added 40 percent more capacity than otherwise would have been built during the late 1990s. By 2001, the industry was saddled with 75 percent overcapacity. Low utilization rates have eroded the productivity of domestic and foreign players alike by at least 20 percent, and tied up considerable amounts of capital that could have been used more efficiently elsewhere in the economy.

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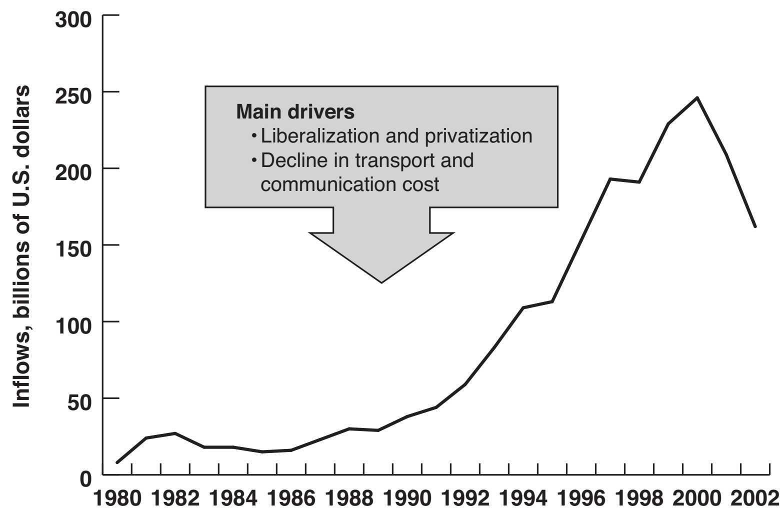
Multinational company investment has increased rapidly in the past decade



Based on estimates from OECD 2000 segmentation of total FDI (developed and developing countries); excludes "resource seeking" FDI (e.g., for petroleum); with this category, FDI is 84 percent market seeking

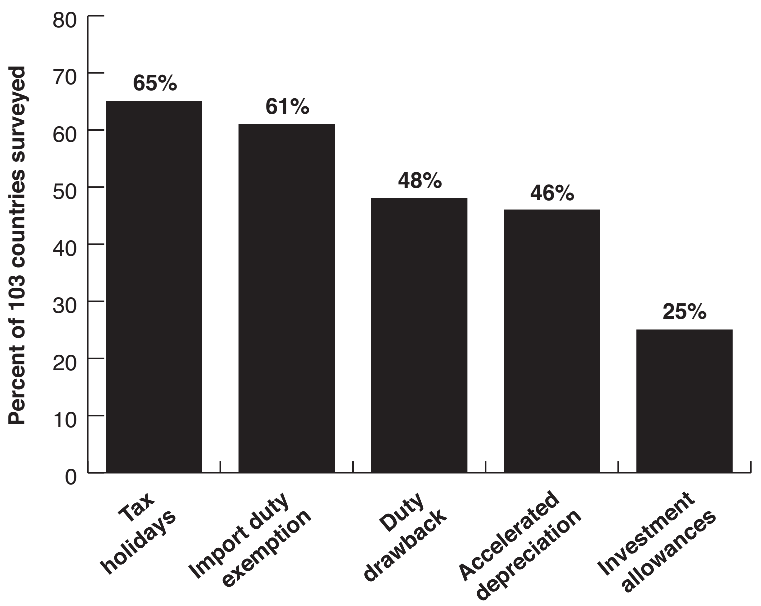
Source: OECD; McKinsey Global Institute; World Development Indicators (The World Bank Group).

Even as they are doling out lucrative incentives, many emerging market governments are wary of multinational corporations and have instituted restrictions designed to protect local industry and maximize spillovers to the domestic economy. The most popular are local content requirements (LCRs), which force foreign companies to purchase a certain percentage of inputs locally, and joint venture requirements. Our research casts doubt on their effectiveness, however, and finds that in some cases they lessen the impact of foreign direct investment by protecting inefficient players.

In three of our case studies where LCRs were present, we found their overall economic impact was marginal at best. Interviews with foreign car makers in India, for instance, found that they would have sourced many components locally even without LCRs because of the cost and time required to import parts, rising import prices, and the large supply of relatively low-wage, technically trained labor in the local component industry. The same reasons would likely apply to China's auto industry.

Moreover, the research clearly demonstrates that LCRs are not necessary for the development of a strong supplier industry. Mexico, for instance, does not have local content requirements for automakers, yet foreign investments have created seven jobs for local suppliers for every one job in car assembly plants. LCRs also diminish the impact of FDI by

Incentives are a popular mechanism for attracting foreign direct investment



Source: UNCTAD 1995; McKinsey Global Institute.

shielding inefficient, subscale suppliers, lowering productivity, and raising prices for manufacturers and consumers. Although China is known for its low-cost manufacturing, LCRs for auto parts have increased their price and made cars produced there 20–30 percent more expensive than in the United States. In India, we estimate LCRs added 20 percent to the cost of cars.

Nor did we find compelling evidence to support joint venture requirements. When joint ventures make economic and strategic sense, foreign players will pursue them. Neither Mexico nor Brazil have joint venture requirements in the retail or retail banking sectors, yet this was the most common way for foreign players to enter the market. This is because local market knowledge is so crucial to success in service industries. In a low-margin business like retail, for instance, understanding the nuances of consumer preferences and building reliable local supply and distribution networks means the difference between success and failure, and these are areas where foreign players are disadvantaged. In China and India, local partnerships often give foreign players needed government contacts to cut through red tape.

WHAT'S A POLICYMAKER TO DO?

To get the most benefit from FDI, developing nations should abandon incentives and regulations and instead focus on stabilizing their economies and promoting competitive markets. Macroeconomic instability discourages long-term investment because it makes demand, prices, and interest rates difficult to forecast. Most foreign investment entered Brazil, for instance, only after the government stabilized the economy through the 1994 Real Plan.

Competition is essential for diffusing the positive impact of foreign investments. Without competitive markets, the entry of foreign players will have little effect on inefficient domestic incumbents and productivity. The only case study in which FDI failed to have a clearly positive impact on the economy was banking in Brazil. One reason was the low competitive intensity of the industry because consumers find it difficult to switch banks. In contrast, the cases where FDI had the most dramatic impact were ones in which domestic incumbents were not shielded from foreign players, such the auto industry in India, or consumer electronics in China. In order to promote competitive markets, developing nations must reduce restrictions on FDI, lower import tariffs, and streamline requirements for starting new businesses and conducting mergers and acquisitions.

Another important way to promote fair competition is to crack down on companies in the informal economy, or "gray" market, who do not pay taxes or follow regulatory requirements. This gives them an unearned cost advantage, allowing them to stay in business despite their small scale and inefficient operations. In the Brazilian food retail sector, we found that cost advantage and discriminatory and inconsistent tax collection in the sector provided strong protection to unproductive operations.

Finally, developing countries must continue to build a strong infrastructure, including roads, power supply, and ports, particularly if they are seeking to attract export-oriented foreign investment. In India, for instance, the liberalization of the power and telecom sectors in the 1990s sparked an investment boom that led to infrastructure improvements, which were an important prerequisite for the development of the IT and business process outsourcing industry.

Today there is a growing backlash against globalization and many observers question whether it has broadly alleviated poverty and increased standards of living. The evidence from our research clearly shows that it can. Rather than holding foreign direct investment at arm's length, developing nations would do better by embracing it and implementing sound policies to get the most from it. ◆