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Do developing countries benefit from outward FDI?*

by

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Research and policy analysis on the relationship between FDI and economic development have until now focused almost exclusively on the impact that advanced economy multinational enterprises (MNEs) have when they operate in developing countries. Analyses of the opposite direction – how emerging markets benefit from the outward FDI (OFDI) undertaken by their own "emerging MNEs" (EMNEs) – have, however, been largely non-existent. As EMNEs have greatly expanded their share of global FDI stock over the past decade, the impact their international activities have on their home economies in the developing world has likely become more pronounced. For this reason, Karl P. Sauvant, in his recent *Perspective*,[1] encouraged emerging markets to develop OFDI policies. However, the shortage of research on the impact of such investments on home economies inhibits the formulation of such policies.

Developing countries can benefit from OFDI in at least three ways:[2]

- OFDI generates income in the developing home economy, both when EMNEs repatriate foreign-earned profits and when OFDI increases the exports of EMNEs and other firms in the home economy (such as an EMNE's suppliers).
- OFDI has the potential to enhance knowledge, skills, technologies, and other capabilities in the home economy. Many EMNEs investing in advanced economies acquire strategic assets, conduct overseas R&D and/or benefit from "reverse" linkages, spillovers and competition effects. Some of the capabilities acquired abroad are transferred back to company headquarters. In addition to benefiting investing firms, these acquired capabilities can spill over to other firms and the broader home economy. This facilitates economic and technological catch-up. Moreover, OFDI that transfers lower-end production to other developing countries can induce home economy industrial upgrading by freeing up capacities to focus on higher-end activities.
- OFDI facilitates access to resources, raw materials and capital goods available in host economies. Transferring these to the home country may, for example, ease shortages of natural resources, increase production capacities, enhance resources security, and raise productivity in the developing home economy.

Unfortunately, empirical evidence on the extent of these benefits is scant, and there are limitations. For example, many EMNEs struggle with their international expansion and may not generate profits; their ability successfully to acquire, absorb and transfer foreign knowhow may be limited; and OFDI may not effectively enhance security of access to natural resources.

There may also be outright harmful effects. As OFDI involves an outflow of capital, it may exacerbate capital shortages, come at the cost of much-needed domestic investment, harm the balance-of-payments, and facilitate capital flight. While the above list illustrated how EMNEs and their home countries jointly benefit from OFDI, corporate interests can diverge from countries' economic interests. For example, offshoring through OFDI may, under some circumstances, reduce production, exports, employment, and tax revenues in the home economy. And export-oriented OFDI that builds on low-cost production in the home economy may delay industrial upgrading and could have unexpected side effects in the home economy, such as enhancing industrial pollution and perpetuating low labor standards.

Past empirical research on the development impact of *inward* FDI has mostly produced, on balance, either positive or mixed findings. Similarly, many types of OFDI may, again on balance, benefit home economies, while some OFDI may have weak or even negative effects.

No blueprint exists for an OFDI policy focused on maximizing development benefits while minimizing any costs. Nevertheless, policymakers in developing countries have tools at their disposal that can help them develop appropriate policies:

- They can learn from the policies of developed countries and a few emerging economies (e.g. China, India).[3]
- They could identify what types of OFDI benefit their economies (e.g., specific kinds of export-promoting, capability-improving or resources-securing investments), taking into consideration country-specific macroeconomic conditions, industrial structures, development needs, OFDI patterns, affected firms, etc.
- Measures such as financial and fiscal incentives, reduction of regulatory barriers, OFDI insurance and guarantee schemes, and advice from ministries and embassies can be employed selectively to support or promote OFDI activities identified as beneficial.
- OFDI exhibiting proven harmful effects on domestic finance, employment, the environment, or society could be addressed through negative incentives and tighter regulation in relevant policy areas.
- An OFDI policy should not result in excessive regulation of associated economic activities.

A more complete catalogue of such policy options needs to be developed. It should be developed out of in-depth research that examines the strengths, weaknesses and effectiveness of various kinds of OFDI in contributing to the development of home economies, backed by empirical examinations on the link between OFDI and development. The findings would enable governments in developing countries to tailor their policies so that OFDI best supports development in home economies.

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[1] "A new challenge for emerging markets: the need to develop an outward FDI policy," No. 203, July 3, 2017.

[2] For a detailed discussion, see Jan Knoerich, "How does outward foreign direct investment contribute to economic development in less advanced home countries?" *Oxford Development Studies*, vol. 45 (2017), pp. 443-459.

[3] For an analysis, see Karl P. Sauvant et al., "Trends in FDI, home country measures and competitive neutrality," in *Yearbook on International Investment Law and Policy 2012-2013* (New York: OUP, 2014), pp. 3-107.

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