



# Policy Brief

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## Overview

The rapid rise in the overseas investments of Indian and Chinese firms has attracted widespread attention in recent years. To a large extent, the growing internationalization of these emerging economies has been driven by a search for resources, technology and related assets. What are the implications of this for foreign direct investment policy in both the source and the recipient countries? Furthermore, how will the ongoing global financial crisis affect the continued expansion of multinationals from the two countries, which have relied on international markets to fund their investments?

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## *The Internationalization of Chinese and Indian Firms: Trends, Motivations and Policy Implications*

THE LAST TWO DECADES HAVE SEEN A SIGNIFICANT rise in the internationalization of firms from developing economies. In addition to their growing participation in international trade, a number of leading emerging economies are contributing to growing outflows of foreign direct investment (FDI) and cross-border mergers and acquisitions. According to the 2008 *World Investment Report*, outward flows of FDI from developing countries rose from about US\$6 billion between 1989 and 1991 to US\$225 billion in 2007. As a percentage of total global outflows, the share of developing countries grew from 2.7% to nearly 13.0% during this period.

Within this widespread trend, the growing internationalization of firms from two fast-growing developing countries, China and India, is particularly notable. Table 1 illustrates the size of outward FDI flows from China and India in 2007. Firms from China and India have also been involved in significant and growing levels of mergers and acquisitions abroad. The recent high-profile overseas acquisitions by India's Tata group and China's Lenovo and Haier groups stand out as examples. Between 2005 and 2007, cross-border purchases by Chinese firms averaged about US\$3.5 billion per annum, while those by Indian firms averaged US\$1.5 billion per annum. As some of these acquisitions were financed through raising money in international markets or in the host economies, measures of outward FDI flows probably underestimate the extent of internationalization of firms from these two countries.

However, the quantitative significance of these trends needs to be kept in perspective. Although outward FDI from both countries has increased in recent years, the levels remain paltry relative to the size of these economies and relative to global FDI flows. Both countries also rank quite low in terms of UNCTAD's outward FDI performance index, which measures a country's outward FDI relative to its GDP.

So why have these fledgling flows commanded so much attention? For one, both China and India are large and populous developing countries and their recent growth



spurt has captured the popular imagination. Further, the emerging outward orientation of these countries reflects a distinct break from their historical trajectories: both China and India were inward-looking economies for much of the period after the Second World War and these trends may mark their arrival on the international scene.

Within the context of these trends, two features stand out. First, the pattern of internationalization by Chinese and Indian firms does not conform to the conventional form where firms expand overseas to exploit their firm-specific advantages; rather, these firms have largely been driven by a search for resources, technology and other strategic assets. This has significant implica-

markets, and the emerging pattern may well prove fragile in the wake of the global financial crisis.

### New Patterns of Internationalization

The patterns of internationalization followed by Chinese and Indian firms share a number of common elements. Both countries have experienced rapid growth in recent decades, which has led to large inflows of FDI and portfolio capital and, for China, a sustained current account surplus too. These inflows, combined with high rates of domestic saving, created large reserves of capital at the macroeconomic level, which in turn led to a relaxation of policy restriction on capital outflows. Many outflows in

## The “uphill flow” of capital from labour-rich developing countries to the developed world does not fit textbook economic theory

tions for traditional industrial policy in recipient countries, which have tended to encourage such investments to boost local employment and economic growth. Second, the overseas expansion was to some extent fed by the availability of easy credit in international financial

recent years took place under easy credit conditions in global financial markets, though this situation has changed dramatically since the summer of 2007.

At the same time, there are significant differences in the international behaviour of firms from the two countries. Whereas Chinese overseas acquisitions are more commonly carried out by state-owned enterprises, Indian outward FDI involves mostly private sector firms – typically the large, diversified business houses. Chinese overseas investments are more likely to have been in primary sectors, notably minerals and energy, whereas Indian investments are more distributed across a range of sectors.

These differences are probably closely linked to the underlying policy environment that has guided the industrial evolution of each economy. Despite the economic liberalization that started

Table 1. Outward Foreign Direct Investment from China and India (2007)

	China	India	Developing countries
Outward FDI flows, value (US\$ billion)	22.5	13.6	225.0
Outward FDI flows as share of gross fixed capital formation (%)	1.6	3.5	16.2
Outward FDI stock (US\$ billion)	96.0	29.0	2,288.0
Outward FDI stock as share of annual gross domestic product (%)	3.0	2.6	16.0

Source: UNCTAD 2008 *World Investment Report*



in China in the 1980s, state-owned enterprises continue to play an important part in the Chinese industrial sector. Given the dependence of the economy on sustained exports, many Chinese overseas investments aim to secure access to critical raw materials, especially energy. By contrast, India's industrial sectors have experienced

A second key motivation for firms to invest abroad is to secure access to strategic assets, including natural resources and raw materials, as well as new technologies and brands. Because security of access to essential raw materials is considered important for economic growth, state-owned enterprises have been at the forefront of acquiring ownership stakes

## An alternative view sees the emerging internationalization as the “coming of age” for the Chinese and Indian corporate sectors

many policy gyrations over the decades. India was remarkably open to inward FDI throughout the 1950s, allowing a substantial stock of foreign investment to build up. Through much of the 1960s the policy of import-substituting industrialization allowed considerable scope for private enterprise, creating a significant pool of private firms that have taken advantage of a more liberal regime to internationalize abroad.

### Motivating Factors

What are the specific factors that have driven Chinese and Indian firms to venture abroad, and have enabled them to do this with a degree of success? Judging from recent survey data (for instance the 2006 *World Investment Report*), most developing country multinational corporations (MNCs) report that they invest abroad to access overseas markets or to gain proximity to potential clients. Although Chinese manufacturing firms can gain access to international markets through exports, overseas investments are used as a means of improving access to markets or pre-emptively securing access against potential protectionist barriers. Indian technology firms realize that proximity to their clients can help them understand and service their overseas markets better.

in overseas mining and energy sectors. China National Petrol Corporation and China National Offshore Oil Corporation are typical firms in this category, but India's Oil and Natural Gas Commission has also made substantial forays abroad.

Technology-seeking FDI is not peculiar to China and India. In the past, Korean firms such as Samsung and Hyundai combined foreign investment with international technology licensing to build their technological capabilities. However, the stronger international intellectual property regimes that have emerged in recent years could have created a bias towards technology-seeking overseas acquisitions. In part, this is because ownership of technology assets allows more experimentation. Technology and the related desire to acquire brands and distribution networks are important elements in the internationalization of Indian pharmaceutical and software companies. For China, Lenovo's acquisition of IBM assets and Haier's investments in the United States have provided footholds in overseas markets as a stepping stone to develop their own brand identity. Additionally, in some sectors overseas acquisitions may enable firms to exploit economies of scale and scope,



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for example, Indian firms' investments in steel.

For some firms the rush to go overseas may be fuelled by the desire to steal a march on domestic rivals. There appears, for instance, to be a strong competitive element in the overseas acquisition strategies of Indian business houses. In other cases, outward FDI is seen as a part of a "national strategy", although several studies suggest that this perception is probably exaggerated and is more reflective of anxiety in some recipient economies.

Standard explanations of factors motivating FDI have limited traction when analysing the internationalization activity of MNCs from China and India. A leading theoretical approach, the ownership—location—internalization (OLI) theory, explains the internationalization activity of MNCs as their attempts to extend their ownership advantages (e.g. proprietary access to a superior production technology or a valuable brand) to overseas markets by exploiting locational advantages (locating abroad to access low-cost inputs or better serve local markets) and internalizing the efficiency gains from economies of scale and scope by integrating the firm's activities across borders. In short, FDI enables firms to exploit their existing firm-specific assets.

Typically, firms from China and India have only limited technological or ownership advantages to exploit. Rather than exploiting existing assets, their outward FDI may reflect attempts to acquire or augment these assets.

### Policy Innovations in China and India

The newfound outward orientation in India and China is noticeable for two of its qualitative aspects. First, the time profile of FDI flows does not conform to the conventional investment development path for developing countries.

Traditional theories envisage an initial stage where inward FDI allows developing country firms to acquire technology and other capabilities; they then progress to a stage where they exploit their acquired ability in export markets, and only in time to the stage where they invest overseas. In contrast, both China and India developed their industrial bases through policies of import-substitution without recourse to massive inflows of FDI, China even more so than India. And, for both countries, outward FDI flows have emerged much sooner than expected, whether compared with the trajectory of early industrializing nations or with more recent cases such as South Korea.

Second, traditional patterns suggest that developing country multinationals focus their internationalization activity in economies that are lower down the development ladder. In contrast, and somewhat surprisingly, some of the international investments and acquisitions of Chinese and Indian firms have been in developed economies such as the United Kingdom and the United States. The outward flow of capital from developing countries to acquire assets in developed countries presents a theoretical conundrum. Ordinarily, one would expect the rate of return on capital to be higher for investments in a fast-growing developing economy than for overseas ventures in relatively developed economies. To put it simply, the "uphill flow" of capital from labour-rich developing countries to the developed world does not fit textbook economic theory.

One possible explanation is contextual. Policy liberalization may have given firms new opportunities to diversify their investments. The logic of diversification can make it rational for a firm to expand overseas even when the return on such investment is lower, as long as domestic and overseas returns are less than perfectly correlated. In the

past, when policy restrictions prevented Indian firms from diversifying internationally, firms such as Tata were compelled to diversify domestically across industry sectors, beyond what is suggested by standard economies of scale and scope. Once policy became suitably accommodating to outward FDI, it was only natural that international diversification followed. These firms' quest for economies of scale may also motivate them to invest abroad. This is particularly true in sectors such as steel and metals.

At the same time, some of the overseas investments may have been prompted by "push factors" in the form of policies that distorted the rates of return on capital at the enterprise level, creating an imperative to venture abroad. In China, distortions in the financial intermediation process, combined with a high rate of private savings, may have driven down the rate of return on domestic investments, forcing firms to look overseas for more lucrative opportunities.

### Global Policy Implications

These trends pose some questions. First, what is the economic impact of such emerging internationalization on the developed host economies and on China and India? Second, what policy implications arise from this assessment? And, lastly, what is the likely effect of the current global financial crisis on these trends?

Among potential recipients of foreign direct investments from China and India, many developed economies have long espoused openness to inflows. Greenfield ventures – where foreign firms invest in new factories rather than merely acquiring ownership of existing assets – have been welcomed by recipient governments as a valuable source of new investment and employment generation. Besides, inward foreign investment may improve domestic pro-

ductivity through spillovers of technology, through the demonstration effect of better management practices and also because competition from multinational enterprises provides stimulus for efficiency improvements amongst domestic firms.

However, many Indian and Chinese multinationals have entered international markets by acquiring existing assets rather than through greenfield investment. Public reactions to these acquisitions – and the political realities underlying these reactions – have so far been quite mixed. Although the overall impression generated in the Western media has been of an "invasion" by emerging country upstarts, the reality in many cases is that such acquisitions may have given a new lease of life to failing firms. Many recent Chinese acquisitions in Europe involved the takeover of poorly performing firms. Similarly, Corus and Jaguar, which were acquired by India's Tata group, were both in financial distress. In all such cases, it is likely that the post-acquisition rationalization of these firms will result in labour retrenchment rather than employment generation. To the extent that these were firms in distress, some retrenchment would have happened regardless of foreign takeover, but whether overseas firms are seen as "saviours" or as "asset-strippers" depends on careful enunciation of corporate strategy. Tata, with a credible record of successful about relations, is well placed to cope with this, but may yet need to tread carefully.

The argument that FDI creates the potential of productivity-enhancing spillovers calls for a more cautious assessment. To the extent that some of the outward FDI from China and India is technology seeking in intent, the scope for technological spillovers that benefit the host economy is limited. Nonetheless, the entry of foreign firms could well increase the degree of compe-

### About This Brief

This policy brief draws on ideas that emerged at two UNU-MERIT workshops on "The Internationalisation of Chinese and Indian Firms" in September 2008. We thank all participants for their helpful comments. The papers presented at the first seminar are downloadable from <http://www.merit.unu.edu/icif/agenda.php> and a selection is published in the Special Issue of *Industrial and Corporate Change*, 18(2), April 2009.

Participants in the second seminar who contributed ideas to this brief are:

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tition in the industry and introduce new management practices that spur productivity improvements.

Public perceptions of Chinese and Indian MNCs are inevitably tied up with reactions to the recent economic

Indian corporate sectors and a measure of their ability to compete globally on equal terms. However, this more celebratory approach carries risks too: when competitive foreign acquisitions become an end in themselves, they carry the risk

## If the financial crisis triggers a sustained recession in the developed world, the long-term profitability of existing overseas investments from India and China is likely to suffer

growth of these countries. Most people consider China's success in low-cost manufacturing for global consumers to be a positive development, but the inevitable rise of China and India as significant economic players has caused consternation by challenging the established order of industrial hegemony. In the case of China, for example, there is growing unease about the entry of large sovereign wealth funds, which are largely viewed as instruments of an overbearing Chinese state. Although there are a number of historical and structural explanations for the dominance of state-owned enterprises in China, it nevertheless creates the perception that these firms are beneficiaries of "unfair state aid", an argument that resonates with old debates about strategic trade policy.

What are the likely implications of outward FDI for China and India themselves? One view expresses concern that outward FDI can deprive developing countries of scarce capital, including human capital in the form of managerial resources. This is reminiscent of old concerns about brain-drain. A more balanced view allows that what starts as a brain-drain can become a part of two-way "brain circulation". Besides, even if these flows are perverse, it is hard to control them in an increasingly globalizing world. An alternative view sees the emerging internationalization as the "coming of age" for the Chinese and

of irrational excess. It is conceivable that many of the acquisitions currently being celebrated as badges of success will result in corporate failure.

### Impact of the Global Financial Crisis

The success or failure of these overseas ventures depends on how the current economic crisis plays out. The credit crisis that has gripped global financial markets represents more than just temporary punctuation in a steady trend towards internationalization of firms from China and India. Rather, the process of internationalization was itself shaped by a financial configuration that has spawned the current financial crisis.

Arguably, the build-up of foreign exchange reserves in China enabled a more permissive policy towards outward direct investment, but the same reserves were a manifestation of global imbalances that contributed to the financial excesses leading up to the crisis. Financial innovation, in particular securitization of assets, catered to the growing global demand for investment assets. Foreign acquisitions made by Indian firms were facilitated by easy credit market conditions, but easy credit was also a factor in the real estate boom that was a key ingredient in the crisis. The sustained global construction boom resulted in overheating in many com-

modity markets, especially energy and steel, so that acquisitions in these sectors seemed particularly valuable. More generally, a period of sustained economic growth, especially in the Anglo-Saxon world, generated confidence that spurred investment by Chinese and Indian firms.

The recent reversal of fortunes in global markets has altered this position dramatically. Although securitization had its merits, claims that it somehow distributed risks thinly across those most able to manage them were not justified by events. In the United States, excessive demand for securities resulted in relaxation of lending standards, eventually creating a large pool of what turned out to be sub-prime mortgages. Falling house prices and increased mortgage delinquency resulted in a collapse of the price of these assets, triggering a sharp decline in global liquidity. To the extent overseas acquisitions were reliant on access to credit markets, this has weakened the ability of Indian corporates to retain control of existing acquisitions, let alone contemplate new ones.

Further, the collapse of equity prices and the onset of a global recession make many overseas acquisitions from China and India seem extravagant in hindsight. The value of the US\$3 billion investment made by China Investment Corporation (a sovereign wealth fund established by the Chinese government) in Blackstone, a private equity firm, has fallen to a fraction of its initial value. Similarly, the current recessionary projections do not augur well for Tata's investments in steel and automobiles. In the short run, there may well be a "sudden stop", where new outward investment from these countries dries up. But, in the longer run, if the financial crisis leads to sustained recession in the developed world, the profitability of existing overseas investments from India and China may suffer.

### Coping with the Financial Crisis

The **Tata Group** from India acquired the Anglo-Dutch steel manufacturer Corus in 2007 for £6.7 billion through a special-purpose subsidiary called Tata Steel UK. Declining demand in the steel industry and tight credit market conditions have forced it to divest some holdings. According to the *Financial Times*, Corus has agreed "to sell an 80 per cent stake in one of its UK steel plants to an Italian-South Korean consortium for \$480 million", and it will also reduce its UK workforce by 2,500 workers. The Tata Group "quickly followed the Corus move with the \$2.3bn purchase of Jaguar Land Rover, the British carmaker. Unfortunately . . . , this is another UK business that has suffered severe financial problems because of the downturn. Along with other UK car producers, Jaguar Land Rover is now talking to the government about emergency help." (*Financial Times*, 25 & 28 January 2009)

**Lenovo**, the Chinese-owned personal computer maker, has replaced its American chief executive with its Chinese chairman, in a move aimed at cutting losses and stopping an erosion of market share. The new management was at pains to point out that "the reshuffle should not be seen as a move to change Lenovo from a multinational back to a Chinese company" and that "the company does not plan to relocate its headquarters to China". However, the company "would have to rely on China, its home market, and emerging markets to weather the current global downturn". (*Financial Times*, 5 February 2009)

The return of economic nationalism does not help either. As crisis-hit firms in developed countries queue up for government aid, the tag of foreign ownership places firms at a relative disadvantage. Consider, for instance, Tata's ongoing attempts to obtain state aid to preserve jobs at Jaguar's automobile plants in the United Kingdom. Similarly, as the developed world struggles with levels of unemployment not seen for many decades, we should expect political resistance to further outsourcing of jobs to India, jeopardizing the value of Indian acquisitions in this sector. Nonetheless the financial crisis also provides opportunities. Where the overseas acquisitions and ventures can add value by exploiting advantages such as econo-

mies of scale and scope, better corporate governance and smoother supply chain management, these new ventures may mark the start of truly global businesses.

Thus, in sum, the recent internationalization of firms from China and India was not unrelated to a financial configuration that involved the accumulation of reserves and cheap credit. As global financial markets swing to the other extreme, the durability of this episode of internationalization will come to be tested. There are real dangers to the viability of existing investments but where Chinese- and Indian-owned firms can use the footholds and corporate strengths to survive in overseas markets they may well emerge with a stronger position in the future.



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