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Other "New Forms" of FDI

9.1 New Multinational Enterprises from Developed Countries

9.1a Small and Medium Enterprises

Small-and medium-sized enterprises in the developed world are playing an increasing role in the allocation of international production to developing countries. UNCTAD (1993.c) recently published a study on SME multinational enterprises. It noted two main features of such firms from the developed countries. First, their FDI was small in value but large in relation to the number of affiliates. Even in Japan, which has the largest number of small and medium multinationals, the share of total FDI was less than 20 percent in the mid-1980s. In the USA, small and investors accounted for only 3 percent of foreign assets. Second, because of information gaps and imperfections, small and medium MNEs are more likely to invest in other developed countries rather than in developing countries. Less that 10 percent of their affiliates were located in the latter, compared to well over 20 percent for large multinationals.

SME MNEs from the smaller European countries like Denmark, Sweden, Ireland, Finland and Switzerland tended to have more foreign affiliates than the average (of 2.5 affiliates per MNE), in contrast to counterparts from very large economies like the USA. Most overseas investment by SMEs was relatively recent, with Japanese and European firms investing mainly in the 1980s and early 1990s. As far as developing countries are concerned, Japanese firms tended to concentrate in Asia (see below), US firms in Latin America and European ones in South and East Asia and, more recently, Latin America. There was practically no interest in Africa, reflecting the perception of high costs and risks of doing business there and the shortage of information on opportunities. Manufacturing firms had gone transnational earlier than service firms, with high technology firms leading the movement. Within manufacturing, firms in equipment manufacture were more prone to go overseas than others. SME investors were also very active in selling their technologies at arm's length to developing countries.

Japanese small- and medium-sized enterprises have been the most active in developing countries, and deserve some more discussion.[101] Their transnationalisation was given a fillip by the rapid appreciation of the yen, from ¥252 per dollar in 1985 to ¥112 at end-1993, and to below ¥100 today. This has had four effects on Japanese firms: (i) falling domestic value of export receipts, (ii) deteriorating price competitiveness in the export markets, (iii) intensified foreign competition in the domestic market, and (iv) reduced cost of FDI when calculated in yen.[102]

The very first wave of Japanese overseas investment overseas, in the 1960s, was led by small and medium firms seeking low wage bases overseas. In the 1970s and 1980s, it became dominated by large manufacturers, seeking natural resources, production sites in or near large export markets, and low cost assembly sites for labour-intensive processes in South East Asia. The current wave is led by support industries which produce parts and machinery for the big manufacturers and are finding it increasingly expensive to supply components from their home base. These often launch FDI at the request of the parent firm. Adachi (1992) shows that, from being stagnant in the early 1980s, the number of FDI projects undertaken by SMEs increased from 315 cases in 1985, to 1,625 in 1988, mainly in machinery, miscellaneous goods, textiles, and

metals. SMEs in the manufacturing sector accounted for about 45 percent of the growth.

While N. America has been the largest single destination for Japanese SMEs, over 40 percent of their total FDI is concentrated in Asia, in particular in S E Asia. Within this region, there is a clear shift from the established NIEs to the new NIEs, mainly because of international currency realignments and rising wages. China is also increasingly favoured as a host economy for FDI because of its readily available cheap labour and its huge domestic market. The ASEAN countries, on the other hand, have benefited from their increasing growth-generated domestic absorption, which often more than offset the relatively more expensive labour force.

The new wave of Japanese investment is likely to mean that fewer manufacturing plants are simple assembly points for parts imported from Japan. This is expected to improve the transfer of technology to the region, that so far has been notably slow. The change is likely to be most noticeable in those industries where the rising yen has made domestic suppliers non competitive—for instance in the car industry. More radically, some R&D facilities are also been moved from Japan. Hitachi, for example, intends to concentrate its product development and marketing in Malaysia, which has so far served simply as a manufacturing base. However, 'key' technologies will continue to be developed in Japan.

While SME MNEs remain relatively small players in the global FDI scene, their importance should not by underestimated in the long-term. They are bound to become more international as the world economic space continues to shrink. They offer additional resources to host countries. In addition, they have some specific advantages. Some are able to offer highly specialised and advanced technologies, especially in the area of machinery manufacture; one of their most important contributions may be that they can become component suppliers and subcontractors to larger MNEs (as noted, this is already happening in South East Asia). Some can offer simpler technologies and can diffuse skills and know-how to local enterprises more readily than large multinational enterprises. Others can offer specialised services – in fact, a significant part of the recent growth in service FDI comes from enterprises that are relatively small by the standards of the typical manufacturing multinational (though they may be among the largest firms in their own activities). These service MNEs can provide employment, create skills, and raise the flexibility and competitiveness of the host economy.

9.1b Newly Privatised Public Enterprises

As far as the other new form of investment from developed countries – the newly privatised public enterprises – are concerned, there is little available by way of systematic research. However, anecdotal information suggests that many of these firms, with large reserves of cash, surplus capacity in relation to their traditional home markets and aggressive new managements, are seeking to "go global" as a way to expand. The industries involved are mainly in the areas of transport, airport management, communications, power generation and transmission, sewage disposal and treatment, and environment. It could soon include activities like health services, education, postal services and even civil service management.

The process of internationalisation has started. For instance, in the telecommunications industry, British Telecom has sparked off a struggle for strategic international alliances in order to boost its global competitiveness.[103] It has taken a 20 percent stake in MCI, and the two are jointly setting up a company to sell services to multinational enterprises. In return, French and German companies have set up their own joint venture; the Dutch, Swedish and Swiss companies have formed a consortium; and AT&T has announced its own world strategy. Others are waiting in the sidelines. Similarly, British Gas is eager to expand its multinational activities, using its large financial reserves and accumulated technology and skills to develop the gas-related infrastructure of developing countries. Many such companies

have excess capacity in their domestic economies, and liberalisation at home is inducing them to look to global markets for growth and profitability.

These developments are just beginning to take shape in the developed world, and they have important implications for developing countries seeking FDI. They promise to open up new and large avenues for the transfer of investment and technology in critical areas of infrastructure and utilities. By increasing international competition, they would allow developing countries to get newer technologies, more financing and better terms than before. These deals could range from arm's length purchases of facilities and equipment to licensing and management arrangements, BOT contracts, and full direct investment with long-term ownership.

Policy makers in developing countries should become more fully aware of the enormous potential that is being opened up in the sphere of newly-privatised enterprises. They should analyse carefully the conditions that they need to offer to obtain a share of the FDI and technology that is starting to flow from these giant enterprises. Apart from the usual requirements for attracting FDI, the entry of privatised firms into utilities and infrastructure would require the framing of an appropriate regulatory and pricing system that meets the needs of the investors as well as the host economy. It would also require that domestic suppliers of the relevant services, generally state monopolies unused to competition, are opened up to market forces to the extent possible, and that the appropriate ministries become more 'businesslike' in their treatment of the activities concerned.

9.2 New Contractual Forms

Entry to overseas markets by multinational enterprises has been facilitated by a new array of cost-savings and risk-reducing investment techniques, allowing foreign companies to take effective control and expand production abroad without majority equity stakes (i.e. ownership control) in the venture. Such techniques include joint ventures, international sub-contracting deals, licensing arrangements, franchising, management contracts, turnkey and product-in-hand operations, and production- and risk-sharing agreements.[104] These new forms of investment (NFIs) reduce the start-up and working capital costs of investment, limit multinational enterprises' exposure to political and commercial risks, and allow them to circumvent administrative barriers to market entry – such as foreign ownership limitations – without losing competitive strength.

During the 1980s NFIs spread to become an important part of international corporate strategies in developing countries. Statistics on FDI unfortunately tend not to reflect the volumes and patterns of use of NFI, primarily due to difficulties in assigning values to the international flow of tangible and intangible assets that constitute NFI. Scattered evidence, however, shows growth in the number and variety of NFI-type arrangements. For example, sub-contracting and design licensing have been widely used for foreign investment in particular sub-sectors, notably the automobile industry. The pioneering experience of Japan, which has been signing such arrangements throughout East Asia since the 1960s, has been followed more recently by other countries, notably the United States. US capital has been increasingly involved in the maquiladora industry in Mexico, largely through joint ventures (Sklair 1989). Initially developed by US multinationals as assembly centres for the purpose of labour-cost savings, and dominated by garments, Mexican maquiladoras evolved in the 1980s into a channel for the transfer of mature technology (including the upgrading of labour force), particularly in the automotive, electric and electronic industry.

Among the most promising recent approaches to bridging the gap between private financing of export-oriented manufacturing, and of infrastructure or other projects with long gestation periods, are BOT and BOO schemes. Multilateral

agencies, particularly the World Bank and the regional development banks,[105] are devoting much attention to this new form of financing, as a way of alleviating the burden on public finances, savings and foreign exchanges in developing countries, improving essential infrastructure, as well as encouraging better risk sharing, accountability, monitoring and management. In a BOT financing scheme, a private consortium raises cash for a large project, usually in infrastructure, which it builds and operates for a fixed term at an agreed rate of return, until it is transferred to the state. Due to problems with ownership transfer to the public sector, the BOT principle is increasingly being substituted by one where the private sector "build-own-operate" (BOO), retaining an equity and operating interest over the long term.

BOT/BOO schemes generally need some mechanism to cover foreign exchange risk. Because most infrastructure projects typically generate local currency revenues, such mechanisms assure foreign investors that the foreign exchange equivalent value of the project's revenue stream is maintained. Fundamentally, two issues are involved:

- **Convertibility:** whether authorisation for conversion in foreign exchange will be granted to cover debt service and equity payments, or whether such payments will be constrained because foreign exchange is rationed; and
- **Exchange Rate Depreciation:** whether the exchange rate will be maintained at levels that is adequate to service foreign debt and equity.

All mechanisms to cope with exchange risk generally involve official agencies, such as the central bank, the export-import bank, or the government, and use contractual relationships as a risk management tool. Normal exchange hedging techniques are also used, but the long-term nature of the involvement means that additional measures are often called for. Central banks may guarantee against convertibility risks by ensuring that sufficient foreign exchange will be placed in a priority account for the foreign debt (although this strategy is not macroeconomically desirable), to be serviced even if the host country suffers a balance of payments crisis. Governments can provide guarantees against adverse foreign exchange movements, for instance, by building foreign exchange exposure into tariff adjustments. Another approach, applicable to economies that are highly dollarised and to companies that deal with international customers (like some telecommunications, ports and airports), is to levy charges to customers in US dollars.[106] It should be noted that these arrangements are not, and should not be, intended to guarantee against normal commercial risk, and the normal precautions of completion clauses and performance should be in force.

There is no doubt, however, that BOO and BOT schemes involve some economic, technical, institutional and political complexities. These are sometimes considered major constraints to the widespread use of this type of infrastructure finance.[107] Macroeconomic stability and access to foreign exchange to service debt and equity are important prerequisites, as well as a well-functioning legal system, a pricing and regulatory framework that protects the investor as well as the national interest, and strong negotiating capabilities within the government. Developed local capital markets are also crucial in enabling the private sector to participate in the financing. Augenblick and Custer (1990) have argued that when host countries have structural bottlenecks, traditional external borrowing (e.g. for a turnkey project) might be a more viable option. "Nevertheless, the fact remains that many projects considered essential could not be built without BOT financing schemes because governments do not have the budgetary resources or the borrowing capacity to build."[108]

The example of the US$ 1.8 billion Hub River thermal energy project in Pakistan illustrates this point. The agreement, between the Pakistani government, local and foreign debt and

equity investment, and the World Bank, commits the government to protect the foreign counterpart against sovereign risk, while leaving project risk with all lenders and investors. It also provides a mechanism through which foreign lenders and equity investors are guaranteed repayment even though the investment output – in this case electricity – does not directly earn foreign exchange. Pakistan has to undertake to service the debt out of its general foreign exchange earnings, with part of them being especially dedicated to the project.

The rapid increase in demand for private sector involvement in infrastructure projects through BOT schemes confirm the potential of this form of financing. Countries in East Asia and the Pacific region have been the biggest user of BOTs. As noted earlier, Malaysia is using BOT schemes on a very large scale basis, more extensively than other countries in the region.[109] Other cases are found in Hong Kong (the Eastern Harbour Crossing), China (the Shajiao power plant and a railway project), and Pakistan (above). India is a relative new-comer to this mechanism, but is promising to become a major user (see Box 6). Outside Asia, developing countries with significant inflows of capital for BOT projects on a per capita basis are Argentina, Belize, and Panama.

It is interesting to note that BOT/BOO operations are not only the preserve of large MNEs from the developed world. Box 6 describes a private Hong Kong firm which is a major player in this area. The ability of a developing world firm to provide such projects is impressive in itself; it also fits into the prospects for increasing intra-developing country investment discussed above. The entrepreneur behind this firm, Gordon Wu, has become an almost legendary figure in Asia , and is sought by institutions like the World Bank and the Asian Development Bank to launch large infrastructure projects, particularly in the power sector.

It is evident, therefore, that BOT type of projects are going to be of major significance in many developing countries in the near future,

Box 6: **Hopewell Holdings' BOT/BOO Projects**

Hopewell Holdings of Hong Kong, run by Gordon Wu, has already built several power plants in China and the Philippines. According to a recent report,[110] under its power subsidiary CEPA (Consolidated Electric Power Asia), it has a $526 million plant in operation in China, with 50% equity share, and three smaller plants in the Philippines, with shares from 50 to 100%. It is currently constructing a $1.9 billion power plant in China (with 27% equity) and another for nearly $1 billion (49%) in the Philippines. It had now reached preliminary agreements to construct more generating plants in Indonesia (100%, for $2 billion)[111], China ($2.3 billion, equity share unknown) and the Philippines ($1.6 billion, 100%). If the last deal goes ahead the firm will become the largest foreign investor in the Philippines.

Apart from power generation, Hopewell is also building a super-highway in Thailand, which has been delayed in construction.

CEPA has more recently signed BOT deals in India and Pakistan to build and manage power stations worth about $19.5 billion over ten years, and is scouting the subcontinent for more. The India connection was brought about through the World Bank. However, apart from its plans in Shenzhen, it has mothballed BOT plans for power stations in China because of caps (of 12 to 15%) being imposed on returns on power projects.[112] In India the company believes it can obtain rates of return nearer to 20%, while in Pakistan, Indonesia and Philippines it can obtain returns of around 18%.

For the India projects (16 units of 660 MWs each) the company will raise funds from a variety of sources, including the IFC, commercial banks and global equity markets. Each power project may be spun off as a separate listing, raising additional funds from CEPA shareholders. CEPA itself was floated on the Hong Kong exchange in 1993 for $769 million to provide funds for its BOT projects, at that time mainly for China.

and that their own firms can plan a large role in setting them up. As with other such schemes, it is imperative for host governments to create an appropriate environment for such investments to take place and to develop their own capabilities to negotiate and handle the projects.