Executive Summary

Who benefits from multinational company activity in the developing world, and how? Few topics are more intensely debated or generate more contrasting emotions than the merits and costs of global economic integration. And few topics are more in need of a robust set of facts on which to base assessments. To provide insight, the McKinsey Global Institute launched an in-depth inquiry into multinational company investment in developing countries. A key finding is that the overall economic impact of multinational investment on developing economies has been overwhelmingly positive despite the persistence of host-country policies that can lead to negative, unintended consequences. Moreover, companies have only started to capture the large cost savings and revenue gains possible from operating in these markets. Multinational company investment in the developing world opens up new horizons for economic development and for company strategy.

For this study, MGI developed a set of case studies focusing on five sectors: automotive, consumer electronics, retail, retail banking, and information technology/business process offshoring in four major developing economies: China, India, Brazil and Mexico. These case studies shed new light on two sets of related questions:

¶ What impact has multinational comany investment had on the economies of the developing world? What are meaningful implications for governments and policymakers?

¶ How has multinational company investment in the developing world impacted industry structure and competition globally? What are the implications for companies making decisions about global sourcing, investments and expansion?

MULTINATIONAL COMPANY INVESTMENT IMPROVES LIVING STANDARDS IN DEVELOPING ECONOMIES

1) Most economies clearly benefit. Through the application of capital, technology and a range of skills, multinational companies' overseas investments have created positive economic value in host countries, across different industries and within different policy regimes. In 13 out of 14 case studies, we found the impact overall to be positive or very positive (Exhibit 1).

2) Improved standards of living and muted impact on employment. The single biggest impact of multinational company investment in developing economies is the improvement in the standards of living of the country's population, with consumers directly benefitting from lower prices, higher-quality goods and more choice. Improved productivity and output in the sector and its suppliers indirectly contributed to increasing national income. And despite often-cited worries, the impact on employment was either neutral or positive in two-thirds of the cases. In China, since 1995, global auto companies have driven down prices by 31 percent, while improving the quality and selection of cars in the market. Both labor productivity and output in the sector have increased by at least 30 percent annually and employment has increased moderately over the same period.

3) Impact on host countries differs depending on whether investment is motivated by search for lower-cost locations or for new markets. Investment by companies seeking lower wage costs consistently improved sector productivity, output, employment, and standards of living in the host countries, all without much downside. For example, companies in the information technology/business process offshoring sector have created a new, rapidly growing industry in India that already employs nearly half a million people. Similarly, the activities of companies seeking to expand their market in the host country also had a generally positive economic impact. In these cases, however, the benefits often came at a cost to incumbent, less productive companies, and the impact on employment was mixed. Wal-Mart's entry into the Mexican food retail market has driven down prices to consumers, but also driven down average margins in the industry.

4) The banking sector is the exception. While foreign investment in the banking sector was important to sector capitalization and contributed to productivity, it failed to have a clear positive impact on consumers or on competition.

INVESTMENT POLICIES MOSTLY INEFFECTIVE BUT COSTLY

1) Popular incentives to foreign investments are not the primary drivers of multinational company investment and instead have negative and unintended consequences. Without materially affecting the volume of investment in most cases, popular incentives such as tax holidays, subsidized financing, or free land serve only to detract value from those investments that would likely be made in any case. Many of these policies result in direct fiscal and administrative costs, as well as indirect costs, particularly reduced productivity. For example, government incentives in Brazil's automotive industry contributed to overinvestment and thus low capacity utilization, which reduced productivity performance. Similarly, import barriers and trade-related investment measures such as local content or joint venture requirements did not have clear positive impact, but did limit competition, and protect subscale operations, thereby dampening productivity performance. In the consumer electronics sector in India, high import tariffs limited competition and kept prices higher, which led to significantly lower consumption and output in the sector relative to China. In most cases, these policies did not achieve their objectives and they typically incurred significant costs.

2) Foundations for economic development are critical. Our case evidence suggests that the most value from foreign direct investments can be achieved if policy strengthens the foundations of economic development, through, for example, ensuring macroeconomic stability; promoting a competitive environment; evenly enforcing laws, taxes, and other regulations, and building a strong physical and legal infrastructure. In the Brazilian food retail sector, for example, we found that discriminatory and inconsistent tax collection in the sector provided strong protection to underproductive operations and slowed the transition to higher productivity formats. By contrast, regulatory reform that ushered in a reliable power and telecommunications infrastructure in India was an

important precondition to the rapid development of the information technology/business process offshoring sector in the country.

3) Corruption is not a determining factor. Notably, while we did not explore the issue explicitly or in-depth, we did not find that corruption played an important role in reducing the value from investments made or explaining differences in economic outcomes.

LARGE VALUE POTENTIAL FROM NEW HORIZONS OF INDUSTRY RESTRUCTURING

1) New horizons for large cost savings and revenue generation are opening up. The integration of developing economies into global sectors sets the stage for whole new sets of activities beyond expanding markets and seeking low-cost facilities. Instead of simply locating full production across the value chain in lower-cost regions, companies can disaggregate individual steps of the value chain and locate each step to the lowest-cost location. And rather than simply replicating the production process within each step, companies can capture further savings by substituting lower-cost labor for capital. These two steps can reduce costs by 50 percent, which in turn allows new market entry at significantly lower price points in old and new markets alike.

2) Most companies have only scratched the surface of the opportunity. Multinational companies have been well positioned to transfer their competitive products and processes, but less equipped to tailor them appropriately to local conditions. Strong local players have been well positioned to understand local market conditions but often lack capital, product or process technologies. Until recently, the interplay of industry characteristics, legal or regulatory restrictions, and organizational limitations has acted as a brake on industry restructuring. However, as a result of greater competition, regulatory liberalization and new technologies, many of these seemingly immutable characteristics are now undergoing major change. These changes are opening new possibilities, making a greater degree of specialization likely. For companies that capitalize on these changes, the opportunities are large.

HIGHER STAKES, HIGHER PERFORMANCE STANDARDS

1) The stakes are high. The global auto sector, for example, could create over $150 billion in cost savings and another $170 billion in revenue. Together, these opportunities represent 27 percent of the $1.2 trillion global auto industry. Our sector findings suggest that there are very large opportunities for companies to create value by taking full advantage of falling barriers in regulation, transportation cost, communications costs, and infrastructure. This implies far more than lowest-cost sourcing. It involves rethinking a firm's entire business processes to optimize production or service delivery.

2) Aggressive companies will set radically new performance standards. They will not accept the status quo, but instead push down the barriers or operate around them. Incremental performance mandates will be increasingly inappropriate as bolder targets come within reach. Already, a few companies in consumer electronics, auto, and the information technology/business process offshoring sector are leading the charge. For followers, change will be a matter of survival.

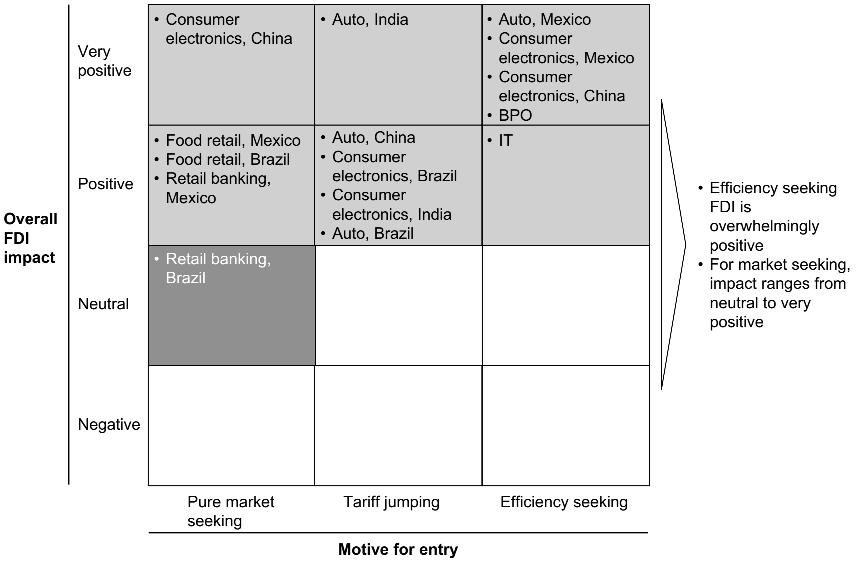
3) Success requires good strategy and execution against new tradeoffs in new market environments. Finding the optimal location and choice of capital and labor inputs in each production step, effectively balancing a company's global capabilities with local knowledge of markets, and shifting to more nuanced global management are just some of the new challenges facing companies.

ABOUT THE STUDY

Like all McKinsey Global Institute initiatives, this study merged detailed, company-level insights with macroeconomic data to produce a unique synthesis and new perspectives. We conducted detailed analysis and extensive interviews with client executives, external experts, and McKinsey experts over the course of more than a year. Nearly 20 fully dedicated team members from around the world invested more than 20,000 hours to produce 14 detailed case studies that form the basis of our more broadly stated conclusions (Exhibit 2). In this effort we benefited from the advice of a team of eminent economists, including Martin Baily, Dick Cooper and Dani Rodrik.

Exhibit 1

FDI TYPOLOGY AND OVERALL FDI IMPACT ASSESSMENT



Overall FDI impact	Pure market seeking	Tariff jumping	Efficiency seeking
Very positive	• Consumer electronics, China	• Auto, India	• Auto, Mexico • Consumer electronics, Mexico • Consumer electronics, China • BPO
Positive	• Food retail, Mexico • Food retail, Brazil • Retail banking, Mexico	• Auto, China • Consumer electronics, Brazil • Consumer electronics, India • Auto, Brazil	• IT
Neutral	• Retail banking, Brazil		
Negative			

Motive for entry

- Efficiency seeking FDI is overwhelmingly positive
- For market seeking, impact ranges from neutral to very positive

Source: McKinsey Global Institute

Exhibit 2

FDI IMPACT IN HOST COUNTRY

▨ Overall positive impact
☐ Mixed
■ Negative

++	Very positive	–	Negative
+	Positive	– –	Very negative
0	Neutral	[ ]	Estimate

	Auto				Consumer electronics				Food retail		Retail banking			
	Brazil	**Mexico**	**China**	**India**	**Brazil**	**Mexico**	**China**	**India**	**Brazil**	**Mexico**	**Brazil**	**Mexico**	**IT**	**BPO**
Level of FDI relative to sector*	52%	6.5%	33%	n/a	30%	15%	29%	35%	4.2%	2.4%	n/a	6.9%	←2.2%→	
Economic impact														
• Sector productivity	+	++	+	++	+	+	+	[+]	+	[+]	0/+	+	[+]	[++]
• Sector output	0	++	+	++	+	++	++	+	[0]	[+]	0	[+]	[+]	[++]
• Sector employment	0	+	+	0	[–]	++	+	[0]	0	[–]	–	–	[+]	[++]
• Suppliers	0	+	+	++	[0]	0	++	[0]	[0]	[+]	n/a	n/a	+	+
Impact on competitive intensity	+	+	+	++	+	[+]	+	+	+	++	0	0	[+]	[+]
Distributional impact														
• Companies														
– Companies with FDI	–	[+]	++	– –	[+/–]	[+]	+/–	+/–	+/–	++/–	+	++	[0]	[0]
– Companies without FDI	n/a	n/a	0	–	–	[0/ –]	+	0/–	[0/–]	–	0	0	[–]	[++]
• Employees														
– Level	0	+	+	0	[0]	++	+	[+]	0	[–]	–	–	[+]	[++]
– Wages	+	++	+	+	[0]	[0]	[0]	[0]	[0]	[0]	[0]	0	[+]	[++]
• Consumers														
– Reduced prices	++	+	+	+	+	[0]	0	+	[0]	++	0	0	n/a	n/a
– Selection	+	+	+	++	[+]	[+]	+	[+]	[0/+]	[+]	0	0	n/a	n/a
• Government														
– Taxes/other	–	+	+	++	[0]	[0]	[+]	[0]	++	[0]	[0]	+	0	[+]
Overall assessment	**+**	**++**	**+**	**++**	**+**	**++**	**++**	**+**	**+**	**+**	**0**	**+**	**+**	**++**

* Average annual FDI/sector value added in last year of focus period