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The escape motivation of emerging market multinational enterprises

by

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Why have relatively poor emerging markets been able to spawn so many global firms in the past two decades?[1] Part of the explanation is that some firms in these countries have honed capabilities in their home markets that are of value in other emerging economies. But why have these firms also made substantial investments in advanced countries? Research suggests that "pull" factors, such as the large markets and wealthier consumers of advanced countries, play an important role. In this *Perspective*, we highlight some "push" factors that may have also driven emerging-market multinational enterprises (EMNEs) to invest in advanced countries. We label the resulting outward foreign direct investment (OFDI) as *escape investments*, which are motivated by the desire to escape the home country's weak institutions and economic underdevelopment.

Let us begin with the problem of weak institutions in emerging markets, which results in *institutional escape* OFDI. For instance, laws may be ambiguous in emerging markets or their enforcement in courts may be weak. In non-democratic countries, the judiciary may be subordinate to politicians, leaving firm owners at the mercy of unpredictable political forces. In other cases, minority communities may own a disproportionate share of national assets, as Chinese-Thais do in Thailand, the Chinese-Malays do in Malaysia or whites do in South Africa. In all these instances, private owners who feel insecure about their property rights may conclude that it is prudent to diversify their assets by investing in countries with more secure property rights and a stronger rule of law. This may have played a part, for instance, in the decision of ThaiBev, owned by a Chinese-Thai billionaire, to bid $8.8 billion for the liquor multinational enterprise, Fraser & Neave. Similarly, Russian oligarchs are believed to have expanded their companies' assets in Western Europe to avoid the expropriation hazards that befell companies like Yukos. Some of these investments may be routed to third countries through offshore financial centers (e.g., Channel Islands) whose primary purpose is to reduce transparency in investments; OFDI in offshore financial centers accounts for between one-quarter to two-thirds of the total OFDI stock of the BRICs (Brazil, Russia, India, China). Some of these escape investments may become later round-trip investments, with EMNEs investing at home from offshore financial centers to benefit from incentives and regulations available to foreign investors.

Another category of escape investments is rooted in managers aiming to reduce the negative country image of emerging markets, compared to advanced economies, which may negatively affect the international competitiveness of their firms; we call these *discrimination escape*. The discrimination in question may arise from several factors, such as: (1) the assumption by governments and consumers in advanced countries that products from emerging markets are produced by workers who have few rights, are paid too little and operate in unsafe conditions; (2) that products made in emerging markets must be inferior in quality to those made in advanced countries because these economies are less technologically sophisticated or have lower product-safety standards than advanced economies; and (3) that companies located in emerging markets are riskier than firms located in advanced countries because of higher macroeconomic volatility and poorer corporate governance standards and should therefore incur a higher cost of capital. In all these instances EMNEs may see value in shifting operations or moving headquarters to an advanced country. One example of discrimination escape is the acquisition of Western brands by EMNEs, as Tata Tea did with the Tetley label, to overcome the negative image of their countries of origin. Another example is the acquisition of operations in Spain, which enabled the Mexican cement producer Cemex to lower its borrowing cost, a significant advantage in the capital-intensive cement business, even though much of its assets were located in emerging markets. Yet another example is Mittal Steel, which claimed during its hostile bid for Luxembourg-based Arcelor that it was a European company, because it was registered in the Netherlands and run from London, even though it started in Indonesia and was controlled by an Indian-born owner.

The policy implication of our analysis is not that governments should forbid escape investments. Rather, they should reduce the incentives to engage in it by improving the domestic business environment. Measures that would help include strengthening the rule of law, improving the country's brand, weeding out unnecessary regulations, pursuing market-friendly policies, strengthening incentives for innovation, and protecting intellectual property rights. Such reforms would not only reduce escape OFDI but also improve the general business climate and increase inward FDI, and support the upgrading of the competitiveness of domestic firms that enable them to expand abroad based on the skills honed in the home market.

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[1] For a full discussion, *see* Alvaro Cuervo-Cazurra and Ravi Ramamurti, *Understanding Multinationals from Emerging Markets* (Cambridge: Cambridge University Press, 2014).

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