

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**THE FINANCIAL CRISIS IN ASIA  
AND FOREIGN DIRECT INVESTMENT:  
AN ASSESSMENT\***

\* This material will subsequently appear in *World Investment Report 1998*, together with an overall discussion of trends in foreign direct investment in Asia and the Pacific. It is being made available to delegations to assist them in their discussions in the forty-fifth session of the Trade and Development Board.

UNCTAD/ITE/IIT/8  
GE.98-51617

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# The financial crisis in Asia and foreign direct investment: An assessment\*

## Introduction

In the second half of 1997, turmoil erupted in the financial markets of some countries in East and South-East Asia. The crisis that ensued has affected the economies of the region in a number of ways (UNCTAD, 1998a; ESCAP, 1998). It has involved, among other things, a sharp decrease in private external capital flows to some developing countries in the region. Net private foreign bank lending and portfolio equity investment were estimated to have turned negative in 1997 for the group of countries most affected by the crisis: Indonesia, Republic of Korea, Malaysia, Philippines and Thailand (figure 1). However, while large amounts of short-term capital left these countries, foreign direct investment (FDI) inflows remained positive and continued to add to the existing FDI stock. Indeed, FDI inflows in 1997 to the five most affected countries, taken together, remained at a level similar to that of 1996 (figure 1) although they have slowed during the first quarter of 1998 when compared to the first quarter of 1997 (table 1).<sup>1</sup>

This is not surprising. FDI flows involve not only financial capital but also technological, managerial and intellectual capital that jointly represents a stock of assets for the production of goods and services. The flows are motivated by the strategic interests of TNCs that invest in host countries in their search for markets, resources, created assets and competitiveness-enhancing efficiencies. They typically involve long-term relationships at the level of production between investors and their foreign affiliates, reflecting the investor's lasting interest in these affiliates and control over them. Since FDI is mainly a real investment in firms, its mobility is limited by such factors as physical assets, networks of suppliers, the local infrastructure, human capital and the institutional environment; FDI stocks are generally not footloose.

Much portfolio investment, on the other hand, is motivated primarily by a search for immediate financial gain and the time horizon for many bank lending decisions is also short term. This short-term orientation may make these investment flows quite volatile at times and may contribute to the emergence of bubbles (UNCTAD, 1997a, chapter III). Unlike FDI, portfolio investment is fully mobile at low cost. Because of their volatility, portfolio investments can cause drastic disruptions in private capital flows during crises which may then spill over into the real sector since such investments are a significant source of productive resources, especially for developing countries.

The behaviour of these two types of investment flows to the Asian economies most affected by the crisis is reminiscent of their behaviour during the crisis that struck Mexico in 1994-1995: total portfolio investment to Mexico fell by nearly 40 per cent, from \$12 billion in 1994 to \$7.5 billion, with portfolio equity investment falling by almost 90 per cent, from \$4.5 billion to \$0.5 billion.<sup>2</sup> FDI flows, in contrast, which had more than doubled in 1994, fell by only 13 per cent in 1995.

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\* The present report builds upon a *Background Note* that partly drew on a survey of transnational corporations undertaken by UNCTAD together with the International Chamber of Commerce, with a view to ascertaining the nature of major companies' responses to the financial crisis in Asia as far as their FDI in and from the region was concerned (UNCTAD, 1998).

Even though FDI is more stable than portfolio investment, it is not insensitive to crises and especially to changes in the determinants of investment induced by a crisis.<sup>3</sup> The eruption of the financial crisis in East and South-East Asia has in fact changed a number of major FDI determinants, at least in the short and medium term. This raises the question of what the effects of the crisis are likely to be on FDI flows to and from Asia and, in particular, to and from the most seriously affected economies.

This is a relevant question because FDI plays an important role in the growth and development of Asian economies, including those most affected by the crisis. Among other things, inward FDI provides a useful supplement to domestic investment, with the ratio of inward FDI flows to gross fixed capital formation ranging from about 5 per cent in Thailand to 12 per cent in Malaysia.<sup>4</sup> It also accounts for a considerable share of exports in some industries (UNCTAD, 1995a, chapter IV). Maintaining and increasing the level of FDI flows to and within the region could therefore assist in the process of economic recovery in the region.

This paper considers, first, the implications of the crisis for inward FDI into the five most affected economies in the region in the short and medium term on account of a number of changes resulting from the crisis. It then proceeds to discuss the implications of the crisis for *outward* FDI from the countries of the region and inward FDI to developing economies *not* directly affected by the crisis. In conclusion, it considers the possible overall impact of the crisis on FDI flows to Asian host countries in the short and medium term, and the long-term FDI prospects of developing Asia.

#### **A. Implications for FDI into the most affected economies**

The most important locational determinants of FDI are the economic factors determining the prospects for TNCs to engage profitably in production activities.<sup>5</sup> If these factors are favourable, there is an inducement for TNCs to invest in a country, provided that the country's policy framework allows them to do so. The extent and nature of any FDI will depend upon the precise combination of the economic opportunities available, the friendliness of the policy framework, and the ease of doing business in a country.

The Asian countries most affected by the crisis have ranked high among developing host countries in the attractiveness of their economies to foreign investors. In particular, they have built up fundamental strengths that make for long-term growth, such as high domestic savings rates and skilled and flexible human resources, thereby creating opportunities for FDI that is competitiveness-enhancing for TNCs. They have also substantially liberalized their FDI policies and taken steps to facilitate business. All of these factors can be expected to remain favourable. Nevertheless, in the short and medium term, the financial crisis and its economic consequences will affect FDI flows to these countries, because they are likely to influence some of the determinants of FDI -- some in a manner conducive to attracting more FDI and others in a manner less favourable.

## 1. Effects on FDI entry and expansion

One reason why inflows of FDI to the crisis-affected countries could be expected to *increase* in the short and medium term is the decrease in the costs, for all firms, of establishing and expanding production facilities in these countries. The decrease is the result of exchange-rate depreciations, lower property prices and more company assets offered for sale, given the heavy indebtedness of domestic firms and their reduced access to liquidity. Companies wishing to establish a presence in the region or seeking to increase the scale of their existing operations may see in the crisis an opportunity for doing so, especially if they react quickly, before recovery starts and the prices of assets and other productive resources rise again. There is some evidence that this may be taking place: in Thailand, for example, there were large increases in FDI flows into a number of industries (annex table A.1) during the second half of 1997 and the first quarter of 1998.

The currency devaluations that have occurred in the affected countries (table 2), as well as the lowered property prices, have reduced the foreign currency costs of acquiring fixed assets such as land, buildings and capital goods manufactured locally. In addition, falling valuations of many Asian firms in the aftermath of the financial crisis have reduced the costs of acquiring firms. For example, as the crisis unfolded, stock market prices -- a rough measure of the price of acquisitions -- plunged (table 2). As a result, foreign firms require much smaller resources in home country currencies to establish new production capacities or add to existing ones.<sup>6</sup> Indeed, for firms already planning to invest or expand their investments in Asia, the current situation presents a unique opportunity to do so at lower than anticipated costs. In Thailand, for example, FDI flows into financial services tripled in 1997 in comparison with 1996 and flows in the first quarter of 1998 alone are 30 per cent higher than total flows in 1997 (annex table A.1).

Moreover, the restructuring of firms faced with large debt repayments and rising interest rates (table 2) and their urgent need for funds, combined with lower stock prices and a more liberal policy towards M&As, provide opportunities for TNCs to undertake direct investments in the region through M&As involving host country firms, including firms that might otherwise go bankrupt. Indeed, a number of large M&As have already taken place in the five most affected countries since the turmoil began (annex table A.2), led by firms from the United States and Singapore during the second half of 1997 (figure 2). However, so far, no clear trend towards an increase in the total value of cross-border merger and acquisitions in the five crisis-stricken countries taken together is discernible;<sup>7</sup> among individual host countries, substantial increases were evident only in the case of the Republic of Korea (figure 3). Overall, the value of M&As as a percentage of FDI flows into the five most affected countries was somewhat higher than that for Asia as a whole, but relatively low as compared to that for Latin America and, especially, developed countries (figure 4). This suggests that, while the role of M&As assumes greater importance as firms respond to the restructuring taking place in the affected Asian economies, its importance as a vehicle for market entry is, nevertheless, stronger the higher the level of development of a country, reflecting factors related to industry structure, stronger technology-based competition, and the need of firms not only to acquire created assets.

Naturally, there are growing concerns over the loss of national control over enterprises, especially as there has been a noticeable increase in the value of M&As in which foreign firms acquired majority shares.<sup>8</sup> Although M&As are generally regarded as less desirable than

greenfield investments, much depends on the specific circumstances and on the available alternatives, which may include bankruptcy (box 1). Still, concerns are understandable, particularly when M&As seem like “fire sales” (Krugman, 1998). In any case, foreign control of large portions of any industry -- or even small portions of key industries -- is often a sensitive issue in developed as well as developing countries. Hostile takeovers, in particular, are therefore viewed cautiously in a number of countries. Sensitivities in this respect must be appreciated, as otherwise the prospects for a long-term partnership between foreign investors and host countries through FDI could be adversely affected.

### **Box 1. M&As and greenfield investment: a comparison**

Cross-border M&As have been on the rise for some time, accounting for about half the global FDI inflows in 1997. Although they are concentrated in the United States and Western Europe, international M&As are also a phenomenon increasingly associated with the privatization of state enterprises and with the sales of bankrupt or near-bankrupt business units in various regions, including Asia.

The corporate motivations for M&A deals vary and so do the effects of cross-border M&As for countries. The private and public costs and benefits of cross-border M&As can also diverge significantly.

Viewed from a host country's standpoint, cross-border M&As are one form of FDI inflows, along with greenfield investments. These two types of inward FDI are often compared in their desirability for host countries. It is argued that, other things being equal, greenfield FDI is more desirable than M&A FDI, since the former immediately and directly adds to the existing industrial capacity in host countries, whereas the latter merely transfers ownership of local assets from domestic to foreign interests. This may be true as far as the immediate impact is concerned and greenfield FDI is normally preferred by host countries for this reason. In addition to this short-term capital stock effect, however, there are a host of possible long-term effects that also need to be taken into account in evaluating the relative merits of these two kinds of FDI.

#### **! Capital formation.**

Greenfield FDI is, by definition, investment in new productive facilities. Hence, assuming that no viable domestic investment will take place in the absence of such FDI, it immediately adds to the stock of capital in the host country. Furthermore, it is necessarily accompanied by the transfer of foreign TNCs' intangible assets such as technology and managerial skills, which are internalized/embodied in their greenfield projects, assets that enable foreign TNCs to stay competitive relative to host country firms in the latter's own backyard. Greenfield projects are thus likely to result in new capital formation, both physical and human.

/...



**(Box 1, cont'd.)**

In contrast, M&As may not lead to capital formation in the short run. The immediate effect is merely an asset transfer from a host country owner to a foreign TNC. But the acquirer may carry out modernization and capacity expansion (perhaps as a condition of the deal, as is usually the case with privatized state properties in developing countries and Central and Eastern Europe) or induce other related investments (perhaps other related FDI undertaken by suppliers). New incremental or supplementary capital formation may then eventually occur in the form of both *sequential* and *associated* FDI which is larger than the original purchase (UNCTAD, 1995a). Furthermore, if the acquired firm would otherwise have gone bankrupt, thereby decreasing the capital stock involved, the M&A may have been instrumental in maintaining or revitalizing a host country's capital formation. There is, of course, the danger that the acquisition may have been undertaken for the sole purpose of eliminating competition by eventually closing down the acquired firm (UNCTAD, 1997a).

**! Employment and the tax base.**

Just as with capital accumulation, greenfield FDI immediately creates new jobs (assuming again the absence of credible domestic investment). M&As would have no such positive employment effect in the short run. In fact, job reduction may ensue if an acquisition involves a troubled high-cost firm that needs to be restructured and slimmed down. In the long run, however, if a TNC turns an acquired firm into a successful unit as part of its corporate network, employment may rise.

In general, the tax base is likely to expand more favourably under greenfield FDI than through M&As for the very reason that new business units are created by the former as additional taxable entities. For this reason, in their eagerness to create employment opportunities and expand the tax base, host governments are generally more interested in attracting greenfield FDI than in seeing existing local firms sold off to foreign TNCs. It is thus no surprise that special incentives are often given to greenfield FDI.

Nonetheless, it is conceivable that an acquired firm will end up contributing as much or more to the local tax base, depending on whether it might have gone bankrupt in the absence of the acquisition or on the effectiveness with which it handles new infusions of capital and technology under foreign ownership.

**! Structural diversification.**

From a host country's point of view, FDI is desirable in part because it may bring new assets (e.g. industrial knowledge) in new fields, thereby contributing to industrial diversification in the local economy. Since M&As mostly involve transfers of existing productive assets, they are not likely to help a host economy diversify into new industrial activities, unless the acquired firm itself later diversifies. If the acquired units become integrated with the foreign TNCs' corporate systems, however, they may have an opportunity to move into new fields. Besides, there is no guarantee that greenfield FDI necessarily opens up new industrial sectors, although the chances of structural diversification are probably greater in greenfield FDI than in M&As. /...

**(Box 1, cont'd.)**

**! Competition.**

Market competition is desirable because it stimulates and improves efficiency, resulting in lower prices for consumers. Greenfield FDI can enhance local competition if its superior assets/market power are harnessed in such a way as to prevent predatory practices and to attract competitors. In contrast, while M&As will not generate new competition in the short run, they can maintain the level of competition that prevailed before, if the acquired firms might have gone out of business in the absence of a deal. In addition, if a new owner revitalizes a moribund local firm, local competition will be revitalized as well. On the other hand, if the acquiring firms were part of a small number of firms at the global level, the takeover might reduce global competition as well as competition in the host country.

**! Political and cultural considerations.**

Since M&As involve the transfer of ownership of a local productive activity and assets, a national security issue arises when local assets (e.g. technology) have military applications and can thus damage national security if they fall into foreign hands. Greenfield FDI does not directly pose this problem but some greenfield ventures may be aimed at monitoring local technological progress. Similar considerations apply with respect to national sentiment and culture. For example, some countries may consider the broadcasting or film-making industry a cultural industry critical to the preservation of national traditions. It all depends upon the nature of the industry involved, the market power of the new entrant, and the characteristics of the host countries themselves.

**! Liquidity (new capital injection).**

FDI is often welcomed because it brings liquidity, whether in the form of foreign exchange at the national level or in the form of needed funds at the company level. Liquidity is usually a priority for any country that experiences a balance-of-payments crisis and is in dire need of foreign exchange. In terms of national liquidity considerations, greenfield FDI and M&As are equally desirable alternatives.

In developed countries with flexible exchange rates, however, this "foreign reserves" rationale hardly exists. Only a company-level need for liquidity may arise. For example, founders may want to sell because they wish to retire or some young start-up ventures may reach a point where they need additional capital. Here, obviously, greenfield FDI is not an alternative to M&As from the point of view of the individual enterprise.

In some developing countries, on the other hand, the sales of local businesses to foreign firms can become important, precisely because both the governments and the local firms are desperately in need of liquidity. Partial M&A deals may also occur to secure a minimum level of liquidity.

/...

**(Box 1, cont'd.)**

**! Supplementary resources.**

Both M&As and greenfield FDI can bring in some critical supplementary resources such as new managerial, production and marketing techniques that are lacking in host countries. The new owners of local firms may apply new techniques to make their acquired businesses profitable. M&As are also often motivated by the desire to capture synergies by combining sets of corporate assets between the deal-making parties; the intra-corporate supplementing of local assets with foreign assets is a possibility unique to cross-border M&As. The Daimler-Chrysler merger and the VW-Rolls Royce merger are examples. Synergy-creating M&As certainly add to both the host and home countries' stock of resources and may bring both public and private benefits.

Similarly, greenfield FDI is likely to transplant supplementary resources at the national level, since the ownership-specific advantages they internalize are supposed to be superior to their local counterparts if such FDI is to succeed. Hence, the upshot is an augmentation of the host country's resource base. A prime example of such greenfield FDI is NUMMI (New United Motor Manufacturing Incorporated), a joint venture between GM and Toyota, in the United States, which has served as a learning conduit for GM in flexible manufacturing.

In contrast, an M&A may not involve any transfer of new resources from the acquiring foreign firm. It may even cause a reverse transfer, particularly if the new owner's intention is to siphon off knowledge from the acquired firm to the new owners, as is the case with some asset-seeking FDI. In such a case, an M&A results in the draining of resources (e.g. technology) from host countries.

\* \* \*

So which is better from a host country's point of view? "It all depends" is the appropriate answer. Depending upon specific circumstances and the policy priorities of host countries, one or the other may be preferable. At the individual firm level, M&As can enable local firms directly to become parts of transnational corporate systems with a number of competitiveness-enhancing advantages. This source of gain is important, especially when dealing with distressed, non-performing local businesses. They require immediate and direct transfusions of new capital and supplementary resources at the firm level.

In fact, when it comes to distressed local business units, whether privately or publicly owned, the requirement is simply a buyer, whether foreign or domestic. These units need to be sold off, if not entirely then at least partially, for they have to be acquired by or merged into other firms if they are to avoid their ever-accumulating losses or debts and eventual demise. They need transfusions of both new capital and new managerial resources to survive and prosper. In many cases, these existing businesses cannot be purchased and upgraded by domestic firms, simply because they may themselves be short of capital and deficient in technological resources. In these cases, foreign firms may be the only possible suitors.

*Source: Ozawa, 1998.*

## 2. Effects on TNC operations

### (a) *Export-oriented FDI*

Currency devaluations can increase the attractiveness of the affected Asian economies to foreign investors by lowering the costs of production. As wages and other operating costs decrease in terms of foreign currency values, efficiency-seeking mobile foreign investors might find it advantageous to invest in the affected economies, even though inflation might eventually eliminate the advantage.<sup>9</sup> Such advantages are particularly relevant for export-oriented foreign affiliates, since they improve their international competitiveness vis-à-vis firms located in other countries that have not devalued.<sup>10</sup> In Thailand, for example, FDI in such export-oriented industries as electrical appliances and electronics has risen considerably (annex table A.1). A specific example is Seagate, which has expanded its operations in Malaysia to serve the European market (box 2). Something very similar had happened in Mexico after the Peso crisis, when FDI in export-oriented manufacturing and assembly of electrical and electronic equipment more than doubled in 1995 over the previous year (annex table A.3).<sup>11</sup>

In making or expanding FDI in export-oriented production, or switching the output of production from the domestic to the international market, TNCs can draw on their international production systems which can serve as channels to reach markets and access inputs. In these corporate systems, intermediate goods and tradable services produced by an affiliate in one country are exported to the parent firm, or to affiliates of the same parent firm in other countries. Indeed, about one-third of world trade consists of such "intra-firm" trade. Being part of a TNC system therefore gives affiliates "privileged" access to the TNC system, a market in itself, and to markets located elsewhere (UNCTAD, 1996a). This in turn offers a strong motivation for foreign affiliates to take advantage of the lower costs of production following devaluation.

#### **Box 2. TNCs, restructuring and the Asian crisis: Seagate Technology, Inc.**

Seagate Technology, Inc. is a leading provider of technology and of products for storing, accessing, and managing information, with nearly \$7 billion in revenues for its 1997-1998 fiscal year. Based in the United States, the company has the vast majority of its production facilities located in Asia, which account for over four-fifths of its output. It has also been the engine driving the exports of electronic products from Malaysia and Thailand; as the single largest exporter in Thailand, its exports accounted for 4 per cent of the country's GDP during the past few years (TDRI, 1998).

Seagate was affected by the Asian financial crisis both in production and sales, and experienced currency losses because of the devaluations of the Thai baht and the Malaysian ringgit. However, the negative effects of the crisis on its Asian operations are not as obvious as the effects of other economic factors. The company reported a loss for the fiscal year 1997/1998, largely on account of the slump in global computer prices and the consequent cost of restructuring.<sup>a</sup> Its sales revenues in Asia for the first quarter of 1998 remained at a level similar to that in the previous quarter, while its revenues in Europe fell. Overall, the Asia-Pacific region contributes about 15-17 per cent of the company's worldwide sales revenues, with sales in the ASEAN region constituting a major portion.

/...

**(Box 2, cont'd.)**

Faced with worldwide excess capacity, weak demand, technological advances that have intensified competition, the emergence of newcomers and intense pricing pressures in the disk-drive industry, Seagate restructured its global operations in late 1997, aiming at enhancing its competitive position through improvements in productivity and reduction of costs. The restructuring included the closure of certain manufacturing facilities, the consolidation of its five disk-drive product design centres in the United States into three, the consolidation of its domestic media operations, and the downsizing of its worldwide sales and administrative functions.<sup>b</sup>

As part of the restructuring, Seagate announced in December 1997 that it would close a plant in Clonmel, Ireland, which had been opened only in 1995, laying off 1,400 employees and paying back a \$15.8 million grant to the Irish authorities. It also postponed the expansion of its production facilities for a read-write head plant in Springtown in Ireland. As a result of the devaluation of Asian currencies, the competitiveness of the Clonmel plant was weakened. Production costs in Ireland became almost three times those in the affected countries in Asia.<sup>c</sup> The company therefore decided to use the surplus capacity at its plants in Asia to service European markets, which had previously been supplied by the Clonmel plant.<sup>d</sup>

*Source:* UNCTAD, based on information obtained from various sources.

<sup>a</sup> Seagate, *Annual Report*, 1998.

<sup>b</sup> Seagate, press release, June 1998.

<sup>c</sup> *The Irish Times*, 13 December 1998.

<sup>d</sup> *Sunday Times*, 14 December 1997.

Many corporate systems of integrated international production already exist in Asia, led by Japanese TNCs, and closely followed by United States TNCs (UNCTAD, 1996a). Increasingly, these also include small and medium-sized firms which, in the case of Japan, account for more than a half of the country's outward FDI in numbers of projects (UNCTAD, 1998b, pp. 31-32), although their share of FDI in dollar value is much lower (UNCTAD, 1993). To the extent that data for Japanese and United States foreign affiliates in the most affected countries are indicative, TNCs have already had relatively high export propensities in most instances, ranging (for United States majority-owned affiliates) from 14 per cent in the Republic of Korea to 57 per cent in Malaysia and Thailand in 1995 (table 3). Foreign affiliates in industries such as electrical machinery have had even higher export propensities in some countries, reaching 69 per cent and 82 per cent in the case of United States affiliates in Thailand and the Philippines. Export propensities of United States majority-owned foreign affiliates in manufacturing as a whole have been considerably higher for the five most affected countries as a group (42 per cent in 1995) than for Latin America (26 per cent in 1995).<sup>12</sup>

Being part of TNC networks also makes it easier for firms to switch from domestic sales to exports, as could be seen during the Mexican crisis of December 1994-1995. In the case of the Mexican automobile industry, a number of foreign affiliates reacted to the slump in domestic demand by switching -- sometimes within a few months -- a part of their production to foreign markets: exports increased both in absolute terms and as a percentage of total production, from 58 per cent in 1994 to 86 per cent in 1995 (annex table A.4.). Naturally, access to the large North American market in the context of NAFTA and buoyant demand conditions also helped, as did the fact that foreign automobile affiliates in Mexico were already producing at internationally

competitive quality standards.

There are signs that some Asian TNCs are also switching some of their sales from domestic to export markets. Toyota, for example, expects to increase its exports of motor vehicles, both absolutely and relatively to total production, as well as substantially to increase exports of parts and components (box 3). Survey data for Thailand also indicate plans for increased exports by some foreign affiliates (box 4). The most immediate implications of the currency realignment has been that some TNCs are shifting orders from factories from other countries in the region to their affiliates in the most affected countries. For example, Honda is shifting some production activities from Japan to its facilities in Thailand (box 5).

**Box 3. Toyota's response to the Asian crisis: changes in production and exports from Thailand, 1997-1998**

Toyota Motor Corporation, one of the first TNCs to establish operations in the automotive industry of Thailand, increased production capacity in Thailand in the 1990s, principally to serve the domestic market in that country but also to export to other countries inside and outside the region. Toyota's facilities in Thailand include two plants for the assembly of vehicles, mostly pick-up trucks, and plants for the production of components, including diesel engines, engine blocks and camshafts. The changes in production levels and the shares of output for the domestic and export markets during 1997-1998 illustrate how a TNC can respond to rapidly changing economic conditions, including a significant reduction in demand in the local economy and a dramatic depreciation of currency.

On 5 November 1997, Toyota halted production in two of its Thai plants because of declining demand. In mid-November, production was partly resumed. Within a few weeks, however, Toyota announced that it was planning to increase production, especially for export. During the following few weeks it made small changes in the production processes -- for instance, it increased inventory of certain parts used in vehicles for export and undertook some additional maintenance of its facilities. On 7 January 1998, it resumed near-normal production schedules at both of its assembly plants in Thailand, each producing two of Toyota's passenger or commercial vehicle models.

The company then began to expand the volume of exports of assembled vehicles and parts to some countries (Indonesia, Laos, Malaysia, New Zealand, Pakistan and Portugal) to which it had already been exporting prior to the crisis. In addition, it began exporting diesel engines to Japan from Thailand for the first time. The expansion of exports is evident in the box table below, which compares projections for 1997 with 1996 levels of exports and production. Even though the total production of assembled vehicles is expected to decline in 1998 because of the fall in demand within Thailand, the number of vehicles for export is expected to increase from 1,600 in 1997 to 4,800 in 1998, and the value of exports of components was expected to increase from about \$50 million in 1997 to about \$96 million in 1998. Further substantial increases in exports of both vehicles and components are expected by the end of 1998.

Car sales continued to decline as expected in Thailand during the first four months of 1998. Total vehicle sales in April 1998 dropped to 11,000 units, as compared with 15,200 units in December 1997. Altogether, Thailand's car market is reported to have shrunk by more than 70 per cent since September 1997. The continued slump has forced Toyota to revise its production, marketing, and employment plans once again.

/...

**(Box 3, cont'd.)**

The new plan calls for a temporary halt in the production of the new 1.8 liter Corolla launched in January 1998 because sales (less than 400 units per month) do not justify the investment. It also involves reducing the number of employees through an early retirement scheme for factory workers. Some workers have been sent to Japan and jobs previously done by outside subcontractors, such as initial quality surveys, will now be done in-house. Toyota has also taken advantage of the redundant capacity resulting from the crisis to provide a six-month training term at the Japanese headquarters to 50 production-team employees of its Thai affiliate, in order to improve further the quality and competitiveness of its production in Thailand. Toyota is also postponing indefinitely a model change for its pick-up trucks, which was originally planned for the third quarter of 1998.

To help its parts suppliers survive, Toyota Motor Thailand has accepted price increases ranging from 6 per cent to 20 per cent and is providing preshipment payments. Partly for this reason, the parent company had to inject an additional capital of 4,000 million baht into Toyota Motor Thailand, increasing the latter's registered capital to 4.5 billion baht in June 1998. The capital increase also allows Toyota Leasing to provide financing support for car buyers, while dealers have received a credit extension from Toyota Motor Thailand.

Toyota Motor Corporation is helping Toyota Motor Thailand to develop export markets, which is crucial if the local factories are to achieve their minimum production volume of 100,000 units a year. (Toyota Motor Thailand is expected to sell only 60,000-70,000 units in 1998 including exports.) Because of its global production system that includes parts production and vehicle assembly facilities in many countries, Toyota Motor Corporation is able to shift towards a larger share of exports in its production in Thailand in quick response to the crisis. At the same time, Toyota Motor Corporation has used its financial strength to help solve the immediate liquidity problems of Toyota Motor Thailand, which is in turn expected to revise its production, marketing and employment plans so that it becomes leaner and can maintain its competitive edge.

**Box table**  
**Production and exports by Toyota Motor Thailand in 1997 and forecasts for 1998**

| Item                                      | 1997   | 1998 (forecast) | Change (1997-1998) |
|---|--------|-----------------|--------------------|
| Assembled vehicles (units)                |        |                 |                    |
| Total production                          | 97 000 | 60 000          | -37 000 units      |
| Total exports                             | 1 600  | 4 800           | +3 200 units       |
| Total exports as percentage of production | 1.6    | 8.0             |                    |
| Automotive parts and components           |        |                 |                    |
| Exports (million dollars)                 |        |                 |                    |
| Diesel engines                            | 47     | 89              | +\$42 million      |
| Engine blocks and camshafts               | 3      | 7               | +\$4 million       |

*Source:* Toyota Motor Corporation, press release of 8 December 1997, and additional information provided to UNCTAD.

**Box 4. Implications of the financial crisis for foreign affiliates' operations:  
survey results for Thailand**

An annual survey covering foreign affiliates in all industries in Thailand was conducted by the Thai Board of Investment<sup>a</sup> in early 1998 to provide insights, among other things, into how the crisis has affected foreign affiliates, how firms are responding and how they view future prospects:

- C In 1997, 43 per cent of all respondents enjoyed an increase in revenues, while 34 per cent experienced reduced revenues (box table). There is considerable variation among industries: more firms in mining, metal and ceramics, metal products, machinery and transport equipment faced reduced revenues than in agricultural products, light industry and chemicals, and paper and plastics.

**Box table. Performance of foreign affiliates in Thailand, 1997,  
by industry: survey results**

| Sector/industry  | Total number<br>of firms responding | Revenue                 | Revenue   | Remain    |
|--|-------------------------------------|-------------------------|-----------|-----------|
|  |                                     | increased               | reduced   | unchanged |
|  |                                     | (Per cent) <sup>a</sup> |           |           |
| Agriculture and agricultural products                  | 9                                   | 78                      | 11        | 11        |
| Mining metal and ceramics                              | 15                                  | 33                      | 47        | 20        |
| Light industry   | 19                                  | 53                      | 32        | 15        |
| Metal productions machinery and<br>transport equipment | 55                                  | 35                      | 40        | 25        |
| Electronic products and electrical<br>appliances       | 59                                  | 37                      | 34        | 29        |
| Chemicals paper and plastic                            | 46                                  | 52                      | 26        | 22        |
| Services and infrastructure                            | 19                                  | 42                      | 37        | 21        |
| <b>Total</b>   | <b>222</b>                          | <b>43</b>               | <b>34</b> | <b>23</b> |

*Source:* Thailand, Board of Investment.

<sup>a</sup> Percentage of respondents indicating a particular response.

- C Exports of many companies have been increasing in value since 1997. The trend towards increased exports appears to be gaining momentum in 1998. Over 60 per cent of the respondent companies indicated that exports in dollar value were expected to increase (box figure 1).
- C Most companies alleviated their crisis-related problems by reducing production costs such as transportation, packaging and stock. Seeking new export markets presented another important solution. Many firms suffering from the decline in the domestic market have resorted to overseas markets. Among other measures, nearly half the respondents reported turning to the use of domestic raw materials in place of imported inputs. Some laid off employees. 47 per cent of firms in mining, metal and ceramics reduced the number of their employees; electronic products and appliances were at the other end of the spectrum, with only 5.1 per cent of the respondents reporting such an action.

/...



(Box 4, cont'd.)

**Box figure 1. Foreign affiliates in Thailand:  
changes in export value in terms of dollars, survey results**  
(Per cent) <sup>a</sup>

*Source:* Thailand, Board of Investment.

<sup>a</sup> Percentage of respondents indicating reduced, stable, or increased exports in 1997 and expected changes in 1998.

- C The measures to be taken in the future to deal with the economic crisis are more or less the same as those taken over the past months. The most important one is cost reduction. More firms will resort to currency hedging to protect themselves from baht fluctuation.
- C In the light of the economic recession that has set in following the crisis, more than half the responding companies do not plan to expand their investments in 1998. However, 38 per cent still have plans to invest more in Thailand as labour costs and investment incentives remain attractive (box figure 2). The industries with the most ambitious investment-expansion plans are electronics and electrical appliances. Moreover, the percentage of firms planning to shift production to other countries is quite small, with only 1 per cent of respondents indicating such plans.

**Box figure 2. Investment plans of TNCs in Thailand**  
(Per cent)

/...

**(Box 4, cont'd.)**

C Finally, although Thai exports have gained greater price competitiveness thanks to a weaker baht, the fluctuation in the value of the baht has been a major concern among foreign investors (slightly over a half of the respondents). Other problems include the decline in domestic demand and the financial liquidity crunch.

*Source:* Thailand, Board of Investment.

<sup>a</sup> Questionnaires were sent to 592 foreign affiliates operating in Thailand, of which 236 firms (40 per cent) responded. The majority (58 per cent) of the respondents were Japanese companies, followed by Taiwanese and United States' investors. Two-thirds of the respondent companies had been operating in Thailand for more than 5 years. Most of them are medium- and large-scale firms, with 29 per cent of them having more than Bt 1 billion in asset value. Two-thirds of respondent companies exported more than 20 per cent of their production. The industrial breakdown of the respondents was: agriculture and agricultural products - 4 per cent; mining, metals and ceramics - 7 per cent; light industry - 9 per cent; metal products, machinery and transport equipment - 24 per cent; electronic products and electrical appliances - 26 per cent; chemicals, paper and plastics - 21 per cent; and service and infrastructure - 9 per cent.

The impact of the current crisis could therefore be mitigated somewhat for a number of the most affected Asian countries because international integration at the level of production allows TNCs (and firms linked to them) to compensate for declining domestic sales through increased exports spurred by devaluation. Whether and to what extent this potential is realized depends, of course, on the strategies of firms. Moreover, the extent of the cost advantages enjoyed by export-oriented firms varies among industries and firms and is determined in part by their import-dependence. This further underlines the importance of integrating foreign affiliates into their host economies: such integration not only contributes to the building up of local capacities; but the more foreign affiliates can draw on backward linkages with local enterprises, the less import-dependent they are. Survey data suggest also that in Malaysia (box 6) and Thailand (box 4) industries that are more export-oriented have been less affected by the crisis than other industries.

There are, however, important preconditions that need to be fulfilled if increased export competitiveness is to be effectively exploited, be it by export-oriented foreign affiliates or by domestic firms: the principal export markets in other parts of the world need to remain open to exports from the affected Asian countries and, equally important, demand in these markets needs to remain strong enough to absorb additional imports. This is particularly important since demand in the Asian regional market as a whole, which has been absorbing increasing shares of exports from within the region, has been adversely affected by the crisis and by the current economic slowdown in Japan.

### **Box 5. TNCs' response to the Asian crisis: the case of Honda in Thailand**

In the wake of the financial crisis, some leading Japanese automobile makers and their parts producers have been injecting capital into their affiliates located in the most affected countries. This has not only helped the affiliates to deal with their financial problems, but also boosted their parent firm's equity share in their affiliates at a cheaper price than might have been possible in normal times. The crisis has also acted as a catalyst in this restructuring of global production by automobile TNCs, as illustrated by Honda's relocation programme.

Honda's parent company has decided to inject three billion baht into its Thai holding company, of which Bt 2.16 billion will be used to double the capital base of its Thai affiliates. The remainder will be used to purchase those Honda Car Manufacturing (Thailand) shares not fully subscribed by Honda. In addition, Honda Motors of Japan plans to inject 600 million baht into its cash-strapped parts supply subsidiaries in Thailand to boost their capital during the liquidity crunch.<sup>a</sup> Showa Corp., an automobile parts manufacturer affiliated to Honda Motor Co., plans to raise its stake in a joint shock-absorber venture in Thailand from 49 per cent to 53 per cent by doubling the capital of the affiliate.

Furthermore, the cheaper baht has accelerated Honda's restructuring programme to relocate production to Thailand. Honda has 27 subsidiaries in Thailand, most of which are parts manufacturers. The relocation plan envisages the use of existing facilities without new investments. Honda's production facilities in Japan are to cease producing some parts and to transfer the responsibility to its Thai affiliates. The programme is expected to benefit more than 20 parts producers in Thailand in which Honda has a stake. The plan starts with parts production and then proceeds to car and motorcycle manufacturing.<sup>b</sup> Honda is also working on a plan to boost automotive parts exports from Thailand. It has been able to increase exports back to Japan and to outside the region.

The relocation of parts production, boosting exports and injecting capital into its affiliates are a few of the measures Honda has adopted in response to the financial crisis in Thailand. Other measures include increasing local content in its Thai automobile production, negotiating for a price reduction of completely-knocked-down imported units from its Japanese parent, and cutting expenditures.

*Source:* UNCTAD.

<sup>a</sup> *The Nation*, 24 March 1998.

<sup>b</sup> *The Nation*, 24 March 1998.

**Box 6. TNCs' response to the crisis:  
the electrical and electronics industry in Malaysia**

The electrical and electronics industry in Malaysia is dominated by TNCs. It is also the country's single largest foreign exchange earner, accounting for two-thirds of total manufactured exports in 1997 (Malaysia, Bank Negara, 1998). There are currently over 100 sizeable electrical and electronics foreign affiliates in Malaysia. The industry grew by 14 per cent in 1997 (Malaysia, Bank Negara, 1998), stimulated mainly by global demand for semiconductors, particularly from the United States, Europe and the Asia-Pacific countries (excluding Japan).

A survey of foreign affiliates in the industry was carried out by UNCTAD between April and May 1998, with a view to obtaining an understanding of the impact of the crisis on FDI and TNC activities in this key industry.<sup>a</sup> The results of the survey are as follows:

***Financing and financial transactions***

- C A majority of the foreign affiliates surveyed depend on offshore sources of financing. Only one-sixth are self-financing from sales and profits. Local banks are used mainly for day-to-day local transactions.
- C Most of the respondents service their debt in dollars, although some Japanese and Asian firms use the ringgit.
- C The dollar is the currency required to pay for principal inputs. Hence the devaluation has affected the cost of production. Since most foreign affiliates export more than a half of their output, however, the impact of sourcing through dollar-bought imports has not been critical.
- C Profit repatriations are normally made in ringgit, through dividend payments from the Malaysian affiliate to a parent company. However, one-fifth of the affiliates do not repatriate profits to their parent firm.

***Plans for investment or expansion***

- C None of the foreign affiliates surveyed intended to close down or relocate elsewhere. Some consumer electronic firms (28 per cent) have adopted a wait-and-see attitude towards the crisis, partly due to the fact that some of their products target domestic and/or regional markets. Half of the respondents see some opportunities to expand Malaysian operations in the wake of the crisis.

***Coping with the crisis***

- C Almost all of the respondents see cost reduction as a priority arising from the crisis. In addition, improvements in efficiency and marketing are seen as necessary for coping with the crisis.

/...

**(Box 6, cont'd.)**

*Expectations of future performance*

- C Despite the crisis, the firms surveyed have positive expectations regarding various production parameters. More than 60 per cent expressed the view that production, sales and exports will increase in the next three years. Others felt they would remain at the present level. None of the respondents suggested that they would decline significantly.

To sum up, there is some negative impact on the operations of foreign affiliates in the electrical and electronic industry of Malaysia resulting from the economic turmoil, but the impact does not appear to be significant. The surveyed companies still have confidence in Malaysia as a destination for FDI and are optimistic about the next three years. Some of them see the current crisis as an opportunity for expansion. In the meantime, because FDI in the electrical and electronic industry is mostly export-oriented, the ups and downs of the global electrical and electronic industry represent more of a challenge than the domestic or subregional economic upheavals such as the one now affecting Malaysia.

*Source:* UNCTAD survey.

<sup>a</sup> Responses were obtained from 20 major TNCs with manufacturing facilities in the electrical and electronic industry in Malaysia; some of the TNCs have more than one plant. The total value of output from these affiliates (about \$5.7 billion) comprised a large proportion of the industry in 1997. Most of the TNCs surveyed utilize Malaysia as a base for component manufacturing, assembly and testing.

**(b) Domestic-market-oriented FDI**

The downturn in domestic demand in Asia (annex table A.5) obviously has some adverse consequences for foreign affiliates producing for sale in local and regional markets. Reduced demand and slower growth can be expected to lead to some cancelling, scaling down or postponement of FDI in the most affected countries and perhaps elsewhere in the region.

The impact on domestically-oriented foreign affiliates varies among sectors and industries. Foreign affiliates in the services sector are particularly susceptible to local demand conditions because of the non-tradability of most services. According to a survey conducted by UNCTAD and ICC (box 7), expectations of reduced investment in the East and South-East Asian region in the short and medium term were reported most frequently for services: 18 per cent as compared to 12 per cent overall (box 8). FDI declined in real estate in Thailand (annex table A.1) and is expected to fall significantly in construction and civil engineering in the Republic of Korea (box 9). Nevertheless, in certain service industries, FDI could increase. These include banking, insurance and other financial services, and telecommunication, where the combination of the recent liberalization and the availability of assets for acquisition would suggest an increase in FDI inflows. This is precisely what seems to have happened in Thailand where, as mentioned, FDI in financial services has risen, tripling in 1997 and reaching, in the first quarter of 1998 alone, a level nearly a third higher than the total for 1997 (annex table A.1). In the Republic of Korea, the largest increases in FDI are expected to take place in consulting services (box 9).

### **Box 7. The UNCTAD/ICC global survey**

The UNCTAD Secretariat and the International Chamber of Commerce (ICC) jointly conducted a survey of large TNCs in February-March 1998 (UNCTAD and ICC, 1998 and UNCTAD, 1998a). The aim was to ascertain the companies' intentions with respect to FDI in the short-to-medium term in East and South-East Asia in the light of the financial crisis and their opinions regarding the long-term prospects for the region as an investment destination. The survey covered 500 companies. These included the world's 100 largest TNCs (not including banking and finance companies) in foreign assets, drawn from the list of such corporations prepared for UNCTAD's *World Investment Report 1997*; 200 companies that were potential candidates for inclusion in that list; the world's 50 largest TNCs (not including banking and finance companies) headquartered in developing countries, drawn from the list of such corporations published in UNCTAD's *World Investment Report 1997*; 50 companies that were potential candidates for inclusion in that list; and 100 additional firms with significant operations in Asia. A total of 198 firms responded to the survey, for a response rate of 40 per cent. The composition of the sample in terms of countries/regions in which the respondents are located ("home regions") and in terms of economic sectors is contained in the following two box figures:

**Box figure. Breakdown of responses to the questionnaire by home region**

**Box figure. Breakdown of responses to the questionnaire by main sector**

*Source:* UNCTAD.

**Box 8. The UNCTAD/ICC global survey: implications for FDI in Asia  
in the short and medium term**

The findings of the UNCTAD/ICC survey (box 7) show that more than one-quarter of the responding firms expect to increase their FDI in East and South-East Asia as a whole in the short-to-medium term (box figure 1). North American and Japanese firms are close to this average, while firms from Europe are distinctly above it and those from developing Asia distinctly below it (box figure 2). In the case of European firms, this may well reflect the fact that, after having largely neglected Asia until recently (European Commission and UNCTAD, 1996), they are now taking an active interest in this region. In the case of the developing Asia TNCs, the low proportion may reflect the impaired capacity of some TNCs to undertake outward FDI (most of which has traditionally gone to other developing countries). However, they remain committed to the region; 69 per cent expect to maintain their investment at the pre-crisis level. Predictably, firms in manufacturing from all regions have the highest proportion of responses indicating expected expansion of their FDI in Asia, with over one-third of them providing this response, as compared to one-fifth of service firms and less than one-tenth of primary sector firms (box figure 3).

**Box figure 1. Short and medium-term prospects:  
overall response of companies worldwide**

**Box figure 2. Short and medium-term prospects:  
company intentions by home region of parent company**

**Box figure 3. Short and medium-term prospects:  
company intentions by sector**

*Source:* UNCTAD/ICC global survey, March 1998.

### **Box 9. Prospects for inward FDI in various industries in the Republic of Korea**

The financial crisis is expected to influence the prospects for FDI in the Republic of Korea differently in different industries. According to a survey of foreign affiliates in the Republic of Korea, conducted jointly by UNCTAD and the Federation of Korean Industries (FKI), the consulting industry appears to be the brightest spot for FDI in the light of the financial crisis (box figure) -- presumably because the need for professional advice increases as the full-scale restructuring of domestic corporations begins and firms engage actively in M&As.

**Box figure. Prospects for inward FDI in the Republic of Korea  
in the light of crisis, 1997: survey results  
(Points)**

*Source:* UNCTAD/FKI survey, April 1998.

Other areas expected to attract more FDI are the semiconductor and communication equipment industries, and the electrical and electronics industries. Domestic demand for these products is increasing rapidly and national technologies in the industry are relatively advanced. Furthermore, these industries are export-oriented, and their products are internationally competitive. Investment in trading services is also expected to increase as the import and export regulations have been substantially liberalized and will be further streamlined in the future.

However, the surveyed firms were pessimistic about the prospects for FDI in shipping, finance and insurance, industries in which FDI grew rapidly prior to the crisis. The predicted contraction of the economy in general, and a rapid fall in consumer spending in particular, are likely to discourage growth of FDI in these industries. Demand in the metals industry, which produces basic production materials and intermediate goods, may also drop precipitously due to decreased domestic investment and demand and lower levels of production. Finally, FDI in the construction and civil engineering industries is expected to fall substantially, given the serious stagnation in the real estate market.

*Source:* UNCTAD/FKI survey, April 1998.

Among manufacturing industries, foreign affiliates in light industries which produce non-luxury consumer goods are less likely to be affected than affiliates producing durable goods and luxury items. Affiliates producing goods and services that depend mainly on domestic sources of raw materials and intermediate inputs would also be less affected than those relying on imports from countries whose exchange rates have changed little. The automotive industry, in which TNCs figure prominently, is a good example of the impact of the crisis and the range of responses



by firms. Demand for passenger cars in the most affected economies has declined dramatically (figure 5), where considerable capacity had been built up, and a number of automotive TNCs have scaled down, postponed or even cancelled investment projects in some of these countries. One-third of the 18 respondents from that industry to the UNCTAD/ICC survey indicated that they planned to postpone some of their investment projects and another one-sixth indicated a scaling down. Volvo scaled down output at its affiliate in Thailand by suspending car production in late 1997;<sup>13</sup> Mazda closed a joint venture in the same country in July 1998;<sup>14</sup> and GM scaled down its investment plans for a plant in Rayong, Thailand, from \$750 million to \$450 million (a reduction in planned capacity from 100,000 units to 40,000 units) and postponed its implementation (TDRI, 1998). At the same time, the same companies sometimes increased, or sought to increase, their investment in the most affected countries. For example, GM acquired an additional 40 per cent in General Motors Buana, Indonesia. In January 1998,<sup>15</sup> Honda increased its share in Honda Thailand, thus injecting funds to help its financially distressed affiliate as well as increasing its level of control over it (box 4); and Ford was competing with several domestic firms to acquire Kia, an automobile producer in the Republic of Korea.<sup>16</sup> At the aggregate level, this is reflected, for example, in the fact that FDI flows into the automobile industry in Thailand remained relatively strong during the second half of 1997 and the first quarter of 1998 (annex table A.1). TNCs also reacted by reallocating production from elsewhere to affiliates in the most seriously affected countries (box 5), switching production into exports (boxes 3 and 4) and/or increasing local content (boxes 5 and 10).

**Box 10. The Asian crisis and its implications for TNCs: the case of Motorola**

Despite the deterioration of economic conditions in some Asian markets and its negative impact on sales and profits, Motorola is holding to its investment plans in Asia. In Malaysia, Motorola plans to invest RM50 million in the Multimedia Super Corridor, the Malaysian silicon valley to develop, among other products, smart cards based on the open systems architecture.<sup>a</sup> The investment is to be spread over two years. In addition, Motorola Malaysia is investing RM3.3 million in the first phase of its wastewater recycling project which would be using the latest “membrane technology”. The project, in which the company plans to recycle up to 40 per cent of current water usage from its plants, is expected to involve a total investment of RM5 million. The company also has an R&D centre in Malaysia. Motorola Malaysia expects to recruit 200 engineers by the year 2000, and 80 to 90 per cent of its 12,000-strong workforce in its five manufacturing facilities in Malaysia are expected to be Malaysian nationals. Motorola is also planning to relocate its ASEAN regional headquarters to Malaysia.<sup>b</sup>

As one of its measures to reduce costs, Motorola Malaysia expects its annual purchases from its local component suppliers to increase, reaching a total value of RM1 billion in the year 2000, compared to RM785 million in 1997. The company sources from more than 100 local suppliers: various types of components including semiconductor lead frames, flexible circuit boards, liquid crystal device, precision tooling, engineering plastic parts and packaging. It also has another 500 local partners which supply and service the company’s daily factory maintenance, repairs and operational requirements for each of its five manufacturing facilities in Malaysia. Motorola intends actively to develop local suppliers and to provide overall support to them in technology, management and training.<sup>c</sup>

/...

**(Box 10, cont'd.)**

In the Republic of Korea, Motorola acquired in May 1998 a stake in Pantech, Seoul, a Korean electronics firm, becoming its second largest shareholder with 20 per cent equity. Exports are expected to account for more than 80 per cent of the company's annual sales by 1999, an increase from about 60 per cent expected for 1998. Pantech and Motorola plan to work together to develop Code Division Multiple Access (CDMA) digital cellular telephones. Motorola plans to invest \$300 million in the Republic of Korea to expand its operations and set up new partnerships.<sup>d</sup>

*Source:* UNCTAD, based upon information obtained from the media and Motorola.

<sup>a</sup> *SUNS: South-North Development Monitor*, 24 January 1998.

<sup>b</sup> *Ibid.*

<sup>c</sup> *New Straits Times*, 11 June 1998.

<sup>d</sup> *New Straits Times*, 15 May 1998.

These examples illustrate both the risks and opportunities that the crisis entails for firms, in the automobile industry as well as in other industries. They show how TNCs can turn adverse effects to their advantage by strategic positioning, among other things by the acquisition of assets. They also show that foreign affiliates are often in a better position than domestic firms to weather difficulties, an example of the protective influence that transnational corporate systems can spread over their affiliates. For countries, all of this helps to alleviate the immediate impact of the crisis.

### **3. Regulatory changes affecting FDI**

The shortage of capital, not only for investment but also for financing production operations and trade, combined with a recognition of the role that FDI can play in restoring growth and development, is leading to an even more flexible attitude towards FDI in the region. As a result, some countries have in recent months further liberalized their FDI regimes (annex table A.6). In addition to unilateral measures and measures implemented in pursuit of multilateral commitments (such as, for example, those made under the General Agreement on Trade in Services), liberalization measures have also been taken in the context of the adjustment programmes linked to the package of financial support from the International Monetary Fund. Recent moves by the five most affected countries include opening industries like banking and other financial services to FDI and relaxing rules with respect to ownership, mode of entry and financing.

Governments in the countries most affected by the crisis have also intensified their efforts to attract FDI both individually and collectively. For example, the Republic of Korea has introduced an automatic approval system (table 4) and Thailand has established a unit to assist foreign companies to bring expatriates to work in promoted projects. At the regional level, ASEAN members are implementing their Plan of Action on Cooperation and Promotion of Investment and, in July 1998, the heads of the ASEAN investment promotion agencies announced that the framework agreement to establish the ASEAN Investment Area would be submitted to Ministers for adoption late in 1998.<sup>17</sup> At the interregional level, at the second Asia-Europe Meeting (ASEM) in London in April 1998, leaders "urged full and rapid implementation by all

ASEM partners of the Trade Facilitation Action Plan and the Investment Promotion Action Plan ....”<sup>18</sup> The Asia-Europe Investment Promotion Action Plan is focused on a number of activities under two broad headings: investment promotion and investment policies and regulations. The proposed activities to promote investment between and within the two regions include a virtual exchange network to disseminate information to investors, a round table with business leaders and a business-to-business exchange programme, as well as high-level dialogue on key investment issues.<sup>19</sup>

Taken together, these liberalization moves and promotion efforts make the policy determinants of FDI in the most affected countries more favourable for foreign investors. There is a danger, however, that countries eager to attract FDI may provide foreign investors incentives that they would not grant under normal circumstances. This could lead to market distortions and intensify incentives competition in the region (UNCTAD, 1996b), especially since the crisis-affected economies have similar industries and demand structures.

### **B. Implications for outward FDI**

Outward FDI by TNCs headquartered in developing Asia has increased substantially in recent years, with the greatest proportion of such flows going to other countries in the region. For the major Asian developing home economies taken together, the stock of FDI located in other developing Asian economies was at least one-half of their total outward FDI (figure 6). The financial crisis is likely to reduce both the capacities and the incentives of a number of Asian TNCs to undertake FDI, both intraregionally and elsewhere.

The region’s TNCs have been financially weakened by the crisis for a number of reasons:

- C *Valuation losses.* The book value of the assets of a number of firms has fallen due to the drastic currency devaluations and the sharp fall of stock prices. This applies both to parent firms and some of their affiliates (in crisis-affected countries) within the region, involving, in the latter case, a reduction in the (dollar) value of TNCs’ FDI stock. The impact is much more pronounced for Asian TNCs than for investors from other regions, since a much higher proportion of Asian TNCs’ assets are located in other Asian countries. Judging from changes in the ranking of Asian companies on the 1997 *Financial Times* “Global 500 list” of the largest companies in the world, several large TNCs from developing Asian economies have experienced considerable losses of the value of their assets.<sup>20</sup> Of the 25 companies that have fallen the most in their ranking on the 1997 list, as compared to the 1996 list, seven were based in developing Asia (and 14 in Japan). In 1996, four newcomers on the 500 list were from the most affected economies;<sup>21</sup> in 1997, there were none and, moreover, an additional six firms from that group of countries departed from the list in 1997. With the worsening of the situation at the end of 1997 and the beginning of 1998, valuation losses may have increased, further impairing their FDI potential.
- C *Debt burden.* Asian TNCs that are mainly Asia-oriented face another possible source of loss if they have relied on borrowed funds denominated in dollars. Such borrowing appeared reasonable as long as various Asian currencies were pegged to the dollar. Higher interest rates in some Asian host countries encouraged dollar-denominated

borrowing. Like domestic borrowers, Asian parent firms and their foreign affiliates were caught by surprise when the dollar pegs of some Asian currencies proved unsustainable.<sup>22</sup> Substantial borrowing in foreign currencies has therefore aggravated the debt-servicing burden of TNCs with high debt-equity ratios. The largest Korean conglomerates, for example, had debt-equity ratios (annex table A.7) that were high by international standards (UNCTAD, forthcoming, b). In the case of banks, a rise in non-performing debt as well as more demanding prudential regulations may further restrict the room for manoeuvre. The problems arising from devaluation in servicing dollar-denominated debt tend to be more pronounced for foreign affiliates oriented to local markets, since they do not earn foreign currency.<sup>23</sup> The effect is again to impair the ability of the affected firms to finance outward FDI.

- C *Reduced profitability.* To the extent that parent firms and affiliates are located in countries that have experienced a decline in demand, their ability to self-finance their operations or to expand further, through reinvestment or in other ways, may also have decreased. Consumption has indeed declined in a number of Asian economies, reflecting in many cases a decline in growth rates or the onset of a recession (annex table A.5). The result has been a steep decline in profits in 1997, averaging 18 per cent for the 15 companies from developing Asia included in the 1998 *Fortune 500* list, compared to an increase of 25 per cent in the profits of European firms at the other end of the spectrum with respect to profits (figure 7).

The impact of these factors is further compounded by high interest rates (and in some cases, a general credit crunch) at home, the increased cost of foreign operations due to depreciation of domestic currency, and the difficulty of raising funds abroad due to lowered credit ratings (table 2). As a result, the financial capacities of a number of Asian TNCs have been weakened, including their capacity to undertake outward FDI. A shortage of cash has induced a number of Asian firms to divest assets abroad, especially in Asia, Europe and the United States, to raise funds (annex table A.8).<sup>24</sup> At the same time, the crisis has changed some of the parameters that induced some Asian firms to invest abroad in the past, at least as far as other parts of Asia are concerned:

- C To the extent that growth and demand in other Asian countries has declined (annex table A.5), TNCs from Asian developing countries seeking national or regional markets have less of an incentive to invest or reinvest in those countries. On the other hand, market-seeking TNCs could switch to countries unaffected by the crisis, if their financial capabilities and ownership advantages this permitted.
- C The calculations of efficiency-seeking TNCs depend very much on the devaluation-related movement of production costs at home as against in other Asian countries. In particular, TNCs headquartered in home countries whose currencies have been significantly devalued (table 2) may find that devaluations have so far reduced the cost differentials between producing at home and producing abroad that it is no longer worthwhile for them to move labour-intensive production abroad in order to be competitive in world markets.

In either case, the incentive for Asian TNCs to invest abroad and to invest in Asia in particular is weakened, at least in the short-to-medium term.

In addition to the factors affecting the capacities and incentives of Asian TNCs to invest abroad, policy measures adopted by governments to deal with the crisis could also discourage some outward FDI. Some of these measures may not be targeted at outward FDI but, to the extent that they aim at minimizing outflows of capital in general, they could also affect FDI. Other measures are specifically FDI-related. For example, the Government of Malaysia had encouraged its firms to invest abroad before the crisis (UNCTAD, 1995a). After the crisis reached that country the Government began to discourage outward (or "reverse") investment by Malaysian firms, so as to maintain liquidity. The Government declared that "reverse" investment, which amounted to 7 billion Malaysian ringgit during the first half of 1997, "will have to be deferred even if these investments are to be financed through foreign borrowing. However, investments which have significant linkages with domestic economy and earn foreign exchange will be continued".<sup>25</sup>

All in all, FDI outflows from developing Asia in general, and from the five most affected countries in particular, can be expected to remain at low levels in the short and perhaps the medium term, as Asian TNCs' capacities to sustain existing operations and initiate new FDI projects are weakened. The year 1997 witnessed a decline of outward FDI from four of the five most affected countries (annex table A.9), including a substantial decrease in cross-border M&As over the second half of 1997 (figure 8). First quarter data for the Republic of Korea and Malaysia suggest that this decline will continue.<sup>26</sup> Furthermore, according to a survey conducted by UNCTAD and the Federation of Korean Industries (FKI) in March 1998,<sup>27</sup> some two-thirds of the 46 large TNC respondents based in the Republic of Korea indicated that they had either cancelled, scaled down or postponed their investment plans (figure 9). This was the case for both manufacturing and non-manufacturing firms (figure 9). It was also the case for investment intentions for 1998-1999, suggesting that Korean firms expect to invest less in virtually every one of their major investment destinations (figure 10) and that reductions in FDI are likely to be particularly large in the four other crisis-stricken economies. Outside Asia, the expected declines in FDI from the Republic of Korea are considerably less pronounced. A survey conducted by the Export and Import Bank of the Republic of Korea in March 1998 corroborates these findings: 108 of 140 Korean TNCs responding had cancelled or postponed their FDI plans<sup>28</sup> and the bank estimated that total outward FDI by Korean TNCs could fall by 60 per cent in 1998.

The picture looks different when the less affected major home economies of Asia (China, Hong Kong (China), Singapore and Taiwan Province of China) are considered: their performance regarding outward FDI improved slightly in 1997 over 1996 (see UNCTAD, forthcoming, a, chapter VII, section A), indicating that the combination of financial capabilities and economic incentives has remained favourable for them so far. This is also reflected in the fact that total M&A purchases outside Asia by firms from major outward-investing economies among the less affected Asian economies increased in 1997 over 1996 (annex table A.10). Whether this will continue in 1998 is uncertain, even though there were a number of M&As by firms from other major developing countries in Asia in the five most affected economies during the first half of 1998 (annex table A.10). When it comes to the longer term, it can be expected that outward FDI from the region (including the crisis-affected economies) will resume its upward trend. This reflects the belief of the corporate executives responding to the survey that most of the fundamental determinants of Asian outward FDI can be expected to reassert themselves once the present difficulties have been overcome. One determinant is marketing and management know-how. Another is accumulated technological capacity, especially in medium-technology industries.

This includes the capacity to adapt technology to the needs of developing economies as well as advantages deriving from R&D activities, especially in the newly industrializing economies. Furthermore, the painful lessons of the crisis and the restructuring in its light could strengthen the competitiveness of Asian TNCs. Over the long term, they can be expected to resume their position as leading developing-country investors, although they may well be more cautious and more focused in their internationalization in the future.

### **C. Implications for FDI flows into other countries**

The implications of the financial crisis for inward FDI are not confined to the five most seriously affected countries. Other Asian countries, especially in developing Asia, may also be affected. Three factors are here particularly relevant:

- C The reduced capacity of TNCs in the region to invest abroad, be it for market-seeking or efficiency-seeking reasons.
- C The possibility of reduced growth in the non-affected countries in the region, making them less attractive as destinations for market-seeking FDI.
- C The reduced export competitiveness of the less affected countries, brought about by the devaluations in the most affected countries, which makes them less attractive for efficiency-seeking FDI.

Developing countries in the region in which any or all of these factors come into play are likely to experience a fall in FDI. In particular, FDI flows into countries that receive significant amounts of investment from within the region -- especially from the most affected countries -- could fall. These are mainly the countries of East and South-East Asia, including China, Viet Nam, the Asian least developed countries (Bangladesh, Cambodia, Lao People's Democratic Republic, Myanmar) and Central Asia (figures 11 to 14). The same considerations could also influence FDI flows from developed countries to the less affected Asian developing countries; in particular, Japanese FDI may be affected (box 11).

To the extent that FDI flows into other developing countries in Asia do decline, there could be broader implications, since interactive TNC-assisted restructuring has been one of the dynamic forces that has assisted Asian development, in the framework of the "flying-geese" pattern (UNCTAD, 1995a). In the first instance, this process took place between Japan (and the United States) on the one hand and the newly industrializing Asian countries on the other hand (UNCTAD, 1995a). At a second stage, a number of other Asian countries joined in, also receiving outward FDI from the newly industrializing economies. For the major developing host economies, FDI originating in other developing Asian economies was at least 40 per cent higher than the share of Europe, Japan or the United States taken singly (European Commission and UNCTAD, 1996). The current crisis could therefore lead to a slowing down or interruption of the process.

### **Box 11. Impact of the Asian financial crisis on Japanese FDI**

Japan has a particularly important role in FDI flows into Asia, and many of the considerations discussed earlier in relation to Asian TNCs are also relevant to Japanese TNCs.

The crisis has meant considerable difficulties for Japanese TNCs. Like other Asian TNCs, their stock has lost value because of devaluations by affected countries, and they too have dollar-denominated debt to service. Asia, including the most affected countries, is an important host region for Japanese TNCs (European Commission and UNCTAD, 1996), and Japan is in turn important for Asia. Japanese TNCs held almost one-third of the inward FDI stock of the Republic of Korea in 1996, and about one-quarter of it in the ASEAN 4 (Indonesia, Malaysia, the Philippines and Thailand) in the mid-1990s. In comparison, the European Union held around 15 per cent and the United States 13 per cent of the inward stock of the ASEAN 4.<sup>a</sup>

When it comes to the adverse effects of depressed demand on the profitability of foreign affiliates focusing on local markets, it is relevant to note that local market-oriented FDI is fairly important for Japanese affiliates in Asia. It accounted for 60 per cent of the total sales of these affiliates in South, East and South-East Asia in 1995 (box figure 1) and exports to the countries of the region accounted for another 15 per cent.<sup>b</sup> The future prospects of local market-oriented FDI in Asia from Japan depend critically on how fast East and South-East Asia overcomes the crisis. The critical industries for Japanese foreign affiliates are chemicals, transport equipment, and iron and steel, in which the proportion of local sales is particularly high (Japan, MITI, 1998, table 2-21-6). In the transport industry, for example, three-quarters of the Japanese affiliates incurred losses in 1997.<sup>c</sup>

**(box figure 1 here)**

/...



**(Box 11, cont'd.)**

The effects of the crisis on export-oriented Japanese FDI in South-East Asia are less straightforward. For example, sales by export-oriented Japanese affiliates in the textile industry in Thailand increased in 1997 and 85 per cent of the firms are expected to make a profit in 1998.<sup>d</sup> On the other hand, the competitiveness-enhancing effect stemming from devaluations is dampened by a fairly high dependence on imported inputs: in 1995, imported inputs accounted for 62 per cent of the total procurements of all Japanese manufacturing affiliates in the ASEAN 4 (Japan, MITI, 1998, table 2-22-6). Devaluation-induced cost increases for imported inputs are probably above average for Japanese investors in textiles, iron and steel, and electric machinery, all of which had relied upon imported inputs in the range of two-thirds to four-fifths of total procurement in 1995. Export-oriented Japanese FDI in the ASEAN 4 may also suffer from depressed demand conditions in Japan, especially in industries in which Japanese foreign affiliates reported a high share of exports to Japan in overall sales. Outstanding in this respect in 1995 were fishery and forestry products (65 per cent), precision machinery (44 per cent) and electric machinery (36 per cent) (Japan, MITI, 1998, table 2-21-6).

Prospects for Japanese FDI in South-East Asia thus depend on a variety of factors: economic recovery in Japan, exchange-rate developments, and the potential to switch from production for the local market to production for exports and from foreign sourcing to local sourcing of inputs. They also depend on the extent to which such FDI is targeted at non-Asian markets in the future.

Finally, new Japanese FDI may be attracted to developing Asia by the liberalization of FDI regulations in the countries affected by the current crisis. Latecomers to FDI in developing Asia, from Japan and elsewhere, who had to fight an uphill struggle against well-established competitors may now have a competitive advantage. Their market access is facilitated by depressed local asset prices and their liquidity less constrained by the valuation losses ensuing from the devaluations of Asian currencies. However, financial tension and liquidity constraints in the Japanese economy may put some Japanese investors at a competitive disadvantage in grasping the favourable FDI opportunities in developing Asia. The discrepancy between profitable investment opportunities in East and South-East Asia and Japan's chances to compete successfully with bidders from Europe and the United States is probably most pronounced in banking and finance. While the liberalization of financial services figures high on the reform agenda in East and South-East Asia, Japanese banks are forced to reduce their engagement in this region because of mounting non-performing debts, an inadequate capital base and more demanding prudential regulations.

All in all, however, Japanese TNCs seem to be responsive to the changing environment in South-East Asia and some of them could turn the recent events to their advantage. This view is supported by the increasing exports of Japanese affiliates in developing Asia. Examples abound. Sharp, Matsushita, Hino Motors, as well as automobile parts and component firms, all plan to increase exports from their affiliates in Asia.<sup>e</sup> Furthermore, in the UNCTAD/ICC survey, two-thirds of Japanese TNCs stated that their investment plans in the region remained unchanged, and almost one-fifth of them even intended to increase their investments despite the crisis. Another survey undertaken in mid-1998 indicates that between 44 per cent (Indonesia) and 75 per cent (Philippines) of Japanese TNCs in the countries affected by the crisis expected to maintain or increase their FDI in the next one-to-three years. Declines are expected to be most pronounced in Indonesia (56 per cent) and Thailand (53 per cent) (box figure 2).<sup>f</sup>

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(Box 11, cont'd.)

**Box figure 2. Investment plans of Japanese TNCs in the next 1-3 years  
in the most affected Asian countries, compared to  
the FDI level in 1997, 1998  
(Per cent)**

*Source:* Tejima, 1998.

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<sup>a</sup> Based on UNCTAD, FDI/TNC database.

<sup>b</sup> These shares, taken together, were somewhat lower, however, than the corresponding shares for Japanese affiliates in Europe and North America. Similarly, United States affiliates in South, East and South-East Asia have lower shares of domestic sales (53 per cent in 1994) than in Europe (65 per cent) (United States, Department of Commerce, 1997c).

<sup>c</sup> *Nihon Keizai Shimbun*, 16 December 1997, p. 11.

<sup>d</sup> *ibid.*

<sup>e</sup> *Nihon Keizai Shimbun*, 20 April 1998 and 5 May 1998.

<sup>f</sup> This survey was conducted by the Research Institute for International Investment and Development, Export-Import Bank of Japan, in the mid-1998 (Tejima, 1998).

Furthermore, countries in the region less closely linked, including through intraregional FDI, to the most affected countries may well gain in relative attractiveness, especially if their basic FDI determinants are in good shape. Indeed, the UNCTAD/ICC survey suggested that FDI to South Asia, where FDI from other developing Asian economies has been relatively low (figure 15),<sup>29</sup> could well increase (table 5). Countries further away -- in Africa, Latin America and the Caribbean, and Central and Eastern Europe -- are unlikely to be touched by the developments in Asia as far as FDI is concerned. Although, if the present slowing down of some economies transpires into a global recession accompanied by a global fall in FDI, they could be. Despite some increases in FDI from developing Asian economies, particularly from the Republic of Korea, the main sources of FDI to those regions are still Europe and the United States (figures 16-18).<sup>30</sup> Similarly, the share of the Asian developing countries in FDI in Japan, the United States and the European Union amounted to between 1.1 per cent (European Union) to 6.3 per cent (Japan) of total inflows, and between 0.5 per cent (European Union) and 4.6 per cent (Japan) of total stock in the first half of the 1990s (table 6).

It might be expected that, in the light of the crisis, some TNCs may find sites in other

regions more attractive relative to those in Asia for new investment projects in the short-to-medium term, if not in the longer term. Survey results suggest that some firms are indeed looking at expansion in Latin America and also in Central and Eastern Europe and Africa in the short-to-medium term (table 5). However, this finding should not be interpreted as necessarily indicating an FDI switch to these regions in response to the crisis. The ability of investors to substitute actual or potential FDI in one host region (or country) with FDI in another depends largely on the type of FDI as well as on the sector or industry concerned. The following points, among others are relevant:

- C Natural-resource-seeking FDI is largely location-specific and substitution is limited.
- C Asset-seeking FDI, as discussed above, may be attracted by the new opportunities in Asia.
- C Efficiency-seeking FDI may also be attracted by falling costs in Asia.
- C Market-seeking FDI depends mainly on the size and income growth of host countries. The contraction of markets in the affected countries in Asia is thus likely to reduce some market-seeking FDI in the short-to-medium term, but this does not necessarily mean a switch to other regions. That would depend on how attractive other regions are, either relatively or absolutely. Furthermore, FDI is not a zero-sum game and it need not be assumed that FDI for other regions must involve some withdrawal from Asia.

Thus the extent of a shift of FDI from the crisis-affected countries to other regions is likely to be limited. Indeed, an overwhelming majority (90 per cent) of the UNCTAD/ICC survey respondents who indicated that they expect to increase their investments in Latin America and the Caribbean and in Central and Eastern Europe did *not* intend to reduce their investments in East and South-East Asia in the short-to-medium term. Furthermore, nearly 50 per cent of them also indicated that they expect to *increase* their investments in East and South-East Asia. In other words, firms see profitable investment opportunities across the spectrum of developing countries and do not necessarily see these countries as alternatives to one another. This is also confirmed by survey responses of foreign affiliates in Thailand, only 1 per cent of which indicated an intention to shift investments to other countries (box 3).

Indeed, FDI flows to Latin America and the Caribbean and to Central and Eastern Europe already showed a substantial upward trend before the Asian crisis (UNCTAD, forthcoming, a, chapters VIII and IX). Central and Eastern Europe, in any event, is a region which offers much potential for further increases. As regards Africa, the characteristics of the host countries in that region and in Asia are so different from those of Asian host countries that there is little direct competition between the two regions (UNCTAD, forthcoming, a, chapter VI).

Finally, it needs to be recognized that, with or without a crisis, Asia's share in the total FDI going to all developing countries would decline in any case, as other regions improved their FDI appeal. In other words, the relative FDI position Asia attained during the past decade is being readjusted as Latin America and the Caribbean emerge from their "lost decade" and Central and Eastern Europe open their economies. Thus, a shift would occur even without any interregional diversion of FDI flows on account of the crisis.

## D. Conclusions

It is difficult to assess the overall impact of the different factors here discussed on FDI inflows in the short and medium term into the countries most affected by the crisis (table 7). The extent to which the financial crisis spills over into the real sector and the way it is handled will determine how it affects the size and nature of TNCs' operations in the region. There is a growing consensus that economic growth will slow in 1998 and perhaps also in 1999, but there is far less agreement over how much it will fall and how quickly the affected economies will recover (International Monetary Fund, 1997; UNCTAD, 1998a). Much will depend upon how quickly the efforts to stabilize the financial markets and external financing positions of the crisis-affected economies are broadly successful.

When it comes to FDI determinants proper, many of them remain attractive. First, regulatory frameworks, which were already quite open and hospitable to FDI prior to the crisis, have become even more so. Second, business facilitation has been strengthened and promotional efforts have been accelerated. Further policy measures and promotional efforts could be considered, especially to deal with the short- and medium-term effects (box 12). Third, as regards the economic determinants of investment, the size of host country markets is bound to contract in countries affected by the crisis and thus discourage some market-oriented investments in the short term. FDI, like domestic investment, is pro-cyclical, declining during recessions and rising as recovery gathers speed, although FDI stock does not fall as a rule and foreign affiliate output and employment show less cyclical variation than FDI flows (Ramstetter, 1998). The crisis also creates opportunities for FDI, specifically for efficiency-seeking and asset-seeking FDI in the form of devaluation-driven cost advantages and cheaper and more easily available assets.

### Box 12. Policy measures

Since continued FDI flows could make a useful contribution to restoring economic growth and maintaining export levels in Asian countries affected by the crisis, policy measures to encourage them deserve attention. Some specific measures that might be considered in this context include the following:

- C Governments of the affected countries could make an extra effort - perhaps helped by regional and international institutions - to provide information about greenfield and joint venture investment opportunities, especially in activities they consider as priority areas. Special attention might be given to industries whose prospects remain (or have become) particularly attractive, such as those in which costs are denominated in local currencies while revenues are obtained in hard currencies. Attractive opportunities could also be highlighted in component or other supplier sectors that are often less visible to foreign investors than final-goods manufactures.
- C Countries might pay greater attention to providing assistance to dynamic and innovative small- and medium-sized enterprises which are also transnationalizing and the role of which as potential partners in international networks and technology alliances would thus be enhanced. These enterprises are even more likely than large TNCs to generate early beneficial effects, such as improvements in the trade balance, the use of local subcontracting, joint venture operations and the transfer of appropriate technologies (UNCTAD, 1993a). They often face obstacles related to their size and governments need to address these if they wish to attract small- and medium-term enterprises as investors (UNCTAD, 1998b).

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**(Box 12, cont'd.)**

- C Where appropriate, Asian TNCs could consider adopting international accounting standards as soon as possible.
- C Within the framework of regional integration arrangements and other fora for international cooperation -- such as the ASEAN Investment Area -- Asian countries could formulate joint measures to encourage FDI and its contributions to the economies of member countries.
- C Home countries whose tax policies allow the use of optional reserves and grant tax deductions for the depreciated value of their firms' foreign affiliates could consider recognizing the present circumstances in Asian countries as meeting the criteria for such reserves and deductions.
- C Home country political-risk insurance programmes for investors could consider expanding their coverage of foreign affiliates to sudden, steep and debilitating devaluations of foreign currencies.
- C Countries that are hosts to foreign affiliates of Asia-based TNCs in financial distress could consider temporary measures of assistance to help sustain existing affiliates, where this is warranted. This would be akin to investment incentives for new inward FDI projects, but adapted to the special present circumstances in the post-investment stage. Care would need to be taken in formulating these measures to avoid introducing undue discrimination against other investors.

Naturally, such efforts would have to be embedded in more general policies aimed at restoring macroeconomic stability and economic performance, as well as strengthening institutional capacities to advance the process of development. While specific efforts aimed at maintaining and increasing FDI flows can make a contribution to the process of overcoming the impact of the crisis, much more will depend on the quality of those more general policies.

The combination of these factors should allow for cautious optimism about FDI flows in the short-to-medium term into the region as a whole, including the five most affected countries. There will, of course, be variations among countries depending on the speed and thoroughness with which they master the crisis and restore macroeconomic stability. If flows are maintained or increased, that would contribute to counteracting, even if modestly, the expected fall in income and employment and would help in the process of recovery.

The extent to which the three sets of FDI determinants mentioned above translate into actual FDI inflows depends upon the longer-term views TNCs take of the future of the region. If they take a negative view, they will be reluctant to invest, especially as far as market-seeking FDI is concerned, and cautious in acquiring assets in the region. They might even consider divesting. If they take a positive view, they would position themselves in the region strategically, by strengthening their portfolio of locational assets to service markets, access resources and improve efficiency. In brief, they would see the crisis as an opportunity for competitiveness-enhancing FDI. The rationale for taking the second view would be that the economic fundamentals of the region remain sound and attractive for FDI. These include high domestic savings rates, skilled and flexible human resources, substantial infrastructure capacity and access to regional markets.

The same determinants are crucial for the long-term prospects for FDI flows to Asian countries. This includes flows from Asian TNCs, even from the most affected countries, since the competitive strengths of firms headquartered in the region remain unchanged and they can be expected to resume their outward FDI once financial strength is restored. Expectations of a continued growth of FDI flows to Asia in the long run are supported by the findings of the UNCTAD/ICC Survey (box 7). The great majority (over four-fifths) of the respondents reported that their confidence in the region as an investment destination had remained unchanged (figure 19). The pattern of the findings in this regard is similar across firms in different sectors (figure 20) and from different home regions (figure 21). Similar findings emerge from surveys of foreign affiliates in Thailand (box 4), the Republic of Korea<sup>31</sup> and Malaysia's electrical and electronics industries (box 6). In each case, the majority of the respondents expressed their confidence in the long-term prospects of those economies as profitable destinations for FDI. Even if these positive expectations may have become more cautious since the surveys were conducted in the first half of 1998, they reflect the fact that Asia remains an attractive region despite the crisis.

As regards the implications of the crisis for Asian countries not directly caught up in the crisis, a number of them -- China, Viet Nam, the Asian LDCs and the countries of Central Asia -- that have depended heavily on outward investments from some of the crisis-stricken countries, as well as competed with them for export-oriented FDI, are likely to receive lower FDI inflows in the short-to-medium term. Effects on FDI to South Asian countries as well as to Asian newly industrializing economies are likely to be modest. Indeed, they might become more attractive to foreign investors looking for new locations for investment in the light of reduced scope for expanding FDI in the most affected countries.

Finally, the extraregional impact of the crisis will probably be modest, although the possibility of adverse indirect effects of a global economic slowdown were to occur cannot be ruled out. The changing parameters for outward FDI by Asian TNCs are unlikely to affect other regions substantially, since Asian firms have not yet made significant inroads as investors in countries outside the region. The likelihood of diversion of non-Asian investors from Asia and, especially from the most affected Asian countries to other regions are also quite limited. In any event, FDI flows to Africa, Latin America and the Caribbean, and Central and Eastern Europe had already showed an upward trend independently of the Asian crisis, because of favourable economic performance and other changes conducive to FDI. This suggests that, while there may be no diversion of FDI to those regions because of the crisis, Asian countries face increasing competition for FDI.

## Notes

1. According to data from national sources.
2. Based on UNCTAD's FDI/TNC database and data provided by the World Bank.
3. For a comprehensive discussion of host country determinants of FDI, see UNCTAD, forthcoming, a.
4. Based on UNCTAD, forthcoming, a, annex table B.5.
5. For a discussion of host country determinants of FDI in the evolving global economy, see UNCTAD, forthcoming, a, chapter IV.
6. Levels of FDI inflows to the most affected countries which are similar to past levels in dollar terms would therefore signal increased interest by TNCs in Asia.
7. The value of M&A sales in the five most affected countries to cross-border purchasers was \$6.5 billion in the first half of 1997, \$5.8 billion in the second half of 1997 and \$5.5 billion in the first half of 1998. (Data provided by KPMG Corporate Finance).
8. The value of M&As involving majority acquisitions in Asia increased from less than \$500 million in 1996 to nearly \$2 billion in 1997. (Data from KPMG Corporate Finance database.)
9. Inflation in South-East Asia is estimated to be 13 per cent in 1998, compared with 6 per cent in 1997 (ADB, 1998, p. 10).
10. However, the extent of the improvement will depend on how far export-oriented foreign affiliates rely upon imported inputs.
11. Based on data obtained from SECOFI, Mexico City, Mexico.
12. Based on data from United States, Department of Commerce, 1997a, tables III.F.2, III.F.7 and III.F.8).
13. "Fall out from Asian Turmoil starts to affect multinationals", *Financial Times*, 14 January 1998.
14. "Mazda closes Thai plant", *Financial Times*, 27 July 1998.
15. "Big three auto makers go shopping for deals in Asia", *International Herald Tribune*, 21 January 1998.
16. "GM decides not to bid for Kia, leaving race to Ford", *International Herald Tribune*, 22-23 August 1998.
17. Statement of ASEAN Heads of Investment Agencies meeting, 24 July, Singapore ([www.aseansec.org/subml.htm](http://www.aseansec.org/subml.htm)). See also chapter III, UNCTAD, forthcoming, a.
18. "ASEM 2 Statement: The Financial and Economic Situation in Asia", Asia-Europe Summit Meeting, London, 3 April 1998 ([www.aseansec.org/world/ase2fin.htm](http://www.aseansec.org/world/ase2fin.htm)).
19. "The Asia-Europe Investment Promotion Action Plan", in European Commission and ASEM, *Terms of Reference for the ASEM Investment Experts Group*, Economic Ministers' Meeting, Makuhari, Japan, 27-28 September 1997, mimeo..

20. “*Financial Times Global 500*”, *Financial Times*, 1997 (n.d.).
21. “*Financial Times Global 500*”, *Financial Times*, 1998 (n.d.).
22. It is only since the outbreak of the financial crisis that Asian TNCs appear to have adopted strategies to avoid currency risk.
23. Foreign affiliates of developed and other country firms in the crisis-stricken countries that have also borrowed heavily face less of a problem since their home country currencies have maintained their value vis-à-vis the dollar.
24. Divestment is a normal occurrence, a part of changing corporate strategies. It is therefore not always easy to determine the reason for a particular divestment. In the specific circumstances mentioned, a firm may judge it preferable to sell foreign assets than to sell domestic ones, especially at unfavourable exchange rates. It is also difficult to ascertain to what extent some of these are distress sales (UNCTAD, forthcoming, a, chapter V, box V.1). For example, Hyundai Electronics Industries Co. of the Republic of Korea is reported to have sold its affiliate Symbios (acquired from AT&T Corp. for \$300 million in 1994) in the United States to Adaptec Inc., a Silicon valley company, at a price of \$775 million, a price considered low by analysts. (“Asian firms beat retreat from U.S.”, *Financial Times*, 4 March 1998.)
25. Ibrahim (1997). This proposal was recently reiterated by the National Economic Advisory Council of Malaysia, which proposed, as a part of its plan to strengthen the ringgit, “to reduce or suspend reverse investment temporarily with the assurance that overseas investment would be allowed when conditions improve”. (“Measures to strengthen ringgit”, 1998 Star Publications (M) Bhd (No. 10894-D). (Retrieved on 28 July 1998 from <http://the.star.com.my/archives/neac>).
26. According to preliminary data obtained from the Bank of Korea, outward FDI from the Republic of Korea during the first quarter of 1998 decreased by 51 per cent as compared to outward FDI over the same period in 1997. As for Malaysia, outward FDI declined from RM1.9 billion in the first quarter of 1997 to RM1.1 billion in the first quarter of 1998 (Malaysia, Bank Negara, 1988; figures subject to revision).
27. The survey on the implications of the financial crisis for outward FDI was conducted by the UNCTAD secretariat and the Federation of Korean Industries in March 1998 and covered the 100 largest TNCs headquartered in the Republic of Korea. A total of 46 firms responded to the survey questionnaires, some of which were followed up with interviews.
28. Cited in *SUNS: South-North Development Monitor*, No. 4193, 16 April 1998.
29. Intra-regional FDI in South Asia, particularly from the Republic of Korea, gained momentum during the mid-1990s. For example, in 1996, the pace of investment from the Republic of Korea in India started outstripping that of India’s traditionally important trade and investment partners. Firms from the Republic of Korea had planned to invest \$4 billion in India between 1997 and 1999 (UNCTAD, 1997b). That growth momentum may have suffered because of the financial crisis.
30. However, the Republic of Korea accounts for 11 per cent of the FDI stock in Romania and 6 per cent of that in Poland.
31. Based on the results of the UNCTAD/FKI survey, 1998.



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