EMERGING MARKET MULTINATIONALS AND UPGRADING IN GLOBAL VALUE CHAINS: IMPLICATIONS FOR HOME-COUNTRY DEVELOPMENT

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Abstract

This paper argues that the international expansion of EMNEs should be viewed as a possible mechanism for economic upgrading because it allows domestic firms to capture more value from their participation in global value chains (GVCs). By integrating the GVC literature to the economic upgrading discussion in development economics, the paper proposes that a country-level OFDI policy framework should integrate the firm-level understanding of the domestic firms' positioning in the value chain of global industries. In order to come up with appropriate a regulatory framework, policy makers should be cognizant of motives, strategies, and interactions of EMNEs to other participants in GVCs. In addition, further studies should explore how the international expansion of EMNEs affects value chain dynamics both at domestic and global levels.

Emerging Market Multinationals and Upgrading in Global Value Chains: Implications on Home-country Development

The international expansion of companies from emerging economies, commonly known as 'emerging market multinational enterprises' (EMNEs) has been an important topic in the field of international business. Scholars have explored and explained different aspects of the rise of this new set of players, covering a wide variety of geographical origins, from Latin America to Asia, as well as addressing many aspects of their emergence, particularly their behaviors and internationalization strategies. At the same time, policy makers have had to ponder how they can cultivate an appropriate regulatory framework to enable these activities to take place and to ensure that home country's interests are aligned with domestic firms' outward foreign direct investment (OFDI).

Yet, OFDI impact on home-country economic development is still an ongoing and inconclusive debate for emerging economy home governments. Benefits and spillovers from OFDI do not appear as clear-cut and as evident as those resulting from inward foreign direct investment (IFDI). It is generally accepted that IFDI brings an overall benefit to host economies, directly via the transfer of capital, resources, and technology, and indirectly through positive externalities and spillovers via different channels. On the contrary, the impacts of OFDI on home-country are still open to debate. While OFDI may benefit the investing firms, questions remain whether these favorable outcomes on the firm translate into positive externalities for the home economy.

This paper argues that the international expansion of EMNEs should be viewed as a possible mechanism for economic upgrading because it allows domestic firms to capture more value from their participation in global value chains (GVCs). By integrating the GVC literature to the economic upgrading discussion in development economics, the paper proposes that a country-level OFDI policy framework should integrate the firm-level understanding of the domestic firms' positioning in the value chain of global industries. In order to come up with appropriate a regulatory framework, policy makers should be cognizant of motives, strategies, and interactions of EMNEs to other participants in GVCs. In addition, further studies should explore how the international expansion of EMNEs affects value chain dynamics both at domestic and global levels.

This is a conceptual paper based on reviews of relevant literature on upgrading at country and at firm levels. The paper comprises three parts. Following this introduction, the literature on country-level upgrading in developing economies is introduced. It is argued that the literature on economic upgrading should pay attention to issues that are beyond domestic factors, especially the GVC of industries. The paper next discusses upgrading in GVCs and argues that the literature has placed more emphasis on the role of global lead firms at the expense of supplier firms in developing economies. The discussion in the last part proposes that the internationalization of EMNEs should integrate the GVC perspective in order to understand how international expansion can be used as an alternative strategy for upgrading in GVCs. Implications on home country economic development are also raised.

Country-level Economic Upgrading: Looking beyond Borders

One of the key themes that have long occupied scholars and policy makers alike is how developing countries can catch up with developed nations. A substantive body of literature has investigated the process of 'economic upgrading' and/or 'catch up' using case studies of a variety of countries, particularly those that are considered success stories, such as South Korea, Taiwan and other high-performing East Asian economies (see, for example, Amsden, 1989; Wade, 1990; World Bank, 1993).

In general, a country's economic development depends on how it can productively use its factors of production, i.e. labor, capital, and technology (Solow, 1956). An economic upgrading therefore reflects a process of economic and social transformation, whereby the structure of production shifts toward activities with higher value added and knowledge intensity (Paus, 2012). Economic development of countries is expected to be a sequential process that reflects the country's transformation in various aspects. Kuznets (1971) indicated that the process of economic development involved: the transfer of resources (i.e. labor and capital) from activities with low productivity (typically agriculture) to those that require higher productivity (e.g. industry and services); the degree of capital accumulation; industrialization and the manufacture of new products and services using new methods of production; urbanization; and changes in social institutions and beliefs.

Given the variety of indicators involved, it is difficult to achieve consensus within the vast and seemingly unending literature on how economic upgrading can be empirically measured (Felipe, Abdon & Kumar, 2012). However, one particular indicator of economic upgrading that has attracted much attention is how developing economies evolve from low-income (poor) to high-income (rich). A natural and typical sequence of economic development should therefore be that countries emerge from low-income to middle-income and, ideally and eventually, to high-income status. Economic development success for countries can be achieved when poor countries sequentially move through these stages.

Recently, a key debate emerges on whether some countries that manage to cross the middle-income threshold some time ago but have yet been able to make it to the next level of the high-income group. In other words, countries may be stuck in the 'middle-income trap' and are unable to upgrade to the next stage of development. This debate receives increasing attention as the question on how to move up to the next stage is crucial for economic development of many developing countries, particularly those in Asia such as Malaysia, Thailand, and Vietnam (Ohno, 2009). Questions focusing on characteristics of the entrapped countries, why some countries make the transition while others do not, or why some do it faster than others, are important and bear significant implications on policy development.

The importance of these questions and the public popularity of the term have rendered debates on the middle-income trap into the broader economic upgrading discourse. The term has attracted much interest after Gill and Kharas (2007) used it to discuss how East Asian governments should adapt development strategies to cope with the breathtaking changes in the global economy since the late 1990s when the region encountered its major 1997 financial crisis. The main challenge of economic upgrading for middle-income countries is to cope with the competition from low-wage-poor-country competitors that dominate in mature industries and the rich-country innovators that dominate in industries undergoing rapid technological changes.

For developing economies, the threat of being stuck in the middle-income trap becomes increasingly intensified as global competition heightens. Many middle-income countries are faced with the declining competitiveness in the production of low-wage and low value-added commodities, but they have yet to develop the capabilities to compete in higher value-added or higher productivity activities (Paus, 2012). Policy suggestions to avoid the middle-income trap often point to improvement in total productivity level, education and other measures that contribute to higher human capital accumulation and technological accumulation (Cai, 2012; Paus, 2012).

While innovation-driven growth in the domestic economy is crucial to moving beyond middle-income level, the global competition in which middle-income countries are squeezed between low-wage, low-productivity countries on the one hand and those with higher productivity and knowledge-intensive capabilities on the other has become even more critical in today's globalization era (Paus, 2012). Despite the rise of these externally-generated challenges, the literature on economic upgrading and the middle-income trap has maintained a rather domestic-oriented view. Debates commonly attribute challenges mainly to a basket of domestically derived factors such as domestic institutions, investment policies, and issues that remain under the control of the state (see Yeung, 2016). Some usual and common factors that are often attributed to include education, effectiveness of macroeconomic policy, level of R&D investment by both the private and public sectors.

While illuminating, the overtly domestic orientation may overlook the importance of the current context of globalization, in which developed and developing economies are linked together through the disaggregation of activities along the value chain of global industries. Global value chains have been considered as a key mechanism that links firms from different countries together through networks of supplier and subsidiary relationships. The extensive role of the GVCs in today's global economy has led many scholars to view it as a key mode of production systems that plays an important role toward industrial development and economic upgrading in developing economies (Humphrey & Schmidtz, 2002; Schmitz, 2004; Gereffi, Humphrey & Sturgeon, 2005; Whittaker, Zhu, Sturgeon, Tsai & Okita, 2010). Integrating the global value chain perspective not only allow the economic upgrading literature to consider how the dynamism of the chain governance influences the direction and degree of economic upgrading in developing economies. It also adds another key level of perspective—the firm-level analysis to the discussion on economic upgrading.

Upgrading in Global Value Chains: A Lead Firm-centric Perspective

An important implication in the GVC literature is firm-level industrial upgrading. Many GVC researchers focus on explaining how firms, especially developing-country ones, can improve their position within these chains so as to generate and capture more value (Bair, 2005). Local firms can enhance their position within GVCs through four channels: product, process, functional, and intersectoral upgrading (Humphrey and Schmitz, 2002). *Product upgrading* takes place when firms move into more sophisticated product lines with increased unit values.

Firms achieve *process upgrading* when they can transform inputs into outputs more efficiently through superior technology or reorganized production systems. When firms can acquire new functions in the chain or increase the overall skill content of activities, they have achieved *functional upgrading*. The fourth type, *intersectoral upgrading*, takes place when firms can apply the competence acquired from a particular function of an industry and move horizontally to a new industry. These upgrading possibilities make participation in GVCs even more attractive to developing economies and their firms.

Building on the technological accumulation argument, the GVC literature predominantly attributes local firms' upgrading of emerging-market firms to their ability in augmenting their technological capabilities (see, for example, Kaplinsky, Morris and Readman, 2002; Giuliani, *et al*, 2005; Pietrobelli and Rabellotti, 2007; Pietrobelli and Saliola, 2008; Morrison *et al*, 2008; Ivarsson and Alvstam, 2005, 2009, 2011). The mechanism of technological accumulation in developing economies encompasses a range of practices, including know-how transfer through foreign direct investment of multinational enterprises (MNEs) from more advanced economies (Lall, 1993, 2001), and purposeful investments undertaken by local firms (Morrison *et al*, 2008).

Because technology is usually under the control of global lead firms, implicit in the upgrading-through-technological-accumulation argument is that the upgrading of local firms is not an entirely independent process. Access and the extent to which local firms can gain from global lead firms depends more on how much the latter is willing to yield for the former's benefits. Humphrey and Schmitz (2002) already pointed out how power asymmetries in GVC may inhibit upgrading of suppliers and limit knowledge flows within the chain. McDermott and Corredeira (2010) similarly pointed out how emerging-market suppliers might encounter an upgrading 'glass-ceiling' and remain confined to peripheral roles in the chain because global lead firms still maintain and reap most of the value creation within the GVC.

As a consequence, upgrading for local firms involved in GVC is not automatic, and is subject to a variety of factors, including the GVC governance structure, the local firms' absorptive capacity and broader strategies of global lead firms (Giuliani *et al*, 2005; Pietrobelli and Rabellotti, 2007; Pietrobelli and Saliola, 2008; Morrison *et al*, 2008; Giroud and Mirza, 2015). It might be fair to say that the upgrading-through-technological-accumulation process emphasizes the role of global lead firms as source of knowledge and other higher value-added resources. In other words, the upgrading process of local firms *depends* on how much they can absorb and create value from interacting with global lead firms.

The predominance of this lead firm-centric view of upgrading has recently been challenged. Navas-Aleman (2011) argued that this view over-emphasized the role of global lead firms, and local firms' access to global chains, at the expense of their activities in domestic and regional chains. According to the author, learning opportunities in domestic and neighboring economies with similar levels of economic development can be greater for certain types of skills. Operating in multiple value chains in domestic and regional levels can therefore allow emerging-market suppliers to engage more freely in upgrading activities that lead to higher value addition for these firms (Navas-Aleman, 2011).

The lead firm-centric view of upgrading is also challenged by Yeung (2016), who argued that earlier works on global and regional production networks have not sufficiently integrated how East Asian firms actively maneuvered and grown from subservient suppliers or subcontractors to become strategic partners of, or in some cases, to replace existing global lead firms. According to Yeung (2016), the successful industrial transformation of South Korea, Taiwan, and Singapore is partly a result of three processes, in which domestic firms play a crucial role. These include strategic partnership selection, industrial market specialization, and (re)positioning of local companies as global lead firms.

The argument that industrial upgrading cannot be exclusively attributed to global lead firms' actions shifts more focus to the role of domestic companies. As supplier firms develop, they are less likely to remain entirely dependent on global lead firms to lead in their upgrading into higher value activities in GVCs. To capture more value, domestic supplier firms may turn to international expansion to undertake a more direct and independent upgrading trajectory. When higher value-adding activities are concentrated beyond the domestic market, international expansion can be an option that would also allow these emerging-market firms to become multinationals in their own right. This process is particularly relevant for domestic firms in emerging economies with export-driven industrial policy, in which local firms gain access to GVCs as suppliers or subcontractors serving mainly as export base for global lead firms.

Internationalization and Upgrading in Global Value Chains: Toward An EMNE Perspective

Internationalization by emerging market firms in GVCs can be an alternative route for supplier firms to improve their positioning by expanding the scope of their GVC activities or deepening the same activities in other countries. This alternative path complements the widely adopted view that incremental technological accumulation is the main mechanism towards a local firm's upgrading in GVCs. Becoming better suppliers through technological accumulation is an incremental process that takes time and requires commitment from both local suppliers and global lead firms. While local firms' absorptive capacity is crucial in this process, the propensity of global lead firms to establish meaningful cooperation with local suppliers through various kinds of governance structure is also instrumental in determining the prospects for upgrading (Giroud & Mirza, 2015; Yeung, 2016).

Under such limitations, domestic firms may opt to use international investment as a strategic move to improve their position vis-à-vis lead firms in the global value chains. When the internationalizing firm evolves semi-independently out of an existing position within its global value chain, its previous position, along with the nature of its relationships with the chain's lead firm, should bear impacts on its subsequent internationalization behavior. Taking the EMNE perspective in looking at upgrading and internationalizing within global value chains should deepen our understanding on the internationalization process of EMNEs.

A key question facing EMNEs in their internationalization in GVCs is how to navigate GVC dynamics to strengthen their position. Further studies could reflect more on how weaker and semi-independent value chain participants approach internationalization of their activities. Emerging market firms are typically integrated into the value chain of global industries at the low end, most notably in undertaking the most standardized activities like manufacturing. While moving into higher value-adding activities should be in their best interest, it may not coincide with how global lead firms perceive the role of their suppliers. Internationalization of EMNEs in GVCs therefore needs to take into consideration the changing dynamics of their relationships with global lead firms. For example, balancing between their role as suppliers in GVCs and establishing their own domestic and regional networks requires clear strategic directions and, at times, trade-offs if lead firms are not enthusiastic about their suppliers' becoming their competitors.

Integrating GVC perspective to the international expansion of EMNEs adds nuances to the understanding of internationalization process. Previously viewed mainly from the perspective of lead firms, internationalization process is considered as independent alternatives MNEs can take to fulfill their strategic goals. Revisiting the internationalization process of EMNEs from the GVC perspective could reveal further insights on the independent nature of the internationalization of global lead firms and their local suppliers that have become regional or multinational players. At the same time, analyzing how domestic suppliers undertake international expansion could shed more light on the changing dynamics of GVC governance and relationships.

In addition, understanding how domestic firms navigate their growth and alter their positioning in the value chain of global industries should bear important implications on home country economic development. How home-country governments promote the participation of domestic firms in global industries is an important question for today's industrial policy discussion. Gaining access to GVCs is only the beginning of how developing economies engage in GVCs for economic development, expanding and strengthening their participation are equally crucial in sustaining economic development (Taglioni and Winkler, 2016).

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