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THE IMPACT OF FDI POLICIES ON INDUSTRIALIZATION, LOCAL ENTREPRENEURSHIP AND THE DEVELOPMENT OF SUPPLY CAPACITY, POLICY ISSUES TO CONSIDER

Note by the UNCTAD secretariat

EXECUTIVE SUMMARY

Foreign direct investment (FDI) can play an important role in the industrialization process of countries. In particular, the experience of some developing countries suggests that FDI can contribute to the export competitiveness of the host economy and strengthen domestic enterprise capabilities and entrepreneurship. However, the benefits from FDI cannot be taken for granted. This paper explores some policy issues to consider for countries wishing to attract and benefit from FDI, with a view towards contributing to their industrialization, entrepreneurship and competitiveness.

CONTENTS

INTRODUCTION

1. The Commission on Investment, Technology and Related Financial Issues, at its fifth session on 12-16 February 2001, recommended that the Trade and Development Board convene an expert meeting on “the impact of FDI policies on industrialization, local entrepreneurship and the development of supply capacity”. This theme is related to the question of policy options that countries can use to influence the role of TNCs in the industrialization of their economies.

2. While it is now widely acknowledged that FDI can bring important benefits to a host country – in the form of inflows of capital, technology and skills and improved market access – such benefits cannot be taken for granted. The extent to which FDI plays a role in the industrialization process of different countries depends on many factors, including the nature of the FDI attracted as well as the specific circumstances (including the national and international policy frameworks) under which FDI is undertaken.

3. The challenge facing policymakers is twofold: (1) to adopt appropriate policies for targeting and attracting the kind of FDI that is likely to contribute to the international competitiveness of the enterprise sector of a given country; and (2) to ensure that the potential benefits from the investment received are optimised, especially by enhancing the supply capacity of the domestic enterprise sector. In essence, the question is how can FDI improve the ability of economic actors – directly, foreign affiliates, and indirectly, local firms or the economy at large – to compete better in a globalizing world, primarily by raising, upgrading and diversifying exports, thus contributing to an internationally competitive industrialization of countries (UNCTAD, 2000, p.1).

4. This note gives a brief background to the role of FDI in promoting the industrialization and export competitiveness of developing countries. It also discusses policy options available to host countries seeking to attract export-oriented FDI and to derive benefits from such investment, notably through backward linkages with domestic suppliers.

I. FDI AND EXPORT COMPETITIVENESS

A. Industrialization and export competitiveness

5. The experiences of many newly industrializing countries have shown the role of competitive exports as a linchpin of a sustainable industrialization strategy. Some countries have succeeded in developing outward-oriented domestic industries on the basis of their own efforts, but also using FDI as a welcome source of capital and technology. Increasingly, in a globalizing world, TNCs are playing a determining role in the flows and directions of trade, reflecting decisions as to whether or not to internalize their production along the value chain and where to locate their production activities. Liberalized trade has further facilitated the scale of intra-firm specialization across the globe.

6. At the same time, the structure of world trade has undergone major shifts recently. In particular, manufactures – especially manufactures not based on natural resources – have become

more prominent at the expense of natural resources (the traditional trade specialization of developing countries). Between 1985 and 1998, the share of manufactures in world exports increased from 73 per cent to 83 per cent, while that of natural resources declined from 23 per cent to 12 per cent.[1] Moreover, non-natural-resource-based manufactures increased their share of world exports from 54 per cent to 68 per cent, while natural-resource-based manufactures fell from 19 per cent to 16 per cent.[2]

7. Some developing countries have significantly increased their share of the most dynamic world exports. While the market share of industrial countries for manufactures not based on natural resources dropped from 82 per cent to 70 per cent, that of developing countries rose from 17.5 per cent to 30 per cent. Asian developing countries accounted for 10.5 percentage points of those gained by the developing world, whereas the share of Latin American countries rose by about 2 percentage points and that of Africa was unchanged. Thus, some countries clearly took advantage of the new opportunities better than others (Mortimore and Peres, 2001). In fact, the great majority of the developing countries have *not* been able to benefit fully from the observed shifts in world trade. Between 1985 and 1998, market share gains in non-natural-resource-based manufactures were concentrated in only 10 economies.[3]

8. In most of the developing countries that have seen the greatest increases in their share of world exports of manufactures, TNCs played important roles in the process. A factor behind the expansion of manufactures as a proportion of world exports of goods has been the establishment of integrated international production systems (IIPS) on the part of TNCs. Increasingly, TNCs are setting up production systems on the basis of their "efficiency-seeking" corporate strategies, which actively seek out production sites that offer significant advantages in terms of production costs and third market access. Many of the developing countries that have obtained the greatest market share gains in the most dynamic elements of world trade are also countries that have received significant shares of such efficiency-seeking FDI (ranging from high-technology activities in the area of computers and electronics to more low-technology activities associated with garments, sports equipment and even travel goods) (Lall, 2000). A central question here is, how can developing countries – by attracting the right FDI – best tap into the new international production systems of TNCs, perhaps the most dynamic elements of international trade?

B. Enhancing export competitiveness through FDI

9. FDI can help increase exports in all three sectors and many industries, including commodities – which remain important sources of foreign exchange for many developing countries – and services. In particular, manufactures constitute the core of trade flows and have, for the past three decades, provided the broadest scope for better integrating a country into the international market and division of labour. At the same time, given the importance of services (especially in the principal export markets), the limited extent to which they have been traded so far and the

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[1] Calculated using the CAN2000 computer programme on international competitiveness developed by UN-ECLAC.
[2] During the period 1980-1998, 47 of the 50 most dynamic imported products were manufactures. Of these, 32 were from six technologically advanced industries — computers, other electrical machinery, electronic equipment, chemicals, automotive products and non-electrical machinery (based on CAN2000).
[3] Eight developing economies: China, Mexico, Singapore, Malaysia, Taiwan Province of China, Thailand, the Republic of Korea and the Philippines; and two developed ones: Spain and Ireland.

increase in their tradability as a result of the application of information and communication technologies, export-oriented policies may need to pay more attention to the potential of services exports. In either case, the key issue is how FDI can contribute to fostering growth and development, converting exports into an engine of growth.

10. The policy issues confronting developing countries that are searching for ways to use FDI as a means of boosting their export competitiveness vary depending on a country's level of development (UNCTAD, 1999, pp. 251-252). For countries with a strong domestic export base and technological capacity, the challenge is mainly to see how inward FDI can help the country to maintain its export competitiveness and to upgrade its exports into more sophisticated products and services. For countries that are active in the dynamic segments of world trade, with the involvement of TNCs, the issues relate to sustainability and upgrading. How can they continue to attract TNCs that source high-technology products as new competition arises and as their own competitive situation evolves, often resulting in higher wages? For countries that have attracted FDI into low-technology export activity but have failed to diversify their export base or to move into higher-value products, the main issues concern how to broaden the competitive production base. Meanwhile, countries that have built up sizeable industries behind protective barriers but have not made the transition to dynamic export growth need to consider how FDI can support the reorientation and upgrading of existing industries to become competitive and export-oriented. Finally, for countries that have weak industries and weak export capacity and are marginal recipients of FDI, the issues relate to their ability to attract FDI that can help create export capacities for any of the three sectors.

11. In general terms, the key question relates to how developing countries can – given their level of development and productive capacity – best take advantage of the opportunities at different stages of production in various industries, in the context of an internationally competitive distribution of production sites through FDI. Countries also need to address the challenge of embedding FDI more firmly in the host economy. This will to a large extent determine whether investments represent solely a unique element of TNCs' production networks or if they also represent an integrated component of a host country's development.

12. Three broad sets of policy measures are relevant in this context (UNCTAD, 1999):

- Policy liberalization in the areas of FDI and trade;
- Policies to target FDI that is conducive to export competitiveness and upgrading; and
- Policy measures to strengthen domestic capacity to foster stronger linkages between foreign affiliates and domestic firms and to enhance the potential for spillovers to and upgrading of the domestic enterprise sector.

13. While each of these areas is important, the analysis below focuses on the latter two. This is in keeping with the main findings of a recent UNCTAD study on competitiveness which indicated that (UNCTAD, 2000, p. 209):

- "Liberal FDI policy, if combined with incentives from the trade regime (essentially strong export orientation), can lead to – and does generally not go beyond – the exploitation of *static* comparative advantages."

- FDI can build *dynamic* comparative advantage in industries in which there are complex and lengthy learning processes, and in countries where the base for such upgrading exists; otherwise the investment closes down or moves on. TNCs differ in their individual reactions, depending on their strategies and competitive positions.
- The extent of dynamism depends critically on government policies: the most important of these are building advanced skills, developing supplier capabilities among domestic enterprises, encouraging technological activity and targeting and guiding FDI."

II. THE EVOLVING POLICY FRAMEWORK

14. Trade and FDI policies continue to evolve. In general, most changes are in the direction of providing a more enabling framework for FDI. Between 1991 and 2000, a total of 1,185 regulatory changes were introduced in national FDI regimes, of which 1,121 (95 per cent) were in the direction of creating a more enabling environment for FDI. During 2000 alone, 69 countries made 150 regulatory changes, of which 147 (98 per cent) were more favourable to foreign investors (UNCTAD, 2001). This shift towards more liberalization and more incentives has reshaped the core enabling framework for FDI.

15. The liberalization process, however, has not been uniform. A number of countries have protected domestic industries using various measures. Selective liberalization has been seen by some countries as a way to reconcile efforts to promote export-oriented FDI while protecting certain activities or industries. Examples of such selective liberalization include export processing zones (EPZs), bonded warehouse and duty drawback systems and gradual tariff phase-outs over a period of time.

16. Preferential trade arrangements – with rules of origin based on the level of domestic value added or local content – can channel FDI into industrialization and improve the trade competitiveness of TNCs in the preference-receiving countries. In general, these effects are the more significant the higher the preferential margin associated with rules of origin and the lower the related administrative costs. Much depends on the nature of existing local entrepreneurial capabilities, local supply capacity and linkages (see below).

17. Meanwhile, the international regulatory framework applied to influence the impact of FDI on industrialization is evolving. In a new context of trade and investment liberalization and WTO commitments, industrialization policies have undergone a significant revision. WTO commitments have changed the policy landscape, and some agreements such as the TRIMs Agreement and the Agreement on Subsidies and Countervailing Measures have disciplined some policy measures used in the past, such as certain performance requirements and subsidies related to trade.

18. While the new international setting has changed the scope for national policy options, there is nevertheless flexibility within this framework, e.g. in the form of extension of transition arrangements and differential treatment of countries at different levels of development. Although some agreements are subject to further review, the challenge for policymakers is to make use of the options allowed within the current framework, as well as other policy measures that are not

subject to multilateral rules, to integrate FDI more deeply into their national industries in such a way that it contributes to the development of production capabilities and a more competitive enterprise sector.

19. Recent developments call for a fresh assessment of the role Governments can play in stimulating the beneficial impact of FDI on the industrialization process. This requires that Governments take into account the potential tension between the objectives of corporate strategies and the goals of developmental policy, especially where export-oriented FDI plays a catalytic role in the national industrialization strategy. Special attention needs to be paid to the case of the least developed countries (LDCs).

III. THE THIRD GENERATION OF INVESTMENT PROMOTION POLICIES: A MORE TARGETED APPROACH

20. Changes in the global environment – in terms of corporate strategies, new technologies and the evolving regulatory framework – affect the ability of countries to attract and benefit from FDI. As competition for investment flows has intensified, the policies to attract FDI are being refined. Among both developed and developing countries, a new, third generation of investment promotion strategies is becoming increasingly important – a more targeted approach that carefully seeks to match the advantages of individual countries and, indeed, specific locations within them with the needs of specific foreign investors.

21. The first generation of FDI promotion strategies consisted of the liberalization of rules and regulations governing the entry and operations of foreign investors, standards of treatment of foreign affiliates and the functioning of markets. As already noted, virtually all countries – to varying degrees – have undertaken steps in this direction.

22. But while such (in a sense passive) liberalization is important to attract much desired investment, it is usually not sufficient, depending on the particular situation of each country, in the increasingly competitive world market for FDI. Consequently, with the second generation of investment promotion policies, many countries have actively “marketed” their countries as locations for FDI. This approach, which typically includes setting up national investment promotion agencies (IPAs), has been widely adopted by developed as well as developing countries. By way of illustration, the World Association of Investment Promotion Agencies, created in 1995, today has more than 100 members. Most IPAs employ horizontal promotion policies, that is, they market their country in a general way that is similar across all sectors and for all investors.

23. An increasing number of countries that want to stay abreast of the competition – and, above all, to benefit more from FDI – are refining their promotional activities further. This is the third generation of investment promotion policies. It takes an enabling framework for FDI and a proactive approach towards attracting FDI as a starting point. It then proceeds to target foreign investors (in accordance with a country’s developmental priorities) at the level of industries and firms and seeks to meet their specific locational needs at the activity and cluster levels. The key to success of this new generation of investment promotion strategies is that it actually addresses

the basic economic FDI determinants while understanding the changing location strategies of TNCs. While such a targeted approach is difficult and takes time to develop, third generation promotion is nevertheless growing in practice.

24. The third generation of investment promotion policies is particularly relevant in terms of enabling FDI to contribute to industrialization in developing countries by seeking to draw FDI into activities in which a host country has a comparative advantage. A critical element of such investment promotion is to improve particular locations and market them to potential investors in specific activities. In order to target specific investors, countries need to have a clear understanding of TNC strategies: they cannot formulate effective strategies otherwise. Thus, investment promotion agencies pursuing the third generation of promotion policies have to include this as a necessary input in their activities. For countries seeking to enhance their export competitiveness, careful targeting can include efforts to attract FDI by TNCs that are organizing their activities in IIPSs.

25. In order to increase the contribution of export-oriented FDI to the local industrialization process, the question becomes: what are the best strategies to target and attract FDI in particular activities, in line with host countries' industrialization policies? Moreover, it may be necessary for FDI promotion policy designed to encourage TNCs to establish local export platforms to be coordinated with complementary policies in related areas. Thus, along with policies to attract certain FDI, other policies dealing with regional development and/or clustering and linkages may be required. Policy coherence relies on a delicate mixture of active FDI attraction coupled with subtle initiatives aimed at rooting FDI in the local industrial landscape.

26. As already noted, a few developing countries have been successful in attracting FDI to their economies in support of their objectives with regard to increasing their global market shares in terms of their exports of manufactures. They usually did so by establishing export processing zones, special industrial zones and the like. Thus, even in the case of these countries, the increase in exports of manufactures often did not result in the complete integration of FDI into the local industrialization process. Thus, Governments sometimes found that even where they obtained important advances in the export competitiveness of their economies based on FDI in manufacturing, it was not in the integrated manner that could make an optimum contribution to the development process. There is therefore a need to explore how the promotion of export-oriented inward FDI can be combined with efforts to strengthen the integration of foreign affiliates into the domestic enterprise sector (see below).

27. The increasing sophistication of investment promotion poses important policy challenges for developing countries. Without special assistance in this area, many countries, in particular the least developed countries, risk becoming even more marginal to the dynamics of international trade, especially as regards TNCs that are reconfiguring their existing IIPSs and establishing new ones, because they cannot compete adequately in responding to the requirements for attracting high-quality FDI.

28. In view of these remarks, issues that could be examined by experts include:

(a) To what extent do countries go beyond the first and second generation of investment promotion strategies and apply a more targeted approach to attract FDI?

(b) What instruments/tools and policy measures can be used in a more proactive, third generation of FDI promotion strategies? What types of action/measure should be avoided in this context?

(c) What are the best strategies for targeting FDI in particular industries, in line with host countries' development policies and consonant with the needs of TNCs establishing their international production systems?

(d) What criteria are normally applied by countries to determine what industries and activities to target?

(e) How many industries and at what level of specificity are they normally targeted?

(f) How do countries evaluate their success in attracting FDI in the chosen industries and activities?

(g) How do countries coordinate national efforts to promote inward FDI with sub-national investment efforts, where the latter exist?

(h) What can be done to assist LDCs in refining their efforts to attract export-oriented FDI?

(i) How can improved access to developed country markets enhance the chances of attracting export-oriented FDI? What else can developed countries do to assist a more targeted approach to attract FDI?

IV. PROMOTING BACKWARD LINKAGES

29. Regardless of the precise mix of the three generations of FDI promotion strategies that is being pursued, the competitiveness of the domestic enterprise sector and the existence of a pool of skilled labour are key to success in optimizing the benefits of FDI for industrialization. Strong local firms can attract FDI; the entry of foreign affiliates, in turn, can feed into the competitiveness, entrepreneurship and dynamism of the domestic enterprise sector. Furthermore, strong domestic capabilities enhance the absorptive capacity of a host economy and thereby increase the chances of positive spillovers from FDI. The most direct channel for diffusing skills, knowledge and technology from foreign affiliates is the linkages they develop with local firms and institutions.

30. Foreign affiliates often have a strong interest in fostering links with local firms. The continuous liberalization of FDI and trade policies means that TNCs can exploit new opportunities for improving the efficiency of their production networks and become more competitive. In many industries and firms, this results in a higher degree of specialization, a stronger focus on core activities and a greater reliance on external suppliers of inputs. From the standpoint of foreign affiliates, local procurement can lower production costs in host economies

and allow greater specialization and flexibility, with better adaptation to local conditions of technologies, products and services. The presence of technologically advanced suppliers can also provide affiliates with access to external technological and skill resources, feeding into their own innovative efforts.

31. While this opens up new opportunities for creating linkages through outsourcing and sub-contracting or other types of long-term supply contracts, it also involves major challenges, particularly for SMEs in developing countries. Becoming a supplier to a large TNC is no easy task. Increased competitive pressure is forcing firms at all points of the supply chain to select suppliers that meet highly stringent demands in terms of cost, quality and timely delivery. This often leads foreign affiliates in globally oriented industries (notably in electronics and automobiles) to use other foreign affiliates as suppliers or import from abroad rather than to rely on domestic sources. In some cases, foreign affiliates are unable to use local sources of inputs due to global sourcing arrangements determined at the level of TNC headquarters.

32. Some TNCs organize special development programmes in host developing countries to assist potential or existing suppliers. The experience (described in UNCTAD, 2001) of various companies illustrates how companies in different industries and host countries can actively support suppliers to upgrade their technology, productivity and ability to compete internationally. However, the extent to which foreign affiliates forge linkages with domestic suppliers (as opposed to, say, using imports) is determined by the cost-benefit balance of such efforts. The most important factors are related to corporate strategy and the availability of supply capacity. A lack of efficient domestic suppliers is a common obstacle to the creation of linkages, particularly in developing countries.

33. The willingness of foreign affiliates to use local suppliers can be influenced by government policies addressing different market failures at different levels in the linkage formation process. For example, TNCs may be unaware of the availability of viable suppliers. In developing countries, policies may be required to compensate for weak financial markets or weak institutions like vocational schools, training institutes, technology support centres, R&D and testing laboratories and the like. In this way, well-designed government intervention can raise the benefits and reduce the costs of using domestic suppliers.

34. The role of policy is most significant where there is an information gap on the part of both buyers and suppliers about linkage opportunities, where there is a capability gap between the requirements of buyers and the supply capacity of suppliers, and where the costs and risks of setting up linkages or deepening them can be reduced. While the linkage formation process is affected by a host country’s overall policy environment, its economic and institutional framework, the availability of human resources, the quality of infrastructure and political and macroeconomic stability, the most important host country factor relates to the availability, cost and quality of domestic suppliers.

35. In the area of supplier development, one approach involves encouraging linkages through various measures to bring domestic suppliers and foreign affiliates together and to strengthen their linkages in the key areas of information, technology, training and finance. Such measures can include, for example, the provision of information and matchmaking to help domestic firms

link up with foreign affiliates; encouraging foreign affiliates to participate in programmes aimed at upgrading domestic suppliers' technological capabilities; promoting the establishment of supplier associations or clubs; the joint provision of services (especially training); and various schemes to enhance domestic suppliers' access to finance. Another approach goes further in that it involves the establishment of a specific linkage promotion programme combining a number of the measures. This typically focuses on a selected number of industries and firms with a view towards increasing and deepening linkages between foreign affiliates and domestic firms.

36. Some countries have set up specific linkage programmes involving a combination of different policy measures and targeting selected industries and firms. Such programmes have been put in place primarily by countries with a large foreign presence and with a (relatively) well developed base of domestic enterprises. Costa Rica, the Czech Republic, Hungary, Ireland, Malaysia, Singapore, Thailand and the United Kingdom have all made special efforts of this kind. Some of the programmes are organized at the national level, while others have been implemented as regional or local initiatives. There are a few elements that figure frequently in such programmes: the provision of market and business information; matchmaking; and managerial or technical assistance, training and, occasionally, financial support or incentives. Some programmes have also included FDI promotion activities to attract foreign investors to targeted industries. In each case, sustainable linkages will only be created if both foreign affiliates and domestic firms can benefit from them (UNCTAD, 2001).

37. Linkages can be seen as a stepping stone towards strengthening the competitiveness of domestic firms, giving them a foothold in international production networks and embedding foreign affiliates fully in host economies. At the same time, linkage promotion efforts should form part of a broader set of FDI and SME policies. The third generation of FDI promotion policies has a role to play here. In fact, the more linkage promotion policies go hand-in-hand with SME development and targeted FDI promotion policies, the more they are likely to be successful.

38. Based on the research undertaken in connection with the *World Investment Report 2001*, some general points can be made. In the new policy environment, active policy approaches that work with the market are at a premium. Policies are often highly context-specific and need to be adapted to the specific circumstances prevailing in each host country. The starting point for an effective linkage programme is a clear vision of how FDI fits into the overall development strategy and, more specifically, a strategy to build production capacity. The vision has to be based on a clear understanding of the strengths and weaknesses of the economy and of the challenges facing it in a globalizing world. A linkage programme should, in particular, address the competitive requirements of domestic enterprises and the implications these have for policies, private and public support institutions and support measures (including skill and technology upgrading).

39. In the context of linkage promotion, experts may consider the following issues:

(a) What are the main ingredients of a successful linkages promotion policy?

(b) To what degree is success in linkage promotion context-specific and to what degree can generalizations be made?

(c) How can FDI be used in the transition from only the promotion of exports of goods and services to the promotion of exports of goods and services coupled with deeper integration into the host economy? What approaches can be used to tap into the integrated international production systems of TNCs?

(d) What has been the experience of countries with regard to the effectiveness of various measures (including host country operational measures) in attracting FDI and promoting export competitiveness and local linkages to meet the needs of industrialization and technological development?

(e) What is the most appropriate institutional set-up for linkage promotion?

(f) How can the effectiveness of linkage promotion efforts best be evaluated?

V. CONCLUDING REMARKS

40. One of the principal prerequisites for establishing a policy to promote internationally competitive industrialization is the determination on the part of the national authorities of the nature of the integration into the international economy that is being contemplated and the role of TNCs. This can range from a policy with minimal goals beyond the expansion of exports by way of FDI in export processing zone activities to the active targeting of individual TNCs in the context of the industrial relevance of their IIPSs for the host country and the search for ways to improve their integration into the national economy. The nature of the policy selected has to reflect a large number of factors, such as the competitive advantages of the host country, the competitive situation in specific industries, the corporate strategies of individual TNCs, the international regulatory environment and the institutional framework and decision-making capacity of the host Government. Several Asian countries have been able to start with a relatively passive policy aimed simply at increasing export performance and progressively evolve that policy in the direction of targeting particular kinds of FDI and further integrating it into the national industrialization process.

41. The complexity of issues related to FDI promotion, industrialization strategies, enterprise development and linkages promotion policies results in a need for coordination and coherence among these areas. There are at least two major aspects of such coherence. First of all, it should impact the role of FDI promotion policies within the framework of national development strategies. As a result, the aim of FDI promotion will no longer be a simple maximization of the volume of FDI but will increasingly involve a targeted approach that focuses on attracting “higher quality” investment projects. “Higher quality”, in turn, is contextual, depending on the development goals and visions of each host country. The optimization of benefits is made possible only if FDI policies and other development policies mutually reinforce each other. The aim is to go beyond *static* comparative advantages and nurture *dynamic* comparative advantages.

42. Another area where coherence plays a role is the relationship of national investment policies in the broad context of commitments made in the framework of international agreements having an impact on those national investment policies.

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