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## **SPECIAL FEATURE: FOREIGN PORTFOLIO AND DIRECT INVESTMENT**

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### **Preface**

This *Transnational Corporations* special feature is on a timely subject: the relationships between foreign portfolio and foreign direct investments (FPI and FDI). It starts with an article by John Dunning and John Dilyard, suggesting that a general paradigm on FPI and FDI can be developed, based on an expansion of John Dunning's work on OLI (ownership, location, and internalization). Independently, I had been considering the connections between FPI and FDI for a number of years. When I read the first rendition of the Dunning/Dilyard essay, I felt I needed to put on paper some of my own thoughts. Thus, my contribution deals with the "literatures" on FPI and FDI, provides historical insights, and seeks to cast light on the mixtures and varying relationships of FPI and FDI over the years. I conclude that, at this stage, a general paradigm is not possible. Karl Sauvant recognized that the two articles would interest *TNC* readers; Bijit Bora saw the articles through the refereeing process. We have appreciated their cooperation in the development of this set of articles. Our two papers break new ground in providing a formal exploration of the differences between FPI and FDI and the various relationships between the types of investment. The two articles suggest that there are public policy implications associated with the distinctions between types of investments *and*, more specifically, with the separate consideration of FPI and FDI. As we examined the relationships between FPI and FDI we refined and tempered our views, but became ever more convinced that discussions of the FPI/FDI interconnections (or absence thereof) were extremely fruitful. Hopefully, our papers will stimulate new research, new debate and further inquiries.

**Mira Wilkins**





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# Towards a general paradigm of foreign direct and foreign portfolio investment

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John H. Dunning and John R. Dilyard\*

This article attempts to integrate explanations of foreign direct investment and foreign portfolio investment into a single paradigm. It shows that the determinants of each possess both common and distinctive characters, but that historical data on inbound investment into the United States, and contemporary data on foreign direct investment and foreign portfolio investment flows into East Asia and Latin America show they complement, rather than substitute for, each other.

## Introduction

Until the early 1960s, the theory of foreign investment was essentially a theory of international portfolio or indirect capital movements. Capital flowed across national borders, mainly (though not exclusively) through the intermediation of the international capital market; and it did so in search of higher interest rates (discounted for exchange and other risks) and/or higher profits relative to those which could be earned at home. The types of financial devices that were involved in these cross-national flows of capital were bonds and notes from the public and private sectors, equities, money market instruments and financial derivatives.<sup>1</sup>

Capital also crossed borders in the form of direct investments (FDI). FDI historically has been the dominant form of international *private* capital transfers and has represented a significant proportion

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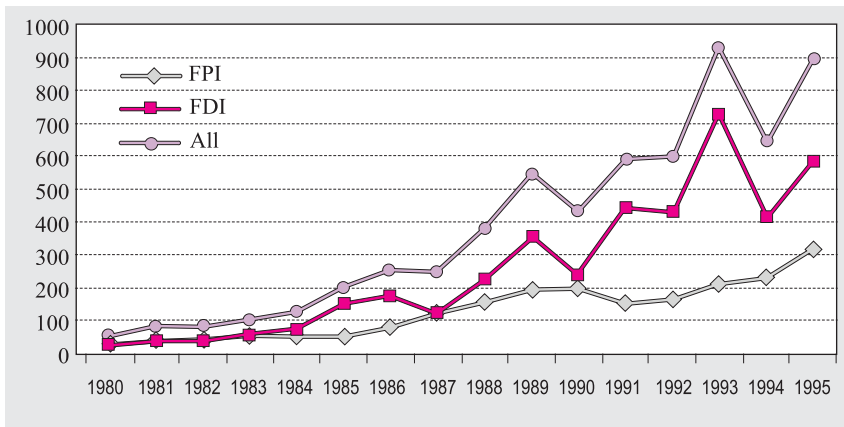
\* Mr. Dunning is Professor of International Business and Mr. Dilyard a Ph.D. candidate in International Business at Rutgers University.

<sup>1</sup> The latter have been included in the IMF's *Balance of Payments Statistics Yearbook* (IMF, various years) only recently and are recorded only for the 1990s. They represent a small fraction of total portfolio capital.

of all investment. As can be seen in figure 1 and annex 1.1<sup>2</sup> from 1980 to 1995, FDI accounted for 38.7 per cent of all inbound foreign investment to all countries in the International Monetary Fund's *Balance of Payments Statistics Yearbook*, with a slightly higher proportion (43.4 per cent) occurring in the first half of the period than in the second half (32.6 per cent).<sup>3</sup>

Figures 2 and 3, and annex table 1.2 show that the vast majority of FDI and foreign portfolio investment (FPI)<sup>4</sup> is directed towards developed countries. During the early 1980s FDI to developing

**Figure 1. Inbound foreign investment**



Source: World Bank (1997a).

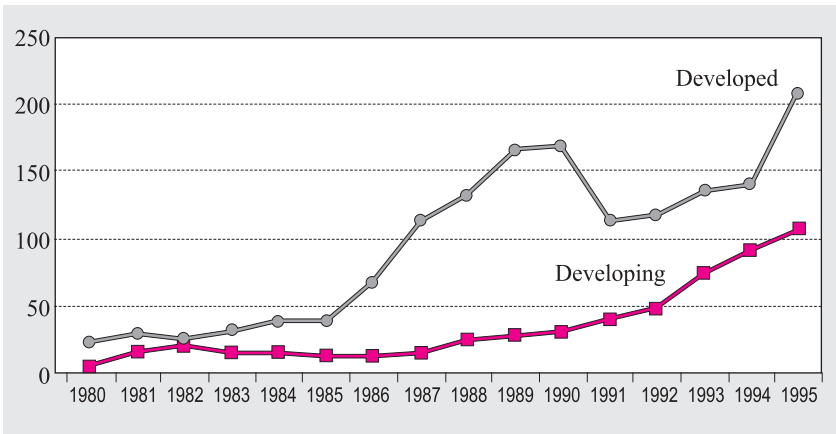
<sup>2</sup> Prior to 1980, the IMF recorded portfolio investment as the net of inbound and outbound investment, even though records of direct and portfolio investment go back to 1970. Also, data from IMF sources differ from that used by the World Bank (and used elsewhere in this paper) for two reasons. First, although economists in both institutions continually analyse the data for accuracy and make adjustments as necessary, the World Bank data goes further back in time. Second, portfolio investment includes public-sector securities and other investments, in addition to the private investments.

<sup>3</sup> Inbound investment reflects all direct and portfolio investment, including government bonds and other public debt, that is going into a country and is therefore a better measure of investment flows than outbound investment, which reflects the source of investment flows. The vast majority of outbound investment comes from developed countries.

<sup>4</sup> *Editor's note:* In balance-of-payments statistics, foreign investment consists of three components: direct, portfolio and *other* investment. In this article, the authors treat portfolio and other investments together as one single entity, and call this entity "portfolio investment".

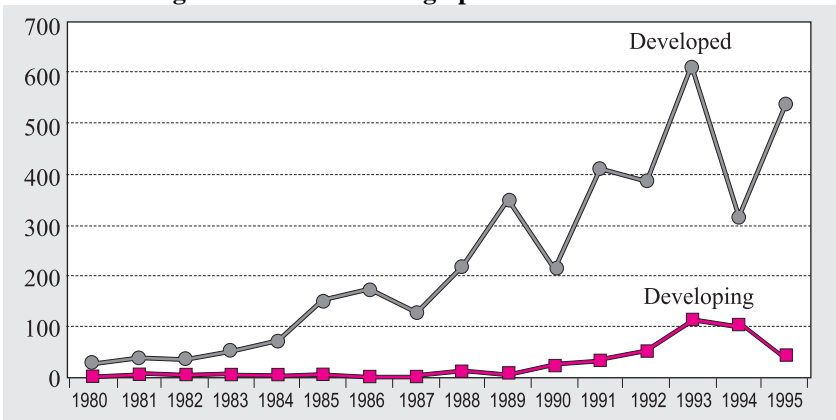
countries was quite small and showed little sign of growth; it has only been in the late 1980s through 1995 that FDI to developing countries has trended upward and has been increasing relative to FDI to developed countries. A similar pattern appears for foreign portfolio investment (FPI), although the proportion of FPI going to developed countries is much higher than that for FDI. This phenomenon is due in large part to the inclusion of government securities as well as equities in the IMF data on portfolio investment, both of which have large, well-developed markets in developed countries.

**Figure 2. Inbound foreign direct investment**



Source: World Bank (1997a).

**Figure 3. Inbound foreign portfolio investment**



Source: World Bank (1997a).

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Traditionally, FDI has been differentiated from FPI in four ways. The first is that, unlike FPI, FDI involves the transfer of non-financial assets, notably technology and intellectual capital, in addition to financial assets. The second is that, in the case of FPI, there is a change in ownership of the assets transferred; this is not so in the case of FDI. Thirdly, FDI is more lumpy (or indivisible) and less fungible than FPI, and is undertaken mainly by corporations, which control the deployment of the assets transferred, rather than by individuals and institutions, which exercise little control or influence over those assets. Fourthly, unlike FPI, which is primarily prompted by higher foreign interest rates, FDI is motivated by the opportunity of achieving a better economic performance than that currently earned by competitor. For this to be achieved, the investing firms need to have some competitive advantage, either prior to, or in consequence of, their foreign activities, over and above that possessed by their foreign rivals, and for this advantage to be transferable across national boundaries.

There is now a well-established body of theory of FDI which, for the most part, is not concerned with explaining intrafirm capital movements per se, but rather that of the foreign value adding activities of firms in which they have a financial stake sufficient enough to allow them some control or influence over such activities. While, de jure, such control is only achievable with a majority equity ownership, in practice most national authorities take a 25 per cent, or even, in some cases, a 10 per cent equity stake, as indicative of some influence on the decision-making of the invested-in firm by the investing firm.<sup>5</sup>

Unlike the theory of FPI, that of FDI is concerned chiefly with explaining why firms extend their territorial boundaries outside their home countries, and why they do so by setting up new subsidiaries or acquiring existing foreign value added activities, rather than by exports from their domestic production units, or by selling the right

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<sup>5</sup> The World Bank, for example, distinguishes between direct and portfolio (or indirect) investment by using the 10 per cent ownership rule. It is not the purpose of this paper to debate the appropriate level of equity ownership by which a portfolio investment becomes a direct one. In any event, the vast majority - probably 80 per cent - 90 per cent of all FDI takes place in enterprises in which the foreign investor has a majority, i.e. 51 per cent or above equity shareholding.

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to use their competitive advantages, especially non-financial assets, through intermediate product markets. In doing so, it draws upon and integrates several branches of economic theory, including the theory of the firm and those of trade, of location and of market structure (Dunning, 1993a, 1998b and 1999).

Yet, in their discussion of why firms should wish to internalize cross-border intermediate product markets, economists have been almost exclusively concerned with real, rather than financial, assets (as for example summarized in Dunning (1993b) and Caves (1996)). For example, while much has been written on the reasons why firms prefer to exploit a particular technological advantage (e.g. the ownership of patents), themselves, rather than license another firm to do so, virtually no attention has been given to why firms prefer to internalize the market for international capital (i.e. engage in foreign direct investment, rather than in foreign indirect investment). This, we believe, is partly because the two phenomena have been treated largely as substitutes for each other, but also because they have been considered as quite different and independent modalities of capital exports.

It is the contention of this article that this is a mistaken view and that, in our contemporary globalizing economy, portfolio and direct foreign investment can best be considered as components of a common paradigmatic approach to explain all kinds of private capital flows. We believe that, although essentially a financial act, FPI can be viewed in the same way as arm's-length trade in any other asset; and that in discussing its relative merits, *vis-à-vis* FDI, one can use many of the tenets of internalization theory, first put forward to explain the intra- rather than interfirm (or market) exchange of non-financial assets.

However, there is a more important reason for our search for a general paradigm of private foreign investment. This is the growing interconnectedness between FDI and FPI – particularly when one takes a dynamic perspective. Historically, FPI – both private and public – has tended to precede FDI. Much of the early nineteenth century European investments in the United States took the form of loans or minority equity stakes by institutions and/or individuals to one of

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the United States, and loans or minority equity stakes in publicly owned utilities or privately owned railroads, rather than by the direct ownership of United States assets by European firms (Wilkins, 1989). Yet, as the United States economy matured, often with the help of inbound direct investment, its own capital markets evolved to absorb new portfolio capital inflows by European institutional and individual investors. In this way, history is now repeating itself in the emerging economies of Asia and Latin America, as successful FDI is helping to foster domestic capital markets, which, in turn, draw in more portfolio investment.

The current interconnections between FDI and FPI are, however, a good deal more complex than those of the nineteenth century. Thus, the FDI by a Chinese transnational corporation (TNC) in an Australian mining venture may be financed by a loan to the former by a foreign bank, or an international lending agency or a foreign government. An acquisition of a French telecommunications company by a United States corporation may – if successful – lead to an inflow of FPI into the acquired company. A strategic alliance between a Canadian and a Brazilian company in which, in exchange for Canadian processing knowledge, the Brazilian company will share its marketing and distribution capabilities with the Canadian firm, may be accompanied by a minority investment of the former in the latter company.

To illustrate this point further, consider three hypothetical cases.

### *Case 1*

Company A, a consumer products company, wants to expand globally and has targeted country X, an emerging market with demand for the products company A has to offer, as a likely place to start. Inside country X is company B, a distributor of consumer products with a strong regional presence in the most populated, economically developed area of the country. Company B would like to expand but is short of capital. Company A's strategic analysts agree that it is expensive to establish a greenfield distribution network and that it would be difficult to compete with company B in its regional market because of its extensive local knowledge and experience. Company A approaches company B about a cooperative venture in which

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company A will utilize B's distribution system and help expand it nationally by providing the necessary financing. This financing is made through a loan from company A to company B. The transaction does not alter company B's ownership structure, nor is a separate company established to house the venture.

### *Case 2*

A consortium of three technology companies has developed a new generation of processing chips and is looking for a location in which the chips can be mass produced at competitive costs. Country D, with a highly skilled but relatively cheap labour pool, has a State-owned chip processing plant with significant overcapacity. To attract foreign capital, country D has embarked on a privatization programme. The consortium and country D's government reach an agreement whereby the consortium acquires 48 per cent of the company's stock (each member of the consortium acquires 16 per cent) and sets up a management structure to control the newly privatized company.

### *Case 3*

A diversified global conglomerate has targeted country Y as a location for expansion of one of its businesses. To test the market, this business acquires 100 per cent of a small domestic company. Because the acquired company seems to be run efficiently and profitably, and is similar in most respects to other companies owned or managed by the acquiring company, no changes are anticipated in the way the acquired company is run. If it looks like the business can be expanded in country Y, the acquiring company intends to invest more capital. If expansion does not appear to be profitable, the acquired company will be sold.

For all intents and purposes, case 1 is a direct investment by company A. However, it does not fit the prevailing definition of a direct investment and could be interpreted as a portfolio investment by company A. Case 2, on the other hand, is a clear example of a direct investment. Case 3, on paper, also is an example of direct investment, but, as far as management is concerned, it is entirely portfolio in nature.

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At the same time, some FDI is increasingly taking on the characteristics of FPI. Thus, a firm rich in liquid assets may acquire the ownership, or part ownership, of a foreign corporation purely as a financial investment (i.e. there is no transfer of non-financial assets). Many of the capital exports by oil-rich countries to Europe and the United States in the 1970s were of this kind. Much more significant, however, is the strategic asset-seeking FDI of the late 1980s and 1990s, the purpose of which is less to exploit a particular competitive advantage of the investing firm by adding value to it in a foreign location, and more to protect or augment that advantage. Here, there is a direct parallel to FPI, viz. to tap into the resources and capabilities of foreign firms; although one of the main differences between FDI and FPI investment remain, viz. that the former transfers ownership rights to the investor while the latter does not.

The character of FPI is also changing as, increasingly in a knowledge-based global economy, de facto control over asset creation and asset usage rests less on the ownership of finance capital and more on that of all kinds of intellectual capital. Thus, in the last 15 years or so, in addition to FDI as a mode of exploiting or augmenting the competitive advantages of firms, we have seen a huge growth in cross-border non-equity alliances and networking relationships. The motives for such alliances are many and varied (for recent studies of alliances, see Duysters and Hagedoorn (1995), Hagedoorn (1985) and UNCTAD (1997), pp. 12-16) but they all have one thing in common, viz. they involve the international transfer of assets - both financial and non-financial - without any FDI on the part of the parties to the alliance or the participants in the network. Sometimes the alliances are intended to exploit a competitive advantage of the contracting firm by way of a written or tacit agreement with a foreign partner e.g. franchising in the hotel and fast-food sector, licensing agreements in the flat-glass industry, a turnkey project in the petrochemicals industry, and subcontracting arrangements in the textiles, shoe and electronics industries. Each of these collaborative ventures usually involves: (i) an ongoing non-equity association between two or more firms of different nationalities; and (ii) a transfer of assets or rights between the partners to the association.

In other cases, however, strategic alliances, like strategic asset-seeking FDI, may be geared towards accessing new knowledge or



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new sources of capital, or better exploiting a foreign market. Sometimes, too, they may be motivated by the need to share financial and non-financial assets and/or speed up the process of efficient asset creation or usage.

The critical feature of the plethora of cross-border arrangements now spanning global commerce is that each involves the transfer and/or governance of a single asset or combination of assets without the formal ownership rights afforded by FDI. Yet, de jure, while each transaction is akin to an arm's length or portfolio transfer of wealth creating assets or rights - de facto they may have many of the governance characteristics of FDI.<sup>6</sup>

All these examples point to two main conclusions, the analysis and implications of which are the main topic of this article. The first is the growing complementarity between FDI and FPI as agents of economic growth and development. Sometimes, this complementarity may be simultaneous; in other cases it may be sequential. But, whatever the time scale might be, the value of the one is enhanced by the other. Hence it is appropriate that, at least at one level of analysis, the determinants of each are considered as part of a whole, rather than separately.

The second conclusion is that with the increasing cross-border mobility of many firm specific assets, or rights to assets, and the ever widening channels by which such assets are transferred, the boundaries between FDI and other modalities of asset transfer, including FPI, are becoming more difficult to delineate. Because of this, we believe there is some merit in considering whether a more holistic explanation of international asset movements - in this case FDI and FPI - is appropriate to those currently offered by the literature.

The rest of this article proceeds as follows: The next section discusses the changing characteristics of private FDI and FPI over the past century, and particularly over the last two decades. It goes on to offer a comprehensive paradigm within which it is suggested

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<sup>6</sup> As, for example, are written into many management contracts in the hotel sector, or franchising agreements in the case of franchisors in the fast food sector, e.g. McDonalds or Kentucky Fried Chicken.

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that more specific, or operational, explanations of FDI and FPI may be accommodated. Then, it goes on to give examples of how FDI and FPI have interacted in the past, and interact today, with each other. It is followed by a description of capital flows between the United Kingdom and the United States, both past and present, and another look at what is happening in emerging economies. The conclusion sets out some general hypotheses which we believe emerge from the “new” paradigm or theory of foreign investment.

### **FDI and FPI: are they really different phenomena?**

Earlier in this article we identified the main analytical differences between FDI and FPI. FDI essentially represented a modality by which a package of created assets<sup>7</sup> is transferred across national boundaries within the jurisdiction of the transferring firm. From a balance-of-payments viewpoint, outbound investment flows embrace all new equity and loan capital supplied by the investing company in the foreign organization over which it has a de facto controlling interest,<sup>8</sup> plus the reinvested profits of the foreign subsidiary and intracompany financial transfers.<sup>9</sup> The stock of FDI is more easily defined. It consists of the share of the total assets (usually valued at book value, but sometimes at replacement value) of the foreign subsidiary owned or financed by the investing company less its current liabilities. It, therefore, comprises both equity capital and long term debt financed from foreign sources.

Private FPI includes the flow of both equity and long-term debt (bonds and loans) between individuals and/or institutions domiciled in different countries.<sup>10</sup> This is achieved either indirectly through

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<sup>7</sup> For a distinction between created assets, e.g. capital, knowledge, technological capacity, entrepreneurship and natural assets, e.g. land and unskilled labor, see Dunning (1992).

<sup>8</sup> Which, itself, is made up of outflows of capital to finance acquisitions and/or greenfield investment, and/or changes in intercompany capital transaction.

<sup>9</sup> Although not all countries report such data.

<sup>10</sup> Including loans with bonds and equity as a form of portfolio investment is done for two reasons. First, the credit circumstances of firms or the condition of domestic financial markets (especially in developing countries) may be such that loans are the only available source of long-term debt. Secondly, prior to 1989, data from the World Bank do not distinguish between loan and bond categories of private long-term debt on a consistent basis, categorizing it as loans only.

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the capital market, or directly in a foreign company, as long as the financial stake is below that which constitutes a direct investment. Such investment may be channelled across national boundaries in several different ways. Historically, the most common of these was through the international capital market, and, in recent years, as section 4 will show, there has been a marked increase in the flow of FPI from and between developed countries, and the emergence of developing countries as new players in that market. Secondly, FPI might take the form of minority equity investments of one corporation in another and/or loans made between two or more corporations. Thirdly, capital may be directly invested or loaned by institutions and/or individuals in non-publicly quoted private companies and/or in public or semi-public bodies.

While, in the last two examples of FPI, there is a direct transfer of funds, the de jure right to deploy the capital loaned or invested is transferred to the recipient institution. De facto, however, as we have already seen and will demonstrate in more detail in the section on the sequential relationship between FPI and FDI, depending on the amount of the minority equity capital<sup>11</sup> and/or the terms and conditions attached to it or to any loan, the investing individual or institution may be able to exert considerable influence over the use made of that capital, for example as part of a franchising, technical service, or subcontracting agreement. As these, and other contractual agreements are becoming an increasingly important component of the global exploitation and harnessing of resources and capabilities, the de facto line between FDI and FPI is becoming an increasingly difficult one to draw.<sup>12</sup> Because of this, and the fact that sequentially FDI and FPI may be closely linked to each other, this article seeks to see how far it is possible to establish a general framework for determining both forms of foreign capital transfer. It is important to keep in mind that this article does not view FPI as being in competition with FDI. Rather, it sees the two as sometimes complementary or, possibly, alternative modes of investment that are, as a result, capable of being described under a common paradigm.

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<sup>11</sup> Both absolutely i.e. 49 per cent or less of the total equity stake.

<sup>12</sup> Both absolutely and relative to that of other portfolio investors.

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## Towards a general paradigm of foreign investment

We start our analysis by reiterating the most widely accepted paradigms of FDI - or more particularly the value-added activities resulting from FDI. The eclectic paradigm (Dunning, 1977, 1988, 1993a, 1995, 1998a and 1998b, and 1999) avers that the amount and pattern of foreign production by firms - i.e. production financed by FDI - will depend on the value of three sets of variables:

- (1) the competitive advantage of the investing (or potentially investing) firms, which are specifically the result of the nationality of their ownership (so-called ownership or O specific advantages), relative to those possessed by firms of other nationalities of ownership; and the ability of the investing firms to transfer, exploit or augment these advantages outside their national boundaries.
- (2) the absolute and relative attractions of different spatial areas (e.g. a country or region within a country) as a location (L specific advantages), both for the creation or acquisition of new O advantages, and for the usage of the O specific advantages. Essentially, the L specific advantages of particular spatial areas rest on the ability of national or subnational markets, and of governments, to provide a unique set of immobile assets necessary for investing firms - both domestic and foreign - to optimize the deployment of their mobile assets.
- (3) the relative merits, to the investing firms, of coordinating their O specific advantages with the L advantages of particular spatial areas, via arm's length markets, or internally through their own hierarchies, or by some intermediate route (e.g. an interfirm alliance or network of alliances). Where a firm chooses to replace the market for these advantages, or the rights to them by its administrative mechanism (i.e. via the modality of FDI), it is presumed to possess internalization (I) advantages. Where some form of alliance capitalism is preferred to the external market, or internal hierarchies, when it may or may not involve some FPI, it is presumed that their advantages rest with quasi-internalized or quasi-market interfirm transactions.

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The eclectic, or OLI, paradigm suggests that the greater the O and I advantages possessed by firms and the more the L advantages of creating, acquiring (or augmenting) and exploiting these advantages from a location outside its home country, the more FDI will be undertaken. Where firms possess substantial O and I advantages but the L advantages, as described above, favour the home country, then domestic investment will be preferred to FDI, and any foreign markets will be supplied by exports. Where firms possess O advantages which are best acquired, augmented and exploited from a foreign market, but by way of interfirm alliances or by the open market, then FDI will be replaced by both a transfer of at least some of the assets normally associated with FDI (e.g. technology, capital, management skills, etc.) and a transfer of ownership of these assets or the right to their use. One of these assets is the equity or loan capital which comprises FPI.

The extent to which the OLI configuration favours FDI, or some other mode of international economic involvement, will be strongly dependent on a number of contextual variables, and it is when the eclectic paradigm is explicitly related to these variables that the paradigm can be translated into a number of operationally testable theories. These contextual variables are essentially fourfold. The first is the *raison d'être* for the FDI. Four motives, or types of FDI, are usually distinguished in the literature<sup>13</sup> - each is designed to further the economic prosperity of the investing firm [see, for example, Dunning (1993a)].

The first is to seek and secure natural resources e.g. minerals, raw materials, or unskilled labour for the investing company (i.e. resource seeking FDI); the second is to identify and exploit new markets for its finished products (i.e. market seeking FDI); the third is to restructure its existing investments (of the first and/or second kind) so as to achieve an efficient allocation of international economic (i.e. rationalized or efficiency seeking FDI); and the fourth is to protect or augment its existing O specific advantages in order to sustain or advance its global competitive position (strategic asset seeking FDI). The *components* and *configuration* of the OLI advantages facing firms

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<sup>13</sup> E.g. to advance its overall profitability, long term growth, market share, etc.

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falling into each of these categories is likely to be very different; so, too, then will be the explanatory variables contained in any operationally testable theory of FDI.

Secondly, within the eclectic paradigm, the determinants of FDI may be different according to the home countries making the FDI (cf., e.g. Japan with Canada) and the host countries receiving the FDI (cf., e.g., Nigeria with Switzerland). Thirdly, the precise configuration of the OLI variables explaining FDI are likely to be sector or activity specific. Thus, for example, the importance of patents, wage rates, government intervention, cross-border transport costs, and agglomerative economies in influencing the extent and pattern of TNC activity in the computer software and pharmaceutical sectors is likely to be very different from that in the iron and steel or building and contracting industry. Fourthly, even within the same industry, the extent and structure of the OLI advantages of particular firms, and their response to particular OLI configurations may vary according to such contextual variables as their size, history, product range, degree of vertical integration, and location of their foreign operations; and also, too, to their managerial strategy (e.g. with respect to knowledge creation and market penetration). Clearly, then, the eclectic paradigm, though a tool offering an analytical foundation to explaining FDI, needs a good deal of contextualization before its principles can be given any empirical validity.

It will be observed that - like its near counterpart, the internalization theory or paradigm - the eclectic paradigm of FDI is concerned with the extent to which, and the form in which, firms allocate their assets across national boundaries. Indeed, it is not a theory of FDI per se.<sup>14</sup> Rather, it draws upon and integrates several separate strands of microeconomic theory - most notably the resource and evolutionary theories of the firm,<sup>15</sup> the theory of location, the

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<sup>14</sup> A point frequently made by some commentators, notably Robert Aliber (1970, 1971).

<sup>15</sup> As these theories have evolved over the past two decades or so. On the resource-based theory see especially Penrose (1959), Barney (1991), Collis (1991), Peteraf (1993). On the evolutionary theory, see Nelson and Winter (1992), Dosi, *et. al.* (1988), and Cantwell (1989). On the concept of the eclectic paradigm being an 'envelope' of several economic and business context-specific theories, see Dunning (1998b).

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theory of economic organization (including the theory of internalization), the theory of international trade, and the theory of risk management. Implicitly or explicitly, it also incorporates a theory of business strategy, i.e. how firms might respond to a given OLI configuration, in terms of the alternative product-marketing innovation strategies open to them.<sup>16</sup> By contrast, the theory of FPI has traditionally drawn on macroeconomic financial variables, notably interest rate differentials and exchange-rate fluctuations. If, however, indirect investment is viewed as a transfer of wealth similar to that of an arm's length transfer of technology, plant and equipment, or human capital, then it would be legitimate to consider its determinants, vis à vis an internalized transfer of capital, in exactly the same way as the third component of the eclectic paradigm, viz. the I component, the purpose of which is to distinguish between the relative advantages of FDI and the market (or quasi-market) as a vehicle for transferring and coordinating the use of non-financial assets.

This, indeed, will be the underlying thrust of this paper, viz. to treat FPI<sup>17</sup> as the cross-border transfer of assets through the open market, or by a non-equity interfirm agreement, rather than within the investing institution; and to see how far one can use the microeconomic and/or strategy-related theories of FDI to explain FPI - and, by inference, foreign investment in toto. This we do in the full recognition that there are certain features about FPI - notably its divisibility into small financial units - which FDI, almost by definition, cannot possess.

Let us, first, consider the three main tenets of the OLI paradigm and see how far we can apply them to FPI.

(1) *O specific advantages.* It is self-evident that for FPI to occur the lending, or investing, entity must have capital to invest. This, in itself, may be regarded as an advantage over other entities

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<sup>16</sup> Strategy is a variable which need only be introduced when time and uncertainty enter into the determinants of FDI. For our own interpretation of how this variable may be incorporated into the eclectic paradigm, see Dunning (1993b), chapters 3 and 4.

<sup>17</sup> Portfolio knowledge is that transferred on the open market or between independent buyers and sellers (i.e. interfirm transfers), as opposed to knowledge transferred within the same firm (i.e. intrafirm transfers).

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that do not possess that asset, or do not possess as much of it. In addition, unless perfect markets exist, and assuming that the advantage is sustainable over time, the entity must have some knowledge about both the prospects of the firm or firms in which the investment is being made and that of alternative foreign investment opportunities and their likely success. Where an intermediary is being used (e.g. an investment broker or mutual fund advisor), such knowledge would also include that about competent sources of advice.

Such O specific advantages are the minimum required for successful FPI in cases where the investment is unconditional and the investing entity has no influence over the outcome of the investment. It embraces most individual and institutional loans, and minority equity investments channeled through the international stock market. However, as we have already seen in other cases, FPI may be part and parcel of a package of assets transferred (e.g. as in the case of a franchising agreement) or have terms and conditions over its use set by the lending or investing entity, even though the foreign investor has no controlling equity ownership of the recipient entity's capital. In such cases, the O advantages attached to the FPI may be similar to those associated with (some kinds of) FDI. Thus, for example, in the hotel sector, long-term loans may be made by a hotel chain to a foreign hotel with which the chain has concluded a franchising agreement or management contract. The FPI is then conditional upon the terms of the agreement or contract, which will normally involve some non-equity transfer of technology, managerial skills and marketing expertise from the contractor to the contractee. O advantages associated with that kind of FPI may then be similar to those associated with a full-fledged FDI by the same hotel chain in a foreign hotel.<sup>18</sup> In other words, in such cases, FPI cannot be considered as an arm's length or a stand alone transfer of financial capital, but as part of a more systemic or integrated package of resource transference - but one which does not involve an equity stake which constitutes an FDI.

(2) *L specific advantages (of countries of regions)*. If the 'how is it possible' for FPI to occur rests upon the possession of capital, knowledge about investment opportunities, the extent and structure

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<sup>18</sup> To the best of our knowledge, there have been no estimates made of the kind of FPI being described.



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of existing investments, and, in some cases, O advantages of a non-financial kind, the “where” of FPI will reflect the likely opportunities for securing a good rate of return (in the form of interest, dividends and capital appreciation) of the capital loaned or invested. Where the expected rate of return, discounted for risk<sup>19</sup> is higher in the home country than elsewhere, domestic investment will be preferred to foreign investment. Where the reverse is the case, the choice between different foreign locations can be assessed by exactly the same criteria as those used to evaluate the choice of location for FDI, with the sole exception that in the case of FPI one is looking at L advantages from the angle of how they affect the prosperity of the recipient entity, rather than that of the investing company - as in the case of an FDI.

We do not propose to rehearse the locational attractions of particular countries, or regions within countries, to domestic corporations in which, directly or indirectly, there is some FPI. For the most part, these will be similar to those facing the subsidiaries of TNCs, except that their industry composition may be different, as may be their respective “embeddedness” (e.g. with respect of research and development activity), in the local economy, and their propensity to engage in international transactions. But, variables such as raw material and labour costs, taxes, quality of infrastructure, size and character of the local market and managerial efficiency, as they affect the prosperity of indigenous firms, are as much likely to affect the location of inbound portfolio investment as that of direct investment.

At the same time, it may be hypothesized that FPI will be more responsive to changes in the value of L specific variables of countries and regions than will FDI. This is partly because the latter tends to be both more indivisible and spatially “sticky”<sup>20</sup> than the former,<sup>21</sup> and, partly because international capital markets are likely to be more volatile than are the internal workings of TNCs. Indeed, it is this

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<sup>19</sup> Which may differ between companies according to their managerial strategies, time preferences and attitude toward risk and uncertainty. In theory, however, it is possible to use financial formula, e.g. net present value or other formulae of the discounted rate of return, to collate alternative locations.

<sup>20</sup> *Inter alia* because of its investment in firm-specific fixed assets.

<sup>21</sup> Exceptions include some kinds of footloose manufacturing investment and some non-capital intensive service investment. Of course, as a last resort an FDI can always be sold to an indigenous firm.

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very volatility<sup>22</sup> which may lead to the replacement of these markets by FDI or some form of inter-firm agreement in the first place.

(3) *The internalization theory of FDI* (see, for example, Buckley and Casson (1976 and 1985) and Hennart (1982 and 1986)) argues that the foreign production of firms arises because of the failure of cross-border markets to transact intermediate goods and services at a cost below that which would be achieved if these transactions were undertaken within the same firm. The market most commonly taken to illustrate the *raison d'être* for FDI is that of intangible assets, and especially technology and all kinds of information. Thus, for example, technology will be bought and sold on the open market, i.e. externalized, as long as the net costs of doing so are less than those of organizing the transactions within the same firm. This, in fact, is only likely to be the case where the technology is reasonably standardized, where there are large numbers of buyers and sellers and where there is little information asymmetry or avenues for opportunism. But, as often as not, these conditions do not exist, in which case the market will either be internalized or be translated into a specific agreement between the parties to the exchange.

In principle, there is no reason why (the services of) finance capital should not be treated like that of any other intangible asset, or part of a group of intangible assets.<sup>23</sup> In practice, of course, finance capital is more fungible (i.e. can be put to many uses), than can intangible real assets, although this fungibility may be constrained where conditions or terms are placed on its deployment. It is also more divisible; hence the large number of individuals engaging in FPI. Such fungibility and divisibility, together with the homogeneity of finance capital (in the sense that one dollar or pound sterling is identical to another), are just some of the reasons why that market is likely to involve fewer transaction or coordination costs than that of the market for real intangible assets; and why, indeed, the volume of FPI greatly exceeds the value of cross-border interfirm flows of such intangible assets (as opposed to claims to intangible assets).

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<sup>22</sup> *Inter alia* because of its investment in firm-specific fixed assets.

<sup>23</sup> We specifically mention groups of products as very rarely does FDI internalize the market for a specific product, but rather a package of complementary intangible assets (e.g. technology, entrepreneurship, organization skills, learning experience, marketing expertise.)

Although in reality [e.g. where they are undertaken by different investors (such as individuals compared to institutions)] or to achieve different goals, FPI and FDI may not be viable alternatives for each other, the internalization paradigm may still offer a robust analytical framework for evaluating the choice of one kind of investment over another; and this is so notwithstanding the fact that the composition and value of the individual I specific variables determining that choice may be different from those used to explain the mode by which other intangible assets are transferred across national boundaries.

To further consider the relationship between FDI and FPI we first identify the major actors involved in FPI; secondly, how the OLI variables facing direct investors need to be modified to explain FPI; and thirdly, how the particular advantages available to private portfolio investors are translated into an FPI. Table 1 sets out the major actors and their objectives. The actors are placed in three categories - viz. mutual funds; banks; and other investors such as corporations, investment banks, insurance companies, pension funds and individuals other than those channelled through the first two actors. Table 2 cross-references the objectives with ownership, location and externalization advantages (OLE) of FPI; and table 3 describes how the advantages are manifested in actions.

**Table 1. Major actors and their objectives in private portfolio investment**

Investor	Objective
Institutional investor	Yield Capital gain Diversification Speculation Market knowledge/access
Bank holding companies	Yield Capital gain Market knowledge/access Diversification
Non-financial firms	Yield Capital gain Speculation Market knowledge/access Diversification

**Table 2. A description of ownership, location and externalization (OLE) variables for portfolio investment**

Ownership (origin of investment)	Location (direction of investment)	Externalization (reason for using external markets rather than internal markets for transferring capital)
Size of investible funds	Political stability of countries in which investments are made	Correlation of returns with other markets, especially home markets
Number of different funds, such as geography-based or sector-based <sup>a</sup>	Commitment to a market economy	Lower transaction costs
Access to new/additional investible funds	Degree of market openness and integration with global or regional markets <sup>b</sup>	Divisibility, transparency, fungibility of finance capital
Ease of transferrability of investment among funds	Level of market sophistication or maturity	Possession of proprietary or non-public information
Research capabilities and access to information about other markets/countries	Level of government support for portfolio investment	
Experience and capabilities of fund managers	Ease with which returns or gains can be repatriated	
Client preference for and attitude about risk	Ease of capital repatriation and/or dividend remission	
Risk-management capabilities, including use of derivative products	Condition of financial market infrastructure (e.g. banking system)	
Electronic funds transfer and communication capabilities	History of or prospects for economic growth	

<sup>a</sup> The institutionalization of savings on OECD countries in the last decade is an example of this. Where and how these savings are invested is dependent on many other factors within the OLE) framework.

<sup>b</sup> The liberalization of financial markets, particularly in emerging and developing economies, has expanded the location options of FPI.

**Table 3. The execution of OLE advantages in private portfolio investment**

Advantage	How executed
Ownership	Choice of investment (e.g. debt or equity), including amount, term, yield, location (geographic and sector), and covariance with other similar investments in other locations.
Location	Investment made to pursue firm and client diversification objectives, as well as to meet client preferences for country and/or sector exposure. Knowledge-gathering investment. To take advantage of favourable tax and/or dividend/repatriation policies.
Externalization	Selective participation in countries, geographic regions or sectors to pursue portfolio structure objectives, as well as the movement among and between countries, regions and sectors.

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While each type of lender or investor has similar objectives, the criteria each uses in making its investment decisions are likely to be different. Diversification, for instance, will have a different meaning for each investor, depending on the structure of the portfolio and the diversification strategies used. An international bond fund will diversify differently from an international stock fund, and both will diversify differently from, say, a single product high-technology firm looking for a minority interest in a foreign firm to help it find new markets for its existing product lines. It is quite possible, of course, that each of these investors may hold the same kind of investment. In fact, if direct investment is included, all types of investor might hold the same asset. In case 2 above, for instance, this situation could occur if the government of country D continues to privatize its 52 per cent interest in the company. As a result, and as cases 1, 2 and 3 illustrate, little can be known about the intent of an investment just by looking at what it is.

As a framework for later discussion, let us first identify the ownership, location and externalization advantages specifically applicable to portfolio investors. Ownership advantages include the size of the portfolio, the investment, risk management and learning capabilities and experience of the portfolio managers, the existing stock of FPI,<sup>24</sup> and market information and knowledge (or the ability to access/acquire market information). All of these are things that can (and do) differ from investor to investor. Location advantages refer both to those provided by the home base and foreign locations (actual or desired). Thus, access to funds and a regulatory and policy-framing environment that is conducive to the marshalling and investing of funds domestically and abroad are locational advantages. Externalization advantages - the counterpart of internalization advantages of FDI - of using markets to support ownership and location advantages, include the ability to take advantage of investments whose returns have limited covariance with the existing stock of investments; the ability of the market to provide the necessary information of investors to exercise their preferred options and investment strategies; and also the lower costs of managing a large number of relatively standard transactions, cf. those incurred by firms.

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<sup>24</sup> It is possible also that investment portfolios will include domestic investments as well.

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Diversification, as used in table 1, refers to the diversification (reduction) of risk as well as the structure of the entire investment portfolio. This can be achieved by diversifying the type of investment made (e.g. stocks in different industries, bonds from different countries, mixing stocks and bonds, etc.) or by selecting investments that have little covariance within and across sectors. The expertise and market knowledge of portfolio managers, displayed in the ability of portfolio managers to research, locate and act upon investment opportunities, and the ability to marshal funds to invest, determine in large part how much the portfolio can be diversified. It is an ownership advantage because that expertise, market knowledge and access to funds can be unique to each type of investor.

The location advantage of having easy access to investible funds and a regulatory, financial and economic environment that eases the marshalling of funds for investment help a mutual fund seek other markets outside its home market. This is not the same thing as simply investing foreign source funds from investors, which would represent a capital outflow from those foreign sources. Rather, it is establishing a foreign base in which those foreign source funds are accumulated for real investment. The mode in which the base is established can take the form of direct investment (e.g. setting up a branch office), portfolio investment (e.g. purchasing a minority interest in a domestic fund in return for access to funds and/or clients), or an arm's length transaction (e.g. buying funds). Access to funds is not the same thing as the ownership advantage of having investible funds. For instance, all mutual funds in the United States share the same locational advantage created by the regulatory and investment climate of the United States, but not all mutual funds have the same level of assets, the same investment objectives and the same mix of investors.

The same rationale for market-seeking actions applies to banks and other investors. Banks, however, also engage in client-following and client-seeking investment behaviour. The role locational advantage plays here is clear: the institutions want to be near their clients and would like to attract new clients. Given the highly regulatory nature of the banking industry, the most effective way foreign banks can get close to existing and potential clients is by being where the clients are (see Sagari, 1989). This could be accomplished through direct investment (branch offices) or portfolio

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investment (joint ventures or partnerships with domestic banks). Both of these advantages could enhance an existing ownership advantage, the former by strengthening ties with clients and attracting more investible funds, and the latter by attracting more investible funds.

One could argue with a fair amount of strength that certain other investors, such as an investment bank, also engages in client-following and client-seeking behavior. For investment banks, however, once capital is mobile across borders, the incentive for it to establish a foreign office simply to be near its existing clients is weakened. A better way to characterize their behaviour, and that of other investors such as pension funds, is resource seeking. Functionally, resource seeking behaviour is the same as the client-seeking behaviour of banks in that the objective (i.e. securing more investible funds) is the same. The distinction is in the underlying purpose of using the locational advantage. For banks, it is primarily in establishing a relationship that may result in funds to invest; for non-banks, on the other hand, it is gaining access to funds. As with the client-seeking and client-following behaviour of banks, the resource-seeking behaviour of non-banks can be achieved through either direct or portfolio investment.

Because of the advantages of using the international capital market rather than internalizing that market are defined in terms of portfolio structure and strategic outlook (attitude towards risk), they will influence the yield-seeking and capital gain-seeking behaviour of all three types of investor. The overall return of an entire portfolio will be affected by the degree of covariance among the assets (see Markowitz, 1959). Volatility of returns will be greater when covariance is high. The amount of total risk in a portfolio therefore will depend a great deal on the level of covariance. Investors comfortable with volatility (risk seeking) will build a portfolio of assets differently from risk-averse investors who are not comfortable with such greater volatility, but both will build portfolios in accordance with the desired structure of those portfolios.

The possibility of a link between diversification and yield-seeking and capital gain-seeking behaviour comes immediately to mind. Obviously, the overall yield of a portfolio and the amount of risk inherent in it will depend on how much the portfolio is diversified

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and how much covariance is present. In a sense, then, the ultimate performance of a portfolio will depend on the interplay of the various ownership, locational and externalization advantages. The size, type and nature of a portfolio and the way it is managed from a cash-flow and risk-perspective (ownership) depends on the assets in the portfolio. The way in which new assets are acquired to meet specific growth objectives (for the individual portfolio or the investing company) depends on the use to which locational advantages are put. Performance (yield and capital gains) objectives, which in turn influence the type of asset acquired or sought, then depend on the strategic outlook of the investor.

The variables and contexts identified in tables 1 and 2 are self-explanatory. Each is firmly grounded in the theory of FDI, of portfolio capital movements, and of locational economics. From these, and taking a medium- to long-term perspective, it is possible to formulate a series of operationally testable hypotheses as to: (a) when FDI and FPI are complements to each other; and (b) if they are substitutes, or are independent of each other, what are the variables likely to determine the final choice or modality of financial asset transfer. While we shall offer some hypotheses later in this article, we shall not seek to formally test them. Instead, we shall offer some illustrations of how, in the past, and in today's globalizing economy, FDI and FPI have been, and are, related to other, in terms of their respective - sometimes similar, sometimes different - OLI or OLE configurations.

### **The sequential relationship between FPI and FDI**

While, at a given moment of time, FPI and FDI may appear to be independently determined and undertaken for different reasons, it is quite possible that over time they may be closely related to each other. History is full of examples of FPI, both in developed and developing countries, laying the ground work for FDI. Usually, and especially in the case of infrastructure investment in countries subject to political or economic volatility, the FPI will be financed by public authorities or international agencies (e.g. the World Bank), or protected by an investment guarantee scheme. In other instances (e.g. as on the American continent in much of the nineteenth century), private foreign capital was steered, mainly through the international



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capital market, to State governments and/or to State-supported ventures. No less today do foreign direct investors expect host countries to provide the human, technological and institutional infrastructure with which their O specific intangible assets may be successfully combined. Frequently, however, especially in some developing and transitional economies, local savings are insufficient to finance these assets and the capital has to be imported, usually by grants from foreign governments, by foreign loans, and/or (minority) equity investments from international agencies and corporations.

At the same time, it is clear by the emergence and dramatic growth of domestic capital markets in several Asian and Latin American countries, that FPI may follow, as well as precede, FDI. But most post-FDI portfolio capital flows are quite differently sourced and directed from pre-FDI portfolio flows. Whereas the former tend to be financed by national governments and international lending agencies and directed to infrastructural projects - and hence are not our immediate concern - the latter are primarily initiated by individual and institutional investors and are directed to (potentially) profitable and/or growth-oriented sectors in the recipient countries - including some infrastructure projects. Furthermore, while pre-FDI portfolio capital flows normally precede the presence of a flourishing domestic economy and capital market, post-FDI flows are drawn largely by these phenomena.

In today's global economy, however, the sequential interaction between FPI and FDI can be both more indirect and more varied than that just described. For example, it is perfectly possible that part of inbound portfolio capital flows may be used to finance outbound direct investment<sup>25</sup> or, for FDI, in a particular sector, to stimulate competitors to seek FPI - often jointly with other intangible assets to upgrade their own core competencies. In their global search for resources and capabilities, TNCs, themselves, frequently draw on loan capital from both national and international capital markets; and, in the case of alliances with foreign firms, they may exchange loans and/or equity stakes. Sometimes, too, foreign-owned banks will make long-term loans to indigenous firms, which are used to finance their

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<sup>25</sup> For example, a joint Chinese/Australian venture for mineral exploitation in Australia is being financed partly by a loan from the World Bank to the Chinese partner. For other examples, see Zhan (1995).

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own international operations; or, in the case of wholesale traders and distributors, to help finance a joint venture with a foreign exporting company. Renewed confidence in an economy, or in a particular sector or region in an economy, which may have been greatly assisted by the activities of foreign subsidiaries, may lead to more FPI in that economy, sector and industry.<sup>26</sup> By contrast, lack of confidence in an economy, region or sector, as demonstrated for example by falling stock prices, might lead not only to a reduction of FPI, but - in the longer run - of FDI as well. More generally, there is some suggestion that, over time, the economic progress of an economy, region or sector suggests that FDI, FPI and indigenous investment parallel each other quite closely.<sup>27</sup>

The following two sections illustrate the changing interaction between FDI and FPI, using the framework of the eclectic paradigm. The first one considers the evolving form and structure of capital flows between the United Kingdom and the United States over the past century or more; and the second one does the same - but for a more recent period, viz. 1972 to 1995 - in respect of foreign capital flows into two emerging regions, East Asia and Latin America.

### **United Kingdom - United States capital flows**

The history of foreign investment in the United States up to 1914 has been well documented by Mira Wilkins (1989). Here we will seek to emphasize a few highlights of that history from the perspective of United Kingdom FDI and FPI.

Applying the concept of the investment development path<sup>28</sup> (Dunning and Narula 1996), most of the created assets (e.g. capital, technology and organizational capacity, etc.) for the economic

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<sup>26</sup> As, for example, has occurred in the United Kingdom auto industry since the mid 1980s.

<sup>27</sup> As shown, for example, in the stock prices of publicly quoted companies in the world's capital markets, GNP data and trends in foreign investment and domestic capital formation. For a recent study comparing the changes in the geographical distribution of FDI and indigenous investments between the early 1970s and 1990s, see Dunning (1997).

<sup>28</sup> The investment development path suggests that as countries develop their propensity to engage in FDI, or be invested in by foreign firms, changes. At an early stage of development, countries tend to be substantial net importers of FDI; later, as the competitive advantages of their own firms increase, they also become capital exporters.

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development of colonial America initially came from Europe and especially the United Kingdom. Partly, by way of migration of human and physical capital, partly by grants and loans from the mother country, and partly by some embryonic American businesses financed by foreign direct or portfolio investment, foreign assets, when combined with the rich natural resources of the Eastern seaboard, helped create the colonies' own location (L) advantages, and its firms to generate a unique set of O specific competencies.<sup>29</sup>

In the post-revolutionary period, foreign capital flowed into the United States. The first half of the century was a time when the new Republic was both making huge investments of roads, canals, ports and railroads, and evolving its own distinctive economic structure, based largely on the comparative advantage of its natural assets and its emerging created assets, the latter being primarily designed to upgrade the value of the former (Wright 1990). Such circumstances combined to create an OLI (or OLE) configuration in which the major vehicles for transferring financial and real assets (or rights) between the United Kingdom and the United States were: (a) migration of human capital; (b) the transfer of knowledge via the export of goods and licensing agreements; and (c) the international capital market (see Wilkins (1989)). In 1853, according to a United States Treasury Department Survey, of the \$222 million of foreign investment stocks held in the United States, 72 per cent was directed to government securities and another 21 per cent to the bonds of railroad, canal and navigation companies. The main FDI's of the time were confined to trading and banking and insurance activities. There was also some United Kingdom ownership of the early railroad companies, but FDI's in manufacturing industry were, according to Mira Wilkins (1989), 'few and far between' (p. 88).

The marked preference for United Kingdom and other European indirect, rather than direct, investments in the United States reflected primarily the (relatively) efficient workings of the international capital market, and partly the (relatively) high trans-Atlantic transaction and coordination costs of operating a United States subsidiary of a United Kingdom company. In addition, the most

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<sup>29</sup> Here, it is worth distinguishing between two separate economies in colonial America, viz. that of the North, based on textiles, shipbuilding and the fishing industry; and that in the South, based on cotton and tobacco plantations.

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capital-intensive sectors in the United States economy were those in which foreign companies were reluctant to hold a major equity stake (viz. public utilities). By contrast, FPI in United States government securities was generally thought to be a relatively safe investment, particularly when they were recommended by a leading United Kingdom merchant banking house.

Technological and organizational advances of the 1870s and the maturing of many United States enterprises dramatically changed the scenario for inbound foreign investment. Although, right up to the First World War, the bulk of such investment was portfolio, rather than direct,<sup>30</sup> the advent of managerial capitalism and the lowering of intracompany spatial transaction and coordination costs, favoured the territorial expansion of foreign firms into the United States, particularly in those sectors in which they were perceived to have an O advantage over their United States counterparts. At the same time, there was a great deal of syndicated FDI in these years,<sup>31</sup> which in its intent at least, has more in common with FPI. By 1910 too, the sectoral preference of United Kingdom investors had switched from government securities to railway stocks and bonds and commercial ventures. According to Sir George Paish (1911), the former accounted for 85.2 per cent of the \$3.3 billion of United Kingdom investments in the United States in 1910, while investments in industrial companies, mining, land and public utilities accounted for most of the balance. Of these latter investments, about two thirds took the form of direct investments, as it was in these sectors that the net transaction costs of markets, relative to administrative hierarchies, were most evident.<sup>32</sup>

During and after the First World War, a sizeable proportion of United Kingdom investments in the United States were sold, while the late 1920s saw the collapse of the international capital market.

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<sup>30</sup> Estimates of the relative significance of FDI vary a great deal. According to Cleona Lewis (1938), some 86 per cent of United Kingdom investments in the United States in 1914 represented the purchase of United States securities and the balance was direct investments in controlled enterprises. Elsewhere (Dunning 1988) we have estimated that \$1,450million, or 21 per cent, of the stock of all long term foreign investments in the United States were FDIs. For an alternative assessment of the portfolio composition of FDI see Svedberg (1978).

<sup>31</sup> For example, in brewing and distilleries, and in the flour milling sector.

<sup>32</sup> For a more detailed analysis of United Kingdom investments in the United States in 1910-1914, see Corley (1994a and b).

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However, while United Kingdom investors lost some of their O advantages as suppliers of finance capital, United Kingdom firms continued to lead the outflow of FDI, and by 1938 they accounted for two fifths of global FDI. During these years, however, United Kingdom firms lost ground to their United States counterparts, particularly in FDI intensive sectors, while new locational attractions were being offered by Commonwealth countries, notably Canada and Australia. The net result of these events was that although the flow of United Kingdom investment into the United States did recover somewhat in the 1930s, this recovery was almost wholly the result of new FDI designed to exploit the growth of the United States market and overcome trade and transaction related barriers.

For much of the first 20 years following the end of the Second World War, there was very little United Kingdom portfolio investment in the United States capital market. Indeed, it was only in 1958 that sterling became fully convertible. FDI was also limited because of the lack of competitive advantages of United Kingdom, cf. United States, firms and because of the high costs of production in the United States relative to those in the United Kingdom. Gradually, however, United Kingdom industrial competitiveness recovered, often aided by the capital, technology and managerial skills transferred via FDI from the United States to the United Kingdom (Dunning 1958); and by the early 1980s. United Kingdom and continental European FDI in the United States was rising at twice to three times the rate of United States FDI in Europe (Dunning, 1993b, chap. 7). By 1982, the United Kingdom FDI stake in the United States once more exceeded that of the United States in the United Kingdom, and by the early 1990s it was one half as much again.

While part of this renewed interest by United Kingdom TNCs in the United States can be explained by the extant theories of FDI, since the early 1980s an increasing proportion of FDI has taken the form of takeovers and mergers which has been geared less to exploiting the existing competitive advantages of the investing companies and more to augmenting these advantages.<sup>33</sup> To this extent,

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<sup>33</sup> For example, by harnessing new technologies and/or management capabilities, fostering synergistic economies, planning the financial risks and reducing the time of innovatory activities, enabling economies of scale and scope to be both exploiting, strengthening global marketing networks, etc.

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the motives of United Kingdom FDI in the United States have begun to parallel those of FPI - viz. to invest in the economic strength of a foreign company, country or region in a country. This has been particularly well demonstrated in the high technology sectors, where FDI by United Kingdom firms in the United States has been complemented by interfirm alliances between United States and United Kingdom firms. Sometimes such alliances have involved an export of loan or equity capital from the United Kingdom to the United States; but, more usually, the main vehicle of financial involvement by individual and institutional investors in the more competitive United States sectors has been through the capital market, for example, by the purchase of unit trusts, mutual funds, and by purchases of stock of United States companies or of United Kingdom TNCs with FDIs in the United States.

Table 4 sets out the trend of United Kingdom FDI flows in the United States and the United States gross national product from 1972 to 1995. We have presented the data as three-year moving averages to iron out at least some of the sharp changes in foreign investment brought about by mergers and acquisitions and/or short-term speculative reasons. Table 5 presents the trend of all FDI and FPI flows to the United States and the United States' gross national product over the same period, also as three-year moving averages. The figures show, first, that both kinds of foreign investment have increased at a faster rate than gross national product; second, that FPI and FDI have broadly paralleled one another, but especially so since the early 1980s; and third, that, although for the period as a whole, the share of FPI in total foreign investment has risen, it has also fluctuated more noticeably than FDI.

In terms of the eclectic paradigm, the rising share of foreign investment in the United States' gross national product - and incidentally of the total gross fixed capital formation in the United States<sup>34</sup> - is consistent with two somewhat conflicting propositions. The first is that the O specific advantages of foreign-owned firms are rising relative to those of United States' owned firms, and hence the

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<sup>34</sup> In 1976 - 1980, the ratio of all inbound FDI flows to gross fixed capital formation in the United States was 2.0 per cent by 1981-1985 it had risen to 2.9 per cent, by 1984-1989 to 5.8 per cent and by 1990-1994 to 41 per cent (Dunning, 1997; UNCTAD, 1996).

firms' ability to invest in the United States is that much greater. The second is that the foreign firms are investing in the United States to protect or augment their existing competitive advantages. This second proposition is consistent with the view of portfolio investors that the United States' economy is a good place in which to invest their capital. Clearly, which of these two propositions is most applicable is likely to be industry and, indeed, firm specific. But from a casual examination of the comparative growth and profitability data on the leading United States and United Kingdom firms (Dunning and Pearce, 1985), and data from the United States Department of Commerce and the industrial distribution of the United Kingdom FDI

**Table 4. FDI flows from the United Kingdom into the United States, 1972-1995**

*(\$ billions)*

Years	FDI	Per cent growth	GNP	Per cent growth
1972 - 1974	0.36		1,350	
1973 - 1975	0.56	55.9	1,478	9.5
1974 - 1976	0.58	2.4	1,619	9.5
1975 - 1977	0.63	9.9	1,792	10.7
1976 - 1978	0.76	19.8	2,011	12.2
1977 - 1979	1.26	66.7	2,257	12.2
1978 - 1980	2.04	61.9	2,506	11.0
1979 - 1981	3.20	56.6	2,776	10.8
1980 - 1982	4.26	33.1	2,995	7.9
1981 - 1983	4.52	6.2	3,226	7.7
1982 - 1984	5.08	12.4	3,472	7.6
1983 - 1985	4.86	-4.3	3,763	8.4
1984 - 1986	6.22	28.0	4,044	7.5
1985 - 1987	10.35	66.2	4,292	6.1
1986 - 1988	15.05	45.5	4,577	6.6
1987 - 1989	19.19	27.5	4,900	7.1
1988 - 1990	14.51	-24.4	5,227	6.7
1989 - 1991	9.71	-33.1	5,503	5.3
1990 - 1992	2.10	-78.4	5,839	6.1
1993	13.23	530.8	6,564	12.4
1994	11.12	-15.9	6,932	5.6
1995	22.08	98.5	7,247	4.5

*Source:* Calculated from various issues of United States Department of Commerce, *Survey of Current Business*. These data include reinvested profits from existing investments.

*Note:* Data are not available on United Kingdom FPI into the United States.

in the United States - including FDI in research and development ventures - it would seem that, while the former proposition may hold good for the less knowledge - but more marketing-intensive industries (especially food, drink and tobacco), the latter proposition better explains the growth of the United Kingdom (and for that matter other European and Japanese) FDI in the high-technology industries, noticeably the biotechnology and the telematics industries).

Over the last two or more decades, the L advantages of United States-based assets have been most evident in two kinds of activity. The first, as witnessed especially by Japanese FDI in the United States, has been in those industries in which the global O advantages of the foreign investors are particularly evident, yet which are best exploited

**Table 5. Trends in all FDI and FPI flows into the United States, 1972-1995**  
(*\$ billions*)

Period	FDI	per cent change	FPI	per cent change	All foreign	
					investment	per cent change
1972-1974	2.8		5.9		8.7	
1973-1975	3.4	19.8	3.0	-48.6	6.4	-26.4
1974-1976	3.9	15.0	2.9	-3.8	6.8	6.3
1975-1977	3.6	-8.9	11.0	278.3	14.6	114.7
1976-1978	5.3	49.3	12.0	8.6	17.3	18.5
1977-1979	7.1	33.8	11.4	-4.8	18.5	6.9
1978-1980	11.5	61.8	6.8	-40.1	18.3	-1.1
1979-1981	17.3	50.7	9.3	37.1	26.6	45.4
1980-1982	18.7	8.0	11.7	25.2	30.4	14.3
1981-1983	17.1	-8.8	8.7	-25.3	25.8	-15.1
1982-1984	17.1	-0.1	12.2	38.9	29.3	13.6
1983-1985	18.8	10.3	31.5	159.3	50.3	71.7
1984-1986	26.1	38.4	58.2	84.7	84.3	67.6
1985-1987	31.6	21.2	70.8	21.7	102.4	21.5
1986-1988	44.3	40.2	73.0	3.0	117.3	14.6
1987-1989	55.7	25.6	77.6	6.4	132.3	12.8
1988-1990	57.6	3.6	63.9	-17.8	121.5	-8.2
1989-1991	45.9	-20.4	58.4	-8.5	104.3	-14.2
1990-1992	29.2	-36.4	50.5	-13.5	79.7	-23.7
1993	43.0	47.4	111.0	119.7	154.0	93.2
1994	49.8	15.7	139.5	25.7	189.3	22.9
1995	60.2	21.0	236.2	69.4	296.4	56.6

Source: IMF (1996), *Balance of Payments Statistical Yearbook, 1996* (Washington, D.C.: IMF).



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from a United States location. The second have been in those industries in which foreign firms perceive they need a presence in the United States to gain access to specific resources and capabilities, including institutional capital, and/or to augment their own advantages by acquiring, or engaging in an alliance with, United States firms. This latter kind of FDI has been particularly noticeable in research and development, knowledge-intensive manufacturing and in the service industries. It is also worth observing that both foreign and domestic investment in these industries has tended to favour particular states in the United States - notably California, Massachusetts, New Jersey, South Carolina and Texas - each of which has an above average share of knowledge-intensive manufacturing and service industries.

For the most part, then, we conclude that, normalizing for industry and firm-specific differences, discounting short-term factors affecting stock market performances and apart from differences in cross-border transaction and transport costs which only affect FDI, that the L advantages of the United States in attracting inbound portfolio and direct investment are broadly the same. However, within the United States, there is some suggestion that foreign subsidiaries do portray different locational preferences than their indigenous competitors (Ulgado, 1996; Shaver, 1998).

While in some cases the premise of the internalization paradigm can be used to explain why FDI is preferred to FPI, much of United Kingdom FPI now directed to the United States is not directly substitutable for FDI, but rather is complementary to it. This is primarily because it is undertaken by different economic agents and the unit size of the investment is, on average, much smaller. In the case of individual (i.e. personal) lenders or investors, for example, the choice is not between FPI and FDI, but between FPI in the United States<sup>35</sup> or in United States firms, and that in other countries or in non-United States firms; this, for example, especially applies to FPI in United States Government securities. At the same time, indirectly and over time, there is some suggestion that FDI and FPI are sometimes alternative and sometimes complementary ways of achieving this goal. Certainly since the late 1980s they have tended to parallel the fortunes of the United States economy. Many non-

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<sup>35</sup> Including that in United Kingdom mutual funds specializing in United States securities.

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equity United Kingdom-United States strategic alliances are also part of the global strategy of foreign firms with major foreign interests in the United States, and are intended to protect or add to the value of these interests. At the same time, FPI invested in United States TNCs may help such firms not only to finance (say) joint research and development or marketing ventures with foreign firms, but to better penetrate new foreign markets, either by way of outbound direct investment or by some form of interfirm collaboration.

### **FDI and FPI in emerging economies**

The last two decades have seen a remarkable increase in the level of private capital flows into developing countries, with the fastest growth occurring in FPI. The entire period from 1975 to 1995 can be divided up into three 7-year subperiods, 1975 - 1981; 1982 - 1988, and 1989 - 1995. These periods coincide roughly with three stages of private capital flows: the pre-debt crisis stage (1975 - 1981); the debt-crisis and its aftermath stage (1982 - 1988), and; the recovery and boom stage (1989 - 1995). Table 6 presents data on the annual average inbound flows of FDI and FPI during these stages for all developing countries, and shows the proportional share of FDI in these flows.<sup>36</sup> The initial stage is indexed at 100.0 to provide a gauge for the changing magnitude of each type of investment. (Further details on the year-to-year FDI and FPI to all developing countries are provided in annex table 2.)

The effect of the debt crisis on FPI from 1982 - 1988 resulted in a slightly negative (\$169 million) net flow. Two factors caused the downturn in private FPI. First, some private debt was either restructured or was converted to public debt, which, in turn was guaranteed by a third party (such as the United States Treasury Department or the IMF) to both forestall economic collapse of the debtors and to protect the lenders.<sup>37</sup> Secondly, the flow of new private

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<sup>36</sup> The reader may note a difference in the level of flows reported in this table versus that in annex table 1.1. The data shown in the tables of this section represent inbound flows to developing countries only. Annex table 1.1 presents inbound flows to all countries from all countries and as such includes investments made in developed countries as well as developing countries.

<sup>37</sup> This does not mean that net flows of public or guaranteed debt increased during this period. Rather, this category of debt fell virtually steadily from a high of \$60.3 billion in 1982 to \$41.4 billion in 1988. Also, some FPI was converted to FDI as part of the debt restructuring (World Bank, 1997a).

debt slowed as the effects of the debt crisis spread across developing countries, making lenders cautious about extending credit until conditions improved.<sup>38</sup> Net flows of FDI, on the other hand, increased by 167 per cent during the debt crisis stage.

**Table 6. Net flows of private investment to all developing countries in three stages from 1975 to 1995**

*(\$ billions)*

Stage	FDI	Index Stage 1 = 100	FPI	Index Stage 1 = 100	Total	FDI as per cent of total
1: 1975-1981	7,035	100.0	7,866	100.0	14,901	47.2
2: 1982-1988	11,764	167.2	-169	-2.1	11,595	101.5
3: 1989-1995	53,037	753.9	35,671	453.5	88,707	59.8

*Source:* Calculated from World Bank (1997a).

These private investment flows, however, were not spread uniformly across developing countries. As can be seen in table 7, two geographic regions - East Asia and Latin America - attracted the largest share of private investment throughout the entire period.<sup>39</sup> From 1975 through 1995, these two regions averaged over 77 per cent of all FDI directed to developing countries, and well over 100 per cent of all FPI (around 80 per cent, excluding the debt crisis stage) directed to developing countries. In terms of combined private flows, and considering that FPI in Latin America during the debt crisis saw a net outflow, these two regions averaged 76 per cent of all private flows going to developing countries from 1975 through 1995. Table 8 describes the effect these two regions had on the changes in flows from stage to stage, and table 9 indexes FDI and FPI flows to the first stage for East Asia, Latin America and all other regions.

<sup>38</sup> This overall decline in private debt was not universal and was confined mostly to Latin America. Some regions, such as East Asia, actually saw an increase in the average flow of private debt from the pre-debt crisis period.

<sup>39</sup> The World Bank divides all developing countries into six geographic regions: East Asia and the Pacific; Latin America; South Asia; Eastern Europe and Central Asia; Middle East and North Africa; and, sub-Saharan Africa. *Editor's note:* The World Bank definition of developing countries differs substantially from the definition used by UNCTAD. The most notable difference is that, in UNCTAD's categorization, Central and Eastern Europe does not belong to the developing world.

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The main features of tables 6 through 9 can be summarized as follows:

- In the initial, pre-debt crisis stage, average FPI actually exceeded average FDI in all developing countries, \$7.9 billion versus \$7.0 billion.
- Most of this FPI is presumed to be in the form of commercial bank loans rather than bonds or equity.
- The proportion of all FDI to all private foreign investment in whole has risen from stage to stage, taking into account the impact of the debt crisis.
- The proportion of FDI to all private foreign investment is generally higher in East Asia than Latin America.
- Following the debt crisis, average FDI, \$41.3 billion, exceeded average FPI, \$35.7 billion, for all developing countries.
- Of the stage-to-stage change in average flows of FDI, 60.1 per cent went to East Asia and Latin America from stage 1 to stage 2, and 79.3 per cent from stage 2 to stage 3.
- Of the stage-to-stage change in average flows of FPI, 116.3 per cent of the change from stage 1 to stage 2 was explained by flows to East Asia and Latin America, and 81.3 per cent from stage 2 to stage 3.
- East Asia experienced higher indexed growth rates than all developing countries in FDI and FPI across all stages.
- Latin America experienced lower indexed growth rates than all developing countries in FDI and FPI across all stages (except for the debt crisis stage).

The last two points indicate that, although East Asia and Latin America combined have attracted the largest share of private foreign investment going to developing countries, the pattern of flows to each region differs. Comparing data in tables 7 and 10 shows that, in terms of indexed growth, both FDI and FPI in Latin America lagged behind East Asia and all developing countries in stages 2 and 3. Even so, the share of average FDI going to Latin America in stages 2 and 3 was 42.3 per cent and 35.6 per cent, respectively (versus 30.1 per cent and 36.5 per cent for East Asia), and the share of average FPI was 46.1 per cent in stage 3, versus 36.5 per cent for East Asia.<sup>40</sup> The reasons for this difference are two-fold. First, Latin America started

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<sup>40</sup> In stage 2, the high level of average net outflows of FPI in Latin America, \$1.4 billion, was greater than all average net inflows to all other regions.

from a much higher base in both FDI and FPI than did East Asia; in 1975, it attracted \$3.3 billion in FDI and \$3.0 billion in FPI, compared to East Asia's \$1.0 billion in FDI and FPI (see annex table 3). Second, more markets were opening up to FDI in East Asia than in Latin America, particularly from 1989 to 1995, the years in which China began to open its markets to foreign participation.<sup>41</sup>

**Table 7. Private investment in East Asia and Latin America as compared to all developing countries during three stages from 1975 - 1995**  
(*\$ billions*)

Stage	FDI	Per cent of all FDI	FPI	Per cent of all FPI	Total	Per cent of total
1: 1975-1981	5,679	80.7	6,212	79.0	11,891	80.0
2: 1982-1988	8,519	72.4	- 475	281.4	8,044	69.4
3: 1989-1995	41,264	77.8	29,439	82.5	70,704	79.7

*Source:* Calculated from World Bank (1997a).

**Table 8. Change in private investment in East Asia and Latin America from stage 1 to stage 2 and stage 2 to stage 3 as compared to all developing countries**  
(*\$ billions*)

East Asia and Latin America						
Stage	Change in FDI	Per cent of all change	Change in FPI	Per cent of all change	Change in total	Percent of total change
From 1 to 2	2,840	60.1	-6,687	83.2	-3,847	116.3
From 2 to 3	32,746	79.3	29,914	83.5	62,660	81.3
All developing countries						
Stage	Change in FDI	change in FPI		Change in total		
From 1 to 2	4,728	-8,035		-3,307		
From 2 to 3	41,273	35,839		77,112		

*Source:* Calculated from World Bank (1997a).

<sup>41</sup> FDI to China increased from \$3.4 billion in 1989 to \$35.8 billion in 1995, growing from 41 per cent to 69 per cent of all FDI going to East Asia. FPI to China in 1995, on the other hand, totalled only \$3.3 billion, or only 13 per cent of all FPI to East Asia (World Bank, 1997a).

Another feature distinguishing the East Asian and Latin American regions is their deeper and richer history of foreign capital inflows as compared to other regions. This being so, they offer a useful case study of how the extension of the eclectic paradigm to embrace FPI might help explain the changing composition of inbound foreign investment in the last 20 years.

**Table 9. Net flows of private investment to East Asia and Latin America in three stages from 1975 to 1995**

*(\$ billions)*

East Asia						
Stage	FDI	Index Stage 1 = 100	FPI	Index Stage 1 = 100	Total	FDI as per cent of total
1: 1975-1981	1,174	100.0	843	100.0	2,017	58.2
2: 1982-1988	3,539	301.4	938	111.3	4,477	79.0
3: 1989-1995	26,592	2,264.5	13,011	1,544.3	39,603	67.1

Latin America						
Stage	FDI	Index Stage 1 = 100	FPI	Index Stage 1 = 100	Total	FDI as per cent of total
1: 1975-81	4,518	100.0	5,370	100.0	9,887	45.7
2: 1982-88	4,980	110.2	-1,413	-26.3	3,567	139.6
3: 1989-95	14,672	324.8	16,429	306.0	31,101	47.2

*Source:* Calculated from The World Bank (1997a).

If we start with the premise that the ownership variables for portfolio investors described in table 2 already are present, the choice of outlet for FPI would depend on location (L) and externalization (E) variables. Several studies of FPI in East Asia and Latin America have concluded that a broad range of macroeconomic reforms and conditions (such as the realignment of exchange rate and monetary controls, reduced restrictions on capital flows and a commitment to a market economy, including privatization) have helped pull portfolio investment to those areas (Lim and Siddall, 1997; Chudnosky, 1997; Frischtak, 1997; World Bank, 1997a and 1997b) These pull factors coincide with a reconfiguration of the location variables for FPI set out in a section on the general paradigm of foreign investment

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(Chuhan, Claessens and Mamingi, 1993; Bekaert, 1995; and Fernandes-Arias and Montiel, 1995). At the same time, declining interest rates in developed economies, particularly the United States, and higher expected rates of return in the developing markets of East Asia and Latin America, combined with a low correlation of returns between developed and developing markets, helped push FPI to those markets in which attractive investment opportunities were present (Harvey, 1995; and Calvo, Liederman and Reinhart, 1993 and 1996). These push factors are consistent with those found in the externalization variable explaining FPI.

The amount of direct and portfolio investment in East Asia and Latin America during the first stage of the past two decades viz. 1975 to 1981 can be used as a base from which changes in the pattern of investment flows within and between regions can be assessed. From table 9 it is evident that Latin America provided more opportunities for both FDI and FPI than did East Asia in that stage, which is consistent with its broader and deeper level of economic development, especially in Mexico, Brazil and Argentina.<sup>42</sup> Given this higher base, it would be likely that the relative rate of increase in FDI and FPI in East Asia would be higher than that found in Latin America even if, in absolute terms, the level of both kinds of flows is higher in Latin America.

In both regions, the increase in L specific advantages sought by foreign TNCs, coupled with the appropriate O and I specific advantages, led to increases in FDI. As might be expected, the rate of increase in FDI in East Asia has been considerably higher than in Latin America, particularly in stage 3 (1989 - 1995), which saw the opening up of China as a major new location for FDI.

At the same time, FPI in many East Asian economies grew rapidly in response to the combination of the increasing openness of their political regimes and their rapid industrialization. The differing pattern of FPI flows in East Asia and Latin America is also worth discussing. In stage 2, growth in FPI in East Asia, as indexed to

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<sup>42</sup> East Asian flows exclude Singapore and Taiwan Province of China, both of which are excluded from the World Bank definition of developing countries.

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stage 1, outpaced FPI growth in Latin America.<sup>43</sup> Given the Mexican debt crisis and its impact on other Latin American countries in the 1980s, it is not surprising that FPI in Latin America was negative. It is interesting to note, however, that the outflow in FPI from Latin America was not matched by a corresponding increase in FPI either in East Asia or any other region.

This phenomenon can be explained within the context of the eclectic paradigm as applied to FPI. Using the terminology of L specific variables in the section on the general paradigm of foreign investment, this crisis was sparked off by a deterioration in basic financial infrastructure, which was exacerbated by over-borrowing and foreign-exchange problems. The degree to which replacements to the “lost” investment in Latin America could be found elsewhere rested on the opportunities for such investment. However, the fact that developing countries as a whole experienced a net outflow of FPI in stage 2, and that FPI was only marginally higher than stage 1 in East Asia, points to the apparent lack of suitable locational advantages found in other developing countries and regions.<sup>44</sup>

The different pattern of FPI flows in East Asia and Latin America from stage 2 to stage 3 also can be described within the context of the eclectic paradigm if one first thinks about how ownership and location advantages for FPI are exercised. The modality of FPI is one of externalization - viz. using the financial markets to pursue the objectives enabled by ownership and location advantages - as opposed to internalizing them as in the case of FDI. As financial markets develop and mature in more places, outlets for potential direct and/or portfolio investment should increase, as should the volume of investible funds. One should expect, therefore, an increase in both types of investment.

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<sup>43</sup> Stage 2 actually saw a net outflow of FPI from Latin America, but some of this outflow was caused by the conversion of private debt to public or publicly guaranteed debt.

<sup>44</sup> Interestingly, the 1997 financial crisis in East Asia also has its root in the financial services industry. While the effects of the crisis have been felt most profoundly in East Asia, the threat of contagion is more widespread than that found in the Mexican/Latin America debt crisis. This is due somewhat to a greater degree of market integration between the Asian markets and other developed and developing markets caused by the FPI in that region.



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How FDI and FPI change in relation to each other depends in large part on the forces of supply and demand. It can be argued that the supply of opportunities for FDI will begin to decline before similar opportunities for FPI begin to decline. Presumably, then, the volume of FPI flows should increase relative to FDI, and perhaps, at some point, surpass it. Taking into consideration that stage 1 FPI consisted mostly of bank loans rather than the “purer” bond and/or equity form of FPI, and the effect of the 1980s debt crisis, this relationship between FPI and FDI has been the case in East Asia and Latin America. In the former region, the ratio of FDI to FPI declined from roughly 4 to 1 in the 1980s to roughly 2 to 1 in the 1990s; in the latter the ratio of FDI to FPI was about 7 to 8. And in both regions the volume of FDI grew dramatically, by a factor of nearly 8 in East Asia from stage 2 to stage 3, and by a factor of around 4 in Latin America. In other words, the evidence strongly suggests that the factors favouring the externalization of ownership and location investment advantages have increased faster than those favoring internalization.

While this analysis uses data prior to the Asian financial crisis of 1997 (trends seen from 1989 to 1995 continued in 1996, however), brief reference to that crisis should be made. In a nutshell, the Asian financial crisis was caused and exacerbated by financial systems that were neither as strong nor as secure as they seemed, and the over-extension of those financial systems that FPI helped to cause. In particular, unlike the Mexican debt crisis some years earlier, the Asian crisis was initiated by the calling in of a very large number of debts over a short period of time (i.e., it was a liquidity crisis). To some extent, this helps support the arguments made here about the applicability of the eclectic paradigm to portfolio investment. For what has happened in Asia, as in Latin America in the 1980s, has been a change for the worse in a key location variable which has resulted in the decision to not externalize existing ownership or other L specific advantages in the form of portfolio investment.<sup>45</sup>

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<sup>45</sup> In the last eighteen months, primarily due to actions taken by their governments, the L advantages of several Asian countries, and especially Korea, have improved considerably. As a result FDI has been stable and FPI, to some extent, has started to flow back into the region. For further details see UNCTAD (1999).

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## Summary and conclusions

This article has sought to extend one of the mainstream themes of FDI, *viz* the eclectic paradigm of international production to embrace FPI, and in particular to examine the situations in which FPI and FDI are substitutable or complementary forms for exploiting or augmenting the ownership specific advantages of investing institutions and/or individuals. After setting out an analytical framework for discussing these issues and offering up some tentative suggestions about the real determinants of FPI, the article went on to illustrate how, first, in the role of foreign (and particularly United Kingdom) investment in the development of the United States economy, and second, in the recent explosive growth in FDI and the emergence of domestic capital markets in some developing countries, FDI and FPI have interacted with each other, and how such interaction may be at least partly explained by the tenets of the eclectic paradigm.

In particular, the eclectic paradigm would seem to provide a good analytical framework for explaining (a) the level and pattern of long term FPI - and particularly that undertaken by corporations and by institutions and private investors investing in commercial institutions, and (b) the choice between FPI and FDI - and particularly where FDI is made to augment existing corporate competitive strengths, and where FPI is part and parcel of a transfer of other real resources.

In addition, our article has offered some casual, statistical and other evidence which suggests that inbound FPI tends to follow FDI as countries proceed along their IDPs. At some point in that path, however, the flows appear to be more complementary to each other as countries become increasingly integrated through both intra- and inter-firm transfers of global resources and capabilities across national boundaries.

The ability to test our assertions in the previous section about the patterns of FDI and FPI in the more advanced emerging economies will depend on further study and more refined methods of collecting data. In particular, detailed analysis of capital transfers, including the type of transfer and the parties involved, is needed to determine,

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for instance, how much a firm or sector receiving FDI flows also makes use of FPI flows. Because developing countries will continue to be a target for FDI and FPI, and as a result of the problems in East Asia during the summer of 1997, these flows will attract greater attention, which means that more and better data should become available. A more rigorous analysis of our conclusions, therefore, will be possible.

Finally a word about the policy implications of this paper. While, in some cases, national or subnational governments, seeking foreign resources and capabilities to help them advance their economic objectives might view FPI (combined with interfirm technology *et al.* transfers) and FDI as competitive modalities, increasingly they would be advised to take a more holistic stance towards their competitive-enhancing strategies and to arrange their domestic economic affairs so as to attract (the right kind of) both FPI and FDI. This is because, as we have shown, FPI and FDI are becoming increasingly complementary to each other, both in their determinants and in their effects. In general, recent economic events have shown that the key economic role of governments in a globalizing knowledge based economy is first to facilitate an efficient market-based economic system, and second to ensure that the appropriate legal, institutional, and moral infrastructure is in place for this to be accomplished. ■

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**Annex table 1.1. All inbound foreign investment, 1980 - 1995**

*(\$ billions)*

Year	FDI	Portfolio	Total	Per cent direct
1980	29.1	30.1	59.2	49.1
1981	45.6	39.9	85.4	53.3
1982	44.0	39.2	83.1	52.9
1983	48.9	55.7	104.6	46.8
1984	53.7	74.4	128.1	41.9
1985	51.0	153.8	204.8	24.9
1986	78.8	177.9	256.8	30.7
1987	126.9	125.4	252.3	50.3
1988	156.8	226.3	383.1	40.9
1989	193.8	356.7	550.6	35.2
1990	201.2	236.1	437.3	46.0
1991	153.8	442.2	596.0	25.8
1992	165.9	434.1	599.9	27.6
1993	210.3	727.5	937.7	22.4
1994	231.0	417.4	648.4	35.6
1995	316.4	583.7	900.2	35.2

*Source: IMF, Balance of Payments Statistical Yearbooks, 1987 - 1996.*

**Annex table 1.2. Distribution of inbound FDI and FPI between developed and developing countries, 1980 - 1995**  
(*\$ billions*)

Year	FDI						FPI					
	Deve- loped	Per cent	Deve- loping	Per cent	Total	Per cent	Deve- loped	Per cent	Deve- loping	Per cent	Total	Per cent
1980	23.8	81.8	5.3	18.2	29.1	100.0	28.6	95.0	1.5	5.0	30.1	100.0
1981	29.9	65.6	15.7	34.4	45.6	100.0	37.2	93.2	2.7	6.8	39.9	100.0
1982	24.2	55.1	19.7	44.9	43.9	100.0	35.0	89.5	4.1	10.5	39.1	100.0
1983	33.3	68.1	15.6	31.9	48.9	100.0	53.1	95.3	2.6	4.7	55.7	100.0
1984	38.5	71.6	15.3	28.4	53.8	100.0	71.6	96.2	2.8	3.8	74.4	100.0
1985	38.5	75.5	12.5	24.5	51.0	100.0	149.5	97.2	4.3	2.8	153.8	100.0
1986	66.4	84.3	12.4	15.7	78.8	100.0	177.0	99.4	1.0	0.6	178.0	100.0
1987	113.2	89.2	13.7	10.8	126.9	100.0	124.9	99.6	0.5	0.4	125.4	100.0
1988	132.1	84.2	24.8	15.8	156.9	100.0	216.8	95.8	9.4	4.2	226.2	100.0
1989	166.5	85.9	27.3	14.1	193.8	100.0	349.9	98.1	6.8	1.9	356.7	100.0
1990	169.6	84.3	31.6	15.7	201.2	100.0	213.6	90.5	22.5	9.5	236.1	100.0
1991	112.9	73.4	40.9	26.6	153.8	100.0	410.9	92.9	31.3	7.1	442.2	100.0
1992	117.7	70.9	48.2	29.1	165.9	100.0	385.3	88.8	48.8	11.2	434.1	100.0
1993	136.5	64.9	73.8	35.1	210.3	100.0	613.4	84.3	114.1	15.7	727.5	100.0
1994	139.5	60.4	91.4	39.6	230.9	100.0	316.2	75.7	101.3	24.3	417.5	100.0
1995	208.9	66.0	107.5	34.0	316.4	100.0	541.5	92.8	42.2	7.2	583.7	100.0

Source: IMF, *Balance of Payments Statistical Yearbooks*, 1987-1996.

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**Annex table 2. Annual flows of FPI and FDI to all developing countries, 1975-1995**

*(\$ billions)*

Year	FDI	FPI
1975	7,309.7	4,857.2
1976	3,461.0	3,979.6
1977	6,107.2	5,527.2
1978	7,015.7	5,564.7
1979	7,429.3	7,248.6
1980	5,092.3	9,216.0
1981	12,832.6	18,668.5
1982	11,335.3	5,706.7
1983	8,424.3	451.2
1984	9,129.3	(998.0)
1985	11,103.4	(1,695.4)
1986	9,464.3	(1,407.8)
1987	13,506.7	(1,388.5)
1988	19,382.4	(1,849.8)
1989	23,168.0	3,847.0
1990	24,549.0	13,285.0
1991	33,478.0	15,740.0
1992	43,644.0	30,704.0
1993	67,214.0	63,931.0
1994	83,716.0	56,548.0
1995	95,489.0	65,639.0

*Source:* World Bank (1997a).

*Note:* brackets ( ) means negative flows.

**Annex table 3. Annual flows of FDI and FPI to East Asia and Latin America, 1975-1995**

(\$ billions)

Year	East Asia				Latin America			
	FDI	Per cent of total	FPI	Per cent of total	FDI	Per cent of total	FPI	Per cent of total
1975	969.1	13.3	971.0	20.0	3,274.0	44.8	3,039.0	62.6
1976	962.0	27.8	787.0	19.8	1,760.0	50.9	2,130.0	53.5
1977	983.0	16.1	762.0	13.8	3,159.0	51.7	2,872.0	52.0
1978	979.0	14.0	162.9	2.9	4,082.0	58.2	3,089.0	55.5
1979	920.0	12.4	563.6	7.8	5,205.0	70.1	4,625.0	63.8
1980	1,312.0	25.8	1,030.0	11.2	6,148.0	120.7	6,000.0	65.1
1981	2,001.0	15.6	1,620.9	8.7	7,996.0	62.3	15,833.0	84.8
1982	2,403.0	180.0	1,532.3	26.9	6,345.0	475.2	4,020.0	70.4
1983	2,820.0	33.5	1,481.8	328.4	3,614.0	42.9	(1,917.0)	NM
1984	2,837.0	31.1	1,067.3	NM	3,234.0	35.4	(2,035.0)	203.9
1985	2,949.0	26.6	373.0	NM	4,373.0	39.4	(2,079.0)	122.6
1986	3,115.0	32.9	(83.5)	5.9	3,556.0	37.6	(1,877.0)	133.3
1987	3,908.0	28.9	554.2	NM	5,788.0	42.9	(2,229.0)	160.5
1988	6,740.0	34.8	1,640.2	NM	7,949.0	41.0	(3,773.0)	204.0
1989	8,330.0	36.0	5,370.0	139.6	8,138.0	35.1	(2,296.0)	NM
1990	10,179.0	41.5	9,022.0	67.9	8,121.0	33.1	3,603.0	27.1
1991	12,706.0	38.0	7,150.0	45.4	12,504.0	37.3	8,921.0	56.7
1992	20,923.0	47.9	9,351.0	30.5	12,740.0	29.2	18,739.0	61.0
1993	38,128.0	56.7	16,692.0	26.1	14,066.0	20.9	39,779.0	62.2
1994	44,105.0	52.7	18,366.0	32.5	24,238.0	29.0	24,531.0	43.4
1995	51,776.0	54.2	25,123.0	38.3	22,897.0	24.0	21,724.0	33.1

Source: World Bank (1997a).

Note: brackets ( ) means negative flows.

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# Two literatures, two storylines: is a general paradigm of foreign portfolio and foreign direct investment feasible?

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Mira Wilkins\*

This article explores the relationships between foreign portfolio investments and foreign direct investments, using an historical perspective. Are the two types of investment substitutes for one another, complements, or unrelated? Is there a pattern – a generalized statement that can be made on the choices of investors participating in international financial transactions and those taking part in transnational corporations type investments? The article concludes that while foreign portfolio investment and foreign direct investment have long coexisted, while both have involved cross-investments, and while they have other common features, foreign portfolio investment and foreign direct investment ratios – outward and inward – have shown no consistency across countries, through time. The separation in thinking about foreign portfolio investment and foreign direct investment that has arisen in the literature has not been capricious. The actors are different as are the motives and conduits. The interactions vary. Their impacts on host countries are markedly distinct. In our present state of knowledge no general paradigm to unite the two types of investment is possible. Public policy makers would do well to understand the substantial differences between foreign portfolio investment and foreign direct investment in their crafting of laws and regulations.

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## Introduction

The recent oft-used metaphor on “oceans” of capital, with tides overwhelming sovereign actions, evokes memories of earlier concerns over transnational corporations' (TNCs) superseding and transcending national States. The message is shared: international capital was not to be trusted. Images of other kinds of capital flows that have played similar roles are those of capital moving internationally propelled by portfolio diversification, or of capital moving abroad through the TNC. These images are followed by the separation rhetoric: “financial” capital (passing through stock markets internationally and subject to suspicion) is distinct from the “real” investments of TNCs, a healthy and desirable activity. In the first two illustrations, foreign portfolio investment (FPI) and foreign direct investment (FDI) are perceived within the same frame of reference; and in the third, the two are seen as not alike and unique. What is the relationship between foreign direct and foreign portfolio investment? Does it depend on the questions we are considering?

In the summer of 1998, as the economic crisis in Asia was capturing headlines, newspapers reported that United States companies were acquiring Asian enterprises at a greater rate than ever before – outward FDI.<sup>1</sup> In May 1998, a careful commentator in a publication of the Federal Reserve Bank of New York had noted that there was no way of discerning from the United States government statistics whether there was a rise or decline in Asian ownership of United States Treasury securities. The commentator found, however, that there had been an overall sharp rise in foreign ownership of treasury securities since the Asian crisis -- presumably a “flight to quality.”<sup>2</sup> Does that indicate “cross investment”? If so, is such cross investment -- United States outward FDI and inward FPI -- compatible with a general paradigm in which we are asking the same questions about the size and the nature of capital flows?

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<sup>1</sup> *Financial Times*, 30 June 1998.

<sup>2</sup> Sobol (1998). The data indicated that the increase showed up in United Kingdom purchases, but as Sobol explained this tells nothing about the actual (beneficial) foreign owner. In terms of “flight to quality,” there can be two explanations of this rise: (1) that Asian monies were going to the United States through London, or alternatively, (2) that monies from the rest of the world (including the United Kingdom) that would have gone to Asia were now going to the United States through London. It is conceivable that both were occurring.

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So, too, during 1998, as this article was being prepared, the privatization process that had been going forward throughout the 1990s continued. As it proceeded, State-owned companies were restructured, and bankers assembled groups of domestic and foreign investors to take part in the newly privatized units. Some of the foreign participants made direct investments in these privatized companies; they did so as TNCs in an economic activity that they knew well. Others, for example, emerging nation funds, made what were portfolio investments in new equity issues. In this fifth case, the two types of foreign investment were in the same direction and were complementary.

And, in yet another contemporary publication, there appeared the suggestion that the distinction between FDI and FPI was “blurred”, since direct investors could employ “financial engineering techniques to convert foreign direct investment into a more liquid form of investment.”<sup>3</sup>

The six cases presented above offer diverse circumstances, perceptions of, and perspectives on, the relationships between FPI and FDI. This article asks whether each set of insights can be generalized, and more important, whether any basis exists for a general paradigm to help us understand the participants, size, nature and direction of long-term international capital flows. Does it matter if the capital considered is portfolio or direct investment? I believe it is material, and that dividing investments by type has economic significance.<sup>4</sup>

A foreign investment, be it FDI or FPI, involves the creation of an on-going obligation. FDI and FPI have this in common. A foreign direct investor, by most established definitions, invests abroad as part of a business strategy with an eye to ownership and control,

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<sup>3</sup> UNCTAD (1998a).

<sup>4</sup> *Transnational Corporations* and the *World Investment Reports* have typically considered only direct investments. For the first time, in the *World Investment Report 1997* (UNCTAD, 1997 pp. 107-132), there appeared a section entitled “foreign portfolio equity investments.” It dealt solely with flows to “emerging markets” and with portfolio *equity* investments; it implied that FPI was a subject that deserved scrutiny by students of FDI. The “Expert Report” cited in footnote 3, was the follow-up.

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potential for control, or at least influence.<sup>5</sup> The foreign direct investor is an “active” one by definition. Moreover, the investor intends to be “active”; the firm is making an investment whereby it plans to obtain a return based not only on its financial contribution, but also on its transfer of intangible assets, its way of doing business and its technology (broadly construed).<sup>6</sup> A portfolio investment is a financial one and can be in debt (securitized or non-securitized; sovereign or corporate) or equity. Discussions of portfolio investments frequently include short- as well as long-term investments; my concern in this paper is with long-term investments, defined by the instrument and not by how long the investor participates.<sup>7</sup> Most important, the *intention* of the portfolio investor is to make a “passive” investment (the portfolio investor does not intend to manage the activity in which the investment is made).<sup>8</sup> The bold face in figure 1 shows our coverage in this article.<sup>9</sup> These general definitions are not clear cut, nor universally accepted. Indeed, definitions are often elusive (see box 1 herein). I will, however, use the ones given in the text above (and in figure 1) as a guide in my narrative and analysis. Definitions (however controversial) are essential for clarity.

While foreign investments share much in common, I have no substantive quarrel with the four distinctions between FDI and FPI outlined in Dunning and Dilyard (1999): (i) FDI includes the transfer

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<sup>5</sup> For statistical purposes, the United States Department of Commerce defines a direct investment as an equity interest in a foreign firm of 10 per cent or more; the reason behind this definition is to capture that element of “control.” The International Monetary Fund and the World Bank have also adopted the 10 per cent definitional rule. The *World Investment Report 1997*, p. 295, defines FDI “as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy...in an enterprise resident in an economy other than that of the foreign direct investor....”

<sup>6</sup> By active, I mean the investor intends to have (or has the possibility of having) continued participation in shaping what happens to the use of its assets abroad.

<sup>7</sup> This is the way I will define the term “portfolio investment” throughout this paper. “Long-term” is traditionally defined by the instrument: all equity is long-term; debt of over a year (whether securitized or not) is long-term. On this taxonomy, see Kindleberger (1987, p. 13).

<sup>8</sup> I emphasize “intention,” for sometimes the intention is not realized--and the investment is not “passive.”

<sup>9</sup> Figure 1 shows only the targets of investment -- *not* the investor. Some authors only deal with private sector investors and others with all investors. I am in the latter category.



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### **Box 1. Definitions of foreign direct investment and foreign portfolio investment**

Foreign direct investment: The United States Department of Commerce and others define FDI in terms of a 10 per cent or greater equity interest. Once an affiliate meets that criterion, borrowing/lending are considered to increase/decrease the parent company's FDI; reinvested earnings are included as part of FDI. This definition is not universal and the *World Investment Report* shows how different countries measure FDI flows and stocks (UNCTAD, 1997, pp. 295-302).

Foreign portfolio investment: The definitions of FPI are far more difficult. Many authors do not use the term "portfolio investment." When it is used, what is included varies radically. My student Giyas Gokkent wrote his Ph.D. dissertation on "Theory of foreign portfolio investment," at Florida International University in 1997. As he (and I) explored the usages of the term "portfolio investments," in the 1980s and 1990s, a range of definitions became apparent. The broadest usage included all investments going to a host country that were not classified as FDI – including short- as well as long-term capital movements. Ruffin and Rassekh (1986, pp. 1126-1130), for example, employed the term "portfolio investment" in this manner. Many authors include – as I do in this paper – only long-term investments other than FDI. Stallings (1989, p. 323), for example, followed this approach. Others include only securitized investments (bonds and stock), once more excluding FDI, but now excluding long-term bank lending as well. The International Monetary Fund, *Balance of Payments Yearbook*, fits into this category; in the years 1988 to the present it has added to the category of "long-term" portfolio capital flows, financial derivatives and other new money market instruments. Some sources classify as FPI only equity investments that are not FDI – i.e. "portfolio equity" flows: the Institute of International Finance, in Washington, in its consideration of private capital flows to emerging markets, divides the latter into four categories: direct equity investment, portfolio equity investment, commercial bank lending, and non-bank private creditors (which included bond holders); see IMF (various) and IMF (1998b, p. 35); in Claessens, et al. (1995, pp. 153-174), the authors use the phrase to cover only portfolio equity investments. In terms of investors abroad, some sources include as foreign portfolio investors all foreign investors in long-term investments, excluding only those making FDI (this is the view I adopt); others leave out all or some government investors; frequently, foreign aid and concessionary lending by governments are excluded from "foreign investment" figures (I agree with the exclusion of foreign aid, since it does not create an obligation to pay interest or dividends; while the foreign aid may be "invested" in income earning assets neither the asset nor the income represents any ongoing obligation to a foreign "investor;" thus foreign aid ought not to  
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**(Box 1, concluded)**

be counted as a “long-term foreign investment.”) In sum, there is no uniformity in the way the term “portfolio investments” is applied.

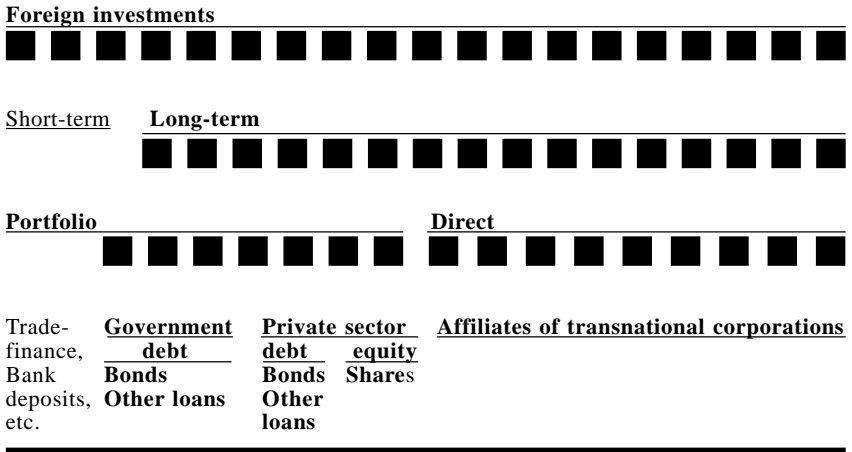
The matter of distinguishing long- and short-term can also be particularly exasperating in the portfolio investment literature. At times, there have been careful delineations. Robert Lipsey recalled that years ago in his work on national balance sheets “we [Raymond Goldsmith and Robert Lipsey] preferred to treat long-term securities that were within three months of maturity as short-term, on the ground that during those months they were good substitutes for securities with originally short maturities, and were treated as such by investors and issuers.” In addition, short-term bank loans, constantly rolled over or expanded, can be tantamount to long-term investments and “can serve to finance physical capital investments just as long-term investment can” (Lipsey, 1993). Today, as the writings on portfolio equity investments multiply (and such investments have shown great expansion), the traditional definitions of short-term – defined by the instrument – have often been discarded and “short-term” is used as equivalent to the length of time the security is held by the individual (the vocabulary has its counterpart in the phrases “long-term” and “short-term” capital gains). I follow the traditional definition. My focus here is on *basic* investments; it should go without saying that all multinational enterprises (foreign direct investors) finance intra- and intercompany trade, providing working capital, thus making “short-term” as well as long-term investments in the course of undertaking business.

of non-financial, as well as financial assets; (ii) FDI involves continuing control, while FPI does not; (iii) FDI is usually more lumpy and indivisible than FPI; and (iv) FPI tends to be prompted by financial returns that are higher abroad than those at home, while motivations for individual FDI projects are far broader.<sup>10</sup> In addition, I will argue that the actors and conduits, along with the impacts, are different. My question is: if we accept the rough divisions between FDI and FPI as offered above, is there a systematic association between the two types of investment? Is a general paradigm on FDI and FPI possible?

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<sup>10</sup> I have formulated these four points slightly differently from Dunning and Dilyard (1999), but I think I have captured our mutual agreement.

**Figure 1. Capital abroad**



This figure is obviously oversimplified. Its focus is on the types of investment. Each “long-term” category has subsets. For example: Government debt can be at a national or subnational (State, province, county, city) level. Private-sector debt and equity can be divided by industries. Government-owned companies (or “private sector” companies with partial government ownership) could be included in a separate category. Affiliates of transnational corporations could be divided by percentage ownership by the direct investor; they could be divided by industrial sector; they could be divided by whether they are acquired or set-up anew. Direct investments are not only made by firms; they are made by wealthy individuals; thus, investments by wealthy individuals in real estate might not seem to fall comfortably into the category of “affiliates of transnational corporations,” albeit they do carry with them control over the property and are thus direct investments; stretching the point, however, the wealthy individual could be seen as a “firm” and his/her investments abroad in real estate could be categorized as a direct investment of that firm or as an affiliate of a transnational corporation – defining the latter as a firm that makes direct investments abroad. The purpose of this oversimplified figure is only to provide the broad overall spectrum.

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Once upon a time, FDI and FPI used to be studied together (and this remains true in some cases even today). Those who did (and do) so assumed (assume) that these capital flows were not only related, but served identical economic functions, and that there was no need to separate FDI and FPI. Nonetheless, for a generation students of TNCs have fashioned a literature that usually equates theories of FDI with those of TNCs. They have seen FDI as different from FPI. A colossal body of writings on FDI has emerged, which is well known to readers of *Transnational Corporations*. Often, however, individuals schooled in open economy macroeconomics, money and banking, international economics, or finance (both domestic and international finance) state that they know little about FDI. Recently, I have heard this from several well-informed academics at the World Bank and the International Monetary Fund. What has occurred is that scholarly contributions on FDI have, to a large extent, evolved quite apart from more general ones on capital flows. Although the literatures have converged and have touched frequently on the edges, despite this, studies of FDI and FPI have taken remarkably separate courses for years, with one set of individuals considering FDI, the other set writing on all foreign investments, including FDI.<sup>11</sup>

Within the wide-ranging literature on capital flows, scholars contemplate such topics as international debt (securitized and non-securitized, sovereign and private), foreign portfolio equity, real versus financial assets, capital asset pricing models, home bias,

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<sup>11</sup> Dunning and Dilyard (1999) and the present paper are a start in changing this. Throughout there have been always been bridges; there has never been a complete gulf; but there is a gulf. One person who has steadily tried to reconcile the FDI and FPI literatures has been Robert Aliber. See Aliber (1970 and 1993, chap. 5). For other past attempts to bridge the gap, see Toyne and Nigh (1997, chap. 10), especially the contributions of Donald Lessard and Ingo Walter. The National Bureau of Economic Research has dealt with FDI and FPI with the splendid working papers of Robert Lipsey (on FDI) and the working papers by M. Baxter and U. Jermann (on the “international diversification puzzle”), yet Lipsey (1999) is the NBER paper that I have seen, which considers the relationships between FDI and FPI. The more I get into this, the more I become convinced that there may be more than two literatures. There is the giant literature of students of FDI and the equally large literature of “all other students of foreign investments,” which divides itself into a number of streams of thought and where there is sometimes a narrow concentration by writers on a particular type of foreign investment.

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savings/investment levels and how active a pension or mutual fund should be in corporate governance. They discuss capital mobility (and the extent of liquidity), capital controls and tax policies. They examine foreign aid and concessionary lending by governments compared with private capital flows. Often, the treatment of FPI embraces the short- as well as the long-term with little attention to the distinctions, or a casualness in definitions.<sup>12</sup> Writers on international debt may know nothing of the home bias (and information asymmetry) literature, while those in finance may concentrate on equity versus debt and be unconcerned with the other topics. Students of bank lending (non-securitized debt) may neglect bond issues traded in capital markets. Discussions of savings/investment ratios do not distinguish FPI from FDI. The international tax literature has its own vocabulary, as does the law and economics literature (as it applies, for example, to international applications of antitrust and property rights law). Writers, who consider private capital flows, may ignore or see publicly initiated capital flows in an entirely separate light (government foreign aid and concessionary lending may be included or excluded from the term “foreign investment”). Foreign governments that invest in United States Treasury bonds for currency stabilization purposes can be perceived as in a separate category. Often, as Raymond Vernon has pointed out, departments of economics and business schools have had as a point of departure in their studies of international capital “efficient markets.”<sup>13</sup> What is clear, however, in all the new literature is that just as foreign direct investors are not operating (and never have operated) in “perfect markets,” so, too, whether recognized or not, today’s wide-ranging discussions on capital flows deal with market imperfections, segmentation of markets, and information asymmetries, many of which are the consequence of various and changing legal and tax regimes.<sup>14</sup>

To analyze the divide in the streams of thought on foreign direct and foreign investment in general, and to consider the connections between FDI and FPI, a large dose of history and historiography seems essential. What follows is an attempt to survey past thinking on capital

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<sup>12</sup> See box 1 on short- and long-term investments; the careful delineations noted there are frequently absent in the general literature.

<sup>13</sup> Raymond Vernon, presentation at AIB Meeting, 8 October 1998.

<sup>14</sup> My figure 1 herein covers all these flows, except for foreign aid, which I exclude because no obligation is created.

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over borders, and in the process to evaluate the as yet fragmentary evidence on the mixtures of, and relationships between, FDI and FPI. One critic of this article asked, “on what a priori grounds should the two types of capital flows be related?” The question is important. That the two forms coexist does not explain their associations. The historical background is crucial. In my article conclusions, I will try to answer the question of whether a general paradigm on FDI and FPI is possible and, at the same time, briefly hint at some of the public policy implications of my findings.

## Historical precedents

Many centuries ago, as is the case to some extent today, capital moved over borders embodied in individual traders, who set up establishments abroad with the ongoing support from a home (head office) locale; such investments have been dated back as far as ancient times.<sup>15</sup> If we consider these capital movements as direct investment then FDI would seem to precede FPI.<sup>16</sup> The amounts involved in such FDI, however, were small. But were we to consider *quantities* of capital crossing borders, by the Middle Ages FPI would probably exceed FDI.

The earliest FPI appears to have been in the form of government debt. Sovereigns have had a long history of borrowing from foreigners, dating at least as early as in the Middle Ages. At times, sovereign loans were linked with trade concessions: fourteenth century loans by Florentine merchant banks, for instance, were designed to secure trade advantages.<sup>17</sup> Passing rapidly through time, Larry Neal (1990), in his book, *The Rise of Financial Capital: International Capital Markets in the Age of Reason*, argued that “the first financial revolution in early modern Europe” arose with Charles V’s levies on the provinces of the Hapsburg Netherlands in 1542.

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<sup>15</sup> Moore and Lewis (1999) argue that the earliest transnational corporations were in the ancient world – by Assyrians circa 2000 B.C. and then a thousand years later Phoenicians.

<sup>16</sup> For a very brief overview of the much later “pre-industrial,” “pre-modern” FDI (from the thirteenth through the eighteenth centuries A.D.), see Wilkins (1997b, p. 96). See also Baskin and Miranti (1997, pp. 33, 38, 40-47).

<sup>17</sup> Governments need to be financed and are typically financed through taxes and borrowing; borrowing can be internal or external. In the Middle Ages Italian bankers were involved in financing British sovereigns (Cameron and Bovykin, 1991, p. 3). On trade concessions accompanying lending to sovereigns, see Baskin and Miranti (1997, p. 42).

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The levies led to the issue of annuities and the creation of a market for long-term securities that were “heritable, transferable, and therefore suitable for resale”. The Dutch sold these securities to residents of surrounding provinces, i.e. to foreigners (Neal, 1990, p. 5). Financial markets came to be linked with trade in foreign bills of exchange. Neal (1990, pp. 5-8) also showed the integration of securities’ markets in the eighteenth century among countries in northwestern Europe.<sup>18</sup>

From the Middle Ages forward, FDI and FPI coexisted. There was a complementarity between the two, when, for example, a fourteenth century Florentine merchant banker established branches abroad (FDI), and at the same time engaged in lending to a foreign sovereign (FPI). By the early seventeenth century, there also existed another relationship -- this time an asymmetrical one: The Dutch East India Company and the East India Company (English) established business affiliates abroad (FDI); as well, the securities of these chartered companies were traded over borders (FPI).

By the nineteenth century, the international movement of capital had expanded greatly, and continued to comprise FDI and FPI. The FDI involved businesses of many sorts and a head office in the homeland. The FPI consisted principally of transactions in government and corporate securities, where new and traded issues were often handled by merchant bankers and stockbrokers, for which stock exchanges were critical. By the late nineteenth and early twentieth century a truly global integration existed, with the United Kingdom as the leading capital exporter.

### **Balance of payments accounting**

In the nineteenth and early twentieth centuries, as the world economy had become more integrated, economists and financial journalists paid attention to the international movements of both outputs (goods and services) and inputs (factors of production). The focus on movements of goods of trade – was accompanied by a consideration of payments and of how trade was financed. Balance of payments accounting took shape (the first primitive attempts date

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<sup>18</sup> By the eighteenth century the securities markets were not merely in government obligations; during the seventeenth century, there was already trading across borders in corporate securities.

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back to the 1890s) with the identification of current account transactions and the “balancing” – below-the-line – transactions.<sup>19</sup> A literature developed that perceived “capital” movements as subordinate to trade transactions. Capital movements were considered as balancing items in a balance of payments account. An attempt was made to measure the flow of factors (that is, the flow of capital) as this balancing item on the balance of payments. In time, a major issue would arise on the “transfer question” – claims on assets versus claims on physical capital.<sup>20</sup> This aside (for a range of reasons often ignored), balance of payments accounting never proved to be a satisfactory means of tracking capital exports (or capital imports), much less international obligations. By 1952, when balance of payments accounting was well accepted, James Meade (1952) differentiated accommodating and autonomous “below-the-line” entries. He noted that flows of long-term capital were autonomous in nature, not simply “balancing items”.<sup>21</sup> Roy Ruffin (1984, p. 240) pointed out that “the United States balance of payments contains statistical discrepancies that rival the net capital outflow”. From the balance of payments accounts, Ruffin stated, it was impossible to determine whether at that time the United States was a net importer or exporter of capital. Today, however, when economists consider trade and investment as part of the same phrase, the tradition of balance of payments accounting is an important facet of their heritage. It is also in evidence in present-day overall discussions of capital liberalization. The International Monetary Fund’s charter is devoted to freeing trade and payments. There are now deliberations as to whether it should be amended to include capital account liberalization.

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<sup>19</sup> We see the “primitive” attempts at balance of payments accounting in the work of Heidelberg (1895, pp. 542-44, 585, 630-633). The first really systematic work was by Bullock, Williams and Tucker (1919, pp. 224-231).

<sup>20</sup> On the “transfer problem,” see Kindleberger (1987, pp. 5-7). It related to reparations and capital flight matters that were discussed at great length in the inter-war years.

<sup>21</sup> Meade (1952, pp. 11-12). Meade believed capital flows were autonomous; he also put more in the category of what was autonomous than I have in my considerations. Four decades later, Robert Lipsey wrote me “that most macro-economists have given up on trying to make this distinction [the one between ‘autonomous’ and ‘accommodating’ or ‘balancing’ capital flows]. Certainly the BEA gave up on using any single measure of balance-of-payments deficits or surpluses as matching these concepts.” Cited from Lipsey (1993). Nevertheless, Meade’s point has to be made, for there remains a residue of confusion on balance of payments ‘balancing’, and what should be included as a ‘capital flow’ – long- versus short-term.



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International stock market transactions are sometimes perceived as a consequence of the post-1980s liberalization of capital accounts and divorced from “real” activities linked with trade. Lois E. Stekler (1998, p. 309), of the Federal Reserve Board’s Division of International Finance, accepts this same notion of capital flows as subordinate to trade: Commenting on the shift of investment income in United States accounts from positive to negative for the first time since 1914, she wrote: “it reflected the cumulative effect of deficits in the current account that have persisted since 1982 and the balancing net capital inflows”.<sup>22</sup> The balance of payments tradition obscures the distinctions between different types of long-term capital flows and does not help us to understand the differences between FDI and FPI -- that is, the different types of capital flows, nor the relationships between the different types. When discussion has been fettered to “accounting identities”, the effect has been not only to veil, but also to hinder analysis of important questions on the participants in, the size, nature, and direction of capital flows.<sup>23</sup>

### **Capital movements: United Kingdom’s tradition and the pre-1914 world economy**

Meanwhile, along with the considerations of balances of trade and payments in the late nineteenth and early twentieth centuries, as United Kingdom’s capital exports soared (by 1914 United Kingdom’s overseas assets were said to be equal to 30 per cent of that country’s national wealth) (Edelstein, 1982, p. 25), there came to be a very full appraisal of various types of international finance that went through stock markets. The studies were coincident with the thinking about trade and payments not subsequent to such deliberations. Because the United Kingdom was the principal capital exporter in the gold

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<sup>22</sup> But Kindleberger (1987, p. 11) posed the question as to whether capital drives the current account rather than the other way around? Subsequently, many others have argued that this may well be the case.

<sup>23</sup> The latest work in this tradition poses fascinating questions on historical flows, but still offers no assistance on the FDI/FPI relationships. See Obstfeld (1998), pp. 11-12, where he takes data that he and Alan Taylor developed on current account balances from 1870 to the present for 12 countries, “reported as the absolute value of the current account divided by the gross domestic investment.” The current account balance equals the difference between national savings and domestic investment. If positive, the current account balance measures a country’s savings invested abroad; if negative, it measures the portion of domestic investment financed by the savings of foreigners. Obstfeld’s table -- designed to show the extent of global integration--contains absolute values (with no signs).

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standard era before 1914, no overall discussion of capital exports excluded that country. However, the integrated world economy before 1914 has also prompted extensive examination of French, German, United States, Dutch, Belgian, Swiss, and Swedish capital exports, and of the emerging international economic order.

In the period 1880-1914, the “gold standard era”, five distinct categories of foreign investment can be identified: (i) in sovereign debt; (ii) in large foreign enterprises (where interest and dividends could be easily collected in the provider-of-capital nation); (iii) in smaller foreign businesses set up in a host country; (iv) by companies registered in the home country to do business abroad; and (v) by companies whose principal business was at home but that had also expanded abroad. All categories have been recognized by contemporaries.<sup>24</sup>

In the sizable literature on international investment covering this period, the terms “portfolio” and “direct” investments were, however, for a long time employed quite differently from today’s usages (as described in box 1). Herbert Feis (1930, p. 15) considered investments by the firms in the fifth category as “direct investments”, companies that invested abroad directly and did not leave “traces” in securities markets. Later, Matthew Simon (1967a and 1967b), who paid careful attention to the United Kingdom firms in the fourth category, called these “portfolio” investments to differentiate them from those in the fifth category.<sup>25</sup>

Then, based on the assumption that investments in categories (i) through (iv) were of a portfolio nature, many writers wrongly concluded that the overwhelming portion of investments during 1880-

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<sup>24</sup> I discuss all these types, contemporary references to them, and some of the vast literature on international investment in the late nineteenth and early twentieth century, in Wilkins (forthcoming).

<sup>25</sup> Although the types were recognized long before 1913, the terms FDI and FPI were not used. Thus, George Paish in his careful 1909, 1911, and 1914 articles on United Kingdom overseas investments, did not use the phrases “direct investments” or “portfolio investments”. Paish’s articles are republished in Wilkins, ed. (1977). Paish’s phrase, when discussing category 5 type investments, was “private capital employed abroad” by banking houses, “branch manufacturing, mercantile, and trade undertakings, &c., &c”. See his 1911 article, in *ibid.*, p. 187. Herbert Feis was interpreting Paish when Feis adopted the phrase “direct investment” to cover those investments that did not leave “traces in the form of a security issue”.

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1914 were FPI. Recent scholarship, using more modern definitions, has revised these conclusions: categories (i) and (ii) were, indeed, FPI (as defined earlier in this article), the smaller category (iii) might be considered as either FDI or FPI; by contrast, the large investments in categories (iv) and (v) were made by firms that conducted their businesses across borders and their investments carried with them management and control; thus, they were FDI.<sup>26</sup>

As research has proceeded and distinctions have been made between FPI and FDI using today's definitions, several salient insights have emerged on the sizable global capital flows during the late nineteenth and early twentieth century. First, *sovereign debt* (category (i) above) became relatively less important, with the growth of more opportunities for investment.<sup>27</sup> Second, FPI was principally in *bonds* (with governments and corporations as the recipients – categories (i) - (iii) above). There was little long-term bank lending overseas in the United Kingdom's capital export story. On the European continent, the path in each country differed; there was long-term lending that was both securitized and made directly by banks. Foreign portfolio equity investment existed, but was of lesser importance in the overall global mix of international investments than corporate bonds. Where there was foreign portfolio equity, it was usually in category (ii), in railroads and large companies such as United States Steel and American Telephone & Telegraph.<sup>28</sup> Third, *railroads* predominated in category (ii). Their securities were floated by banking houses, and were traded on stock exchanges in capital-exporting countries. Railroads were capital intensive and required more funding than could be found in host nations. Although by 1914 the large United Kingdom, Dutch, and French investments in United

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<sup>26</sup> See Jones (1996, p. 30), on the change of thinking; some earlier clearly erroneous estimates had been that 90 percent of the investments were of a portfolio nature. See also Wilkins (forthcoming) for a lengthy discussion of the various types of foreign investment. Much of what is contained herein in this section is based on research done for that article, where more detailed citations are provided.

<sup>27</sup> During much of the nineteenth century, especially in the early part, loans (mainly in the form of bonds) to governments had constituted the largest portion of the capital that moved over borders. See Wilkins (forthcoming).

<sup>28</sup> Stallings (1989, p. 52), makes the very legitimate point on bonds versus long-term bank lending in the British case. Added studies would be helpful on the ratios of bonds and equity – and how this changed through time.

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States railroads were mostly FPI – and fit exclusively in category (ii) – in many other recipient countries, a greater complementarity between FDI and FPI existed. In some cases, in category (iii), there were investments with United Kingdom (or other capital-exporting country) management, with no parent company in the capital-exporting nation, yet the mobilized capital was only obtained with the understanding that the railroad would be under the management of the United Kingdom, other European, or United States management. More often, especially in the developing countries, by the 1890s there were United Kingdom companies (category (iv) investors) set up in the United Kingdom to run railroads abroad (FDI). There were similar companies headquartered in other capital-exporting countries. Apparently, there were numerous interrelationships between FPI and FDI in railroads – the most significant infrastructure foreign investments of that era.<sup>29</sup> Fourth, frequently, *non-railroad companies* would make FPI in United States railroads (principally, category (ii) investments). Some of the same companies also made direct investment in the United States and elsewhere in the world -- category (v) type investments.<sup>30</sup> Fifth, the government of the United Kingdom was not significant as an outward foreign investor.<sup>31</sup> This was, likewise, true of the governments of other major capital-exporting countries.<sup>32</sup> Sixth, FDI was very important (categories (iv) and (v)

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<sup>29</sup> On the importance of railroads and the classification problems, see Twomey (1998). Twomey defined “total foreign investment” as “the sum of foreign portfolio and direct investment,” with the former being loans (including securitized loans, i.e. bonds) and the second being “fixed investment over which the investor maintains control.” He put the railroad sector “somewhere between the categories of portfolio and direct investment,” but in his statistics, he included railroads *in the developing world* as FDI before 1938, but not after. Twomey had an added category of “OFDI” (other FDI, other than railroads). On United Kingdom investments in United States railroads, see Wilkins (1989, chap. 6), where there is documentation on the combinations of bonds and shares held by foreign investors in key United States railroads -- and the ways in which United Kingdom investments in United States railroads were structured. In 1890-96, nine major United States railroads had between 20 and 75 per cent of their equity held abroad (of these, however, only one had over 20 percent of the equity held abroad by 1905). See also Adler (1970); the over 800-page volume, Van Oss (1893); and Veenendaal (1996).

<sup>30</sup> Wilkins (1989, p. 217) found United Kingdom banks, insurance companies, oil companies, and other businesses held American railroad securities as FPI.

<sup>31</sup> The United Kingdom Government did, however, invest in the Suez Canal Company and in the predecessor of British Petroleum Company – two very important businesses over borders. The United Kingdom Government also acted on behalf of private foreign investors in various sets of circumstances – both within and outside the Empire.

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above). In category (iv), there were literally thousands of companies set up in capital-exporting countries that invested globally in railroads, ports, mines, oil wells, plantations, cattle ranches, breweries, jute mills, banking and mortgage lending. Because small companies in host countries that were not European managed (most of them were in category (iii)) were difficult for investors to evaluate and, accordingly, presented major uncertainties, individuals and investment trusts wishing for higher returns abroad than they could obtain at home hesitated to send their monies to “foreign” businesses. The same investors were, however, prepared to invest in known companies, set up in the capital-exporting country that could mobilize capital and provide the means for transferring the capital abroad, while at the same time monitoring its use. These companies [in category (iv)] offered information and reduced the risks for the investor who was making a domestic investment in a familiar currency. The *companies* were the direct investors abroad; they supervised their businesses in the foreign lands -- within and outside Empires. For those firms that survived, they came to add far more than capital to their businesses abroad. For certain capital-exporting countries, by 1914, these may have been the principal kinds of FDI.

The FDI in category (iv) had some characteristics quite different from what we associate with contemporary TNCs. They started anew and did not emerge based on a parent company’s core competencies. They were in clusters obtaining talents from outsiders.<sup>33</sup> However, there were also – in category (v) – a very sizable number of industrial enterprises and insurance companies that bore a striking resemblance in their international business behaviour to TNCs after the Second World War. These firms moved their own core competencies internationally, disseminating high-tech and branded goods and services over borders on a truly global scale.<sup>34</sup> Indeed, we can date the coming of age of “modern” TNCs to the late nineteenth century.

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<sup>32</sup> Once again, Empire often created conducive conditions for private FPI and FDI.

<sup>33</sup> I have called this type of investment that made by “free-standing companies”. Unlike the familiar multinational enterprise that evolved from a home base, these companies were set up anew--hence the term free-standing. See Wilkins (1988), and Wilkins and Schröter, eds. (1998). They were ubiquitous and probably the leading form of managed investments over borders in the 1880-1914 period.

<sup>34</sup> See, for example, Jones (1986); Raynes (1950); Jones and Schröter (1991); and Wilkins (1970).

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And, with both types of FDI [categories (iv) and (v)], firms dispatched abroad more than capital; they spread across borders business cultures and ways of conducting business activities. Seventh, both foreign portfolio and foreign direct investors crafted means of coping with different kinds of *risk*: foreign exchange, commercial, and political risk.<sup>35</sup> Eighth, the presence of a well-developed *stock market* in London (which dealt in bonds, but also equities) was critical to much of the late nineteenth and early twentieth century international investments (the existence of this stock market was essential for the foreign portfolio investors and for some, but not all, foreign direct investors).<sup>36</sup> There were also important stock markets on the European continent and in North America. Ninth, while the literature's emphasis has been on the United Kingdom and on other European countries as capital exporters, these net capital exporters were at the same time the recipients of both inward FPI and FDI; there was a two-way street in both kinds of investment.

There are several crucial matters of note about this last point - particularly as it relates to the United Kingdom, the largest of the capital exporters. First on inward FPI: United Kingdom merchant bankers handled the accounts of continental European investors. Some of the inward FPI that went through the London Stock Exchange went out again as British overseas investments, some of it as FPI (for example, an individual on the continent would buy United States railroad bonds in London), and some of it as FDI (an individual on the continent purchased the securities of a company registered in London that in turn made a FDI).<sup>37</sup> In addition, there was a formidable amount of inward FDI in the United Kingdom.<sup>38</sup> In short, in the first round of major globalization before 1914, both FDI and FPI coexisted, sometimes closely, sometimes loosely inter-related, sometimes quite

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<sup>35</sup> Wilkins (forthcoming). In the case of the FPI, it might not be the investor that developed the risk-avoiding mechanisms; it might be the merchant banker who advised the issuer on how to price and market the public offering.

<sup>36</sup> On this, see Michie (1985, pp. 61-82, and 1992); and Davis and Huttenback (1988).

<sup>37</sup> The United Kingdom was not alone as an entrepôt for FPI. Swiss intermediaries handled French and German accounts, mainly re-exporting capital in the form of FPI. French FPI passed through Brussels, going out as FPI and occasionally as FDI. The Dutch stock market also handled FPI from outside the country, re-exporting these funds – both in the form of FPI and FDI.

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separate. The complexities and changing nature of the relationships between these conduits stand out.

### **Capital movements -- The United States traditions**

After World War I, the United States, a debtor nation before 1914, became a creditor nation in world accounts. Within the United States, new attention was paid to the collection of statistical information (Ross, 1991, pp. 324-325). The United States led in preparing balance of payments records.<sup>39</sup> Beginning in 1922, the United States Department of Commerce began to publish annual studies of the balance of payments of the United States. In this connection, it started to gather data on capital flows and to consider types of capital flow. In the 1920s the Department of Commerce recognized that while certain foreign (outward and inward) investments were in securities, others were by firms that expanded over borders and made investments in operations that they controlled. The Department of Commerce began to distinguish between FDI in “controlled” activities and FPI that consisted of traded securities.<sup>40</sup> Although the Department of Commerce scrutinized both, increasingly its interest laid in FDI.

More gradually, the United States Treasury Department paid attention to international capital movements and by January 1935 it was (along with the Federal Reserve) tracking the purchases by foreigners of American securities -- on a weekly basis.<sup>41</sup> Its

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<sup>38</sup> Jones and Bostock (1996, pp. 207-256); Hagen (1997, pp. 351-380); Wilkins (1970); and Dunning (1998, pp. 8-21). Aside from the inward FDI of a familiar multinational enterprise variety documented in these references, there was also inward FDI by businesses and businessmen who invested in British companies, which in turn used the British joint-stock company form of organization to make direct investments overseas. Wilkins (1998, pp. 15-16). A similar pattern occurred on the continent, with inward FDI in other European net capital-exporting countries and, also, inward FDI by businesses and businessmen who invested, for example, in Dutch companies, which in turn made FDI abroad (particularly in the Netherlands East Indies).

<sup>39</sup> As noted above, the first really systematic work on balance of payments was published in 1919, by Bullock, Williams and Tucker – all Americans.

<sup>40</sup> For an explicit separation of direct investment and portfolio investment, see United States Department of Commerce, Bureau of Foreign and Domestic Commerce (1931, pp. 2-3 and 43-44). This was not the first such differentiation. It appears in different forms in the late 1920s balance of payments renditions.

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information sources were principally financial institutions, banks and brokers. In 1941, the Treasury Department conducted a Census of Foreign Owned Assets in the United States, which separated out different types of foreign assets, including those of “foreign-controlled United States enterprises”. For statistical purposes, the Census determined control on the basis of 25 per cent or more ownership of the voting stock.<sup>42</sup>

The 25 per cent or more criteria was adopted by the United States Department of Commerce as well; the cut-off would be lowered in the 1960s to 10 per cent, first for United States business abroad and then, subsequently in the 1970s, for foreign business in the United States. From the start, in the United States literature on both inward and outward investments, the notion of “direct investment” was identified with a firm’s ability to control operations abroad. This terminology can be found in Cleona Lewis’s seminal work, *America’s Stake in International Investments* (1938). Neither the Treasury Department nor the Federal Reserve used the words “portfolio investments”, albeit Lewis, following the lead of the Commerce Department, in her index (p. 703), refers to “Portfolio holdings. See Securities”. And, advancing through time, Arthur Bloomfield (1968, pp. 3-4) made the distinctions between FDI and FPI in the same way as the Commerce Department had in the 1930s.

In the United States literature, FDI would come to be carefully defined; it was what TNCs did. When John Dunning (1958, p. 55) wrote the *American Investment in British Manufacturing Industry*, he followed the United States tradition in differentiating between FDI and FPI -- and used the United States Department of Commerce’s definitions of direct investment. The United Kingdom (and other

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<sup>41</sup> See Board of Governors, Federal Reserve System (1943, pp. 620-23, 626-29), for data collected on foreign purchases of domestic and foreign securities.

<sup>42</sup> United States Treasury Department (1945). The Census, published in 1945, covered foreign owned assets in the United States as of 14 June 1941. On the 25 per cent criterion, see p. 26, n.3. Earlier, the Department of Commerce had adopted no definite rules on classification, preferring to decide each case of “control” on its merits. See United States Department of Commerce, Bureau of Foreign and Domestic Commerce (1942, p. 34).



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nations) came to adopt the United States terminology in dealing with United States businesses abroad, and later with non-American TNCs as well. Gradually, on a global scale, there came to be a monitoring of “direct” investment, defined in the United States tradition.<sup>43</sup>

In addition, other than FDI, various types of long-term capital flows in the United States were recorded by the Department of Commerce for balance of payments purposes and also by the Treasury and the Federal Reserve. In the years after the Second World War, as statistics became international, long-term capital flow information became available from the International Monetary Fund, the World Bank, the Organisation for Economic Co-operation and Development, and the Bank for International Settlements. National authorities (statistical agencies or central banks) assembled data on capital inflows and outflows and provided information on the various statistical series to the international agencies.<sup>44</sup>

In the process, the term “portfolio investments” became very muddled, as it came to be used in different manners, or not used at all.<sup>45</sup> Throughout the inter-war years, during World War II, and

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<sup>43</sup> Even today the global figures on FDI are still very deficient, albeit the *World Investment Reports* (first published in 1991) have made formidable strides in seeking to develop uniformity (see UNCTAD (1997, pp. 295-302), on the problems of obtaining uniform definitions. To develop appropriate series, recently scholars have been developing and revising *historical* data as well; as noted earlier, there has been a trend toward increasing the portion of FDI relative to FPI in the pre-1914 era – based on both redefinitions and on enlarged research efforts. The most recent rendition on the global level of FDI in 1914 is in Corley (1998, p. 136); some scholars believe these figures are still tentative and may still need to be revised upward. Corley’s figures do not deal with the direction (the location) of the investments, only the source countries. Twomey (1998), suggests that 63 per cent of global FDI in 1914 went to the developing world, compared with only 28 per cent in 1995. If true, these conclusions are dramatic; there is, however, new evidence for 1914 of substantial FDI in the United States, Canada and Europe that may be missed in Twomey’s data; the 63 per cent of global FDI in developing countries may be out of line.

<sup>44</sup> See Mills (1986, pp. 683-694), for data collected on *one* type of FPI: foreign lending by banks. There is no single source for the various types of international capital flows (and stock).

<sup>45</sup> See box at the start of this article. There is not only lack of agreement on definitions, but there is also disagreement as to where to include individual investments. Thus, as an example, Dunning and Dilyard (1999) describe a foreign bank’s “joint-ventures or partnerships” with host country banks as “portfolio investments,” while I would classify this activity as FDI.

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subsequently, discussions of types of foreign investments -- and classifications of the types -- have been abundant. There has been an awareness that different types of investments have different economic implications, but because the tracking of the investments was frequently done by different agencies (and different authors) with different agendas, there has been, until very recently, little analysis of how the types of investments compared with one another (more on this later).

Here, however, it is essential to give a brief background on international investments in the inter-war years, for that period shaped the thinking after the Second World War. The First World War made a major difference. In contrast with the era before the First World War, in the inter-war period the presence of capital controls, large inter-allied debts and reparation obligations arising from the war and its aftermath, periods of formidable currency instability (and only a limited time of stable currencies with the short-lived resumption of the gold standard by major trading countries) and the changes in relative economic strengths of nations affected the size and characteristics of capital flows by source of capital countries and by recipient countries. Government involvements in the capital flow pattern altered radically from the era before the First World War with inter-allied debts, reparations, government currency stabilization plans, or government taxes and regulations.<sup>46</sup> Foreign-financed government debt continued as an important component in capital movements.

As statistics emerged in the inter-war years that differentiated FDI from FPI (and different types of FPI), it was recognized that outward United States FDI had exceeded outward United States FPI in the pre-1914 period. In the 1920s, United States outward private FPI caught up with United States outward FDI. This was United States foreign lending principally in the form of securities (government and corporate bonds). Albeit in the 1920s, the level of

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<sup>46</sup> Kindleberger (1987) (and others) have pointed out that reparations were not unprecedented. But the scale of the German Government obligation was so large it changed the picture. There is no question in my mind that the role of governments was dramatically different in the inter-war period compared with the pre-1914 era.

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outward FDI was also formidable with a vast global expansion of United States TNCs.<sup>47</sup> In the 1930s, from a policy standpoint, in the United States immense concerns arose over foreign debt defaults (affecting United States outward FPI), and at the same time there was a substantial uneasiness over the rapidly rising inward foreign portfolio equity investments – and a fear that foreign withdrawals from United States stocks would send the stock market’s weak recovery from the 1929-1932 debacle into a renewed downward tumble.<sup>48</sup>

In the inter-war period, the United States mix of outward and inward FDI and FPI varied substantially. Moreover, it became clear that the United States “pattern” -- if such a pattern can be discerned -- could not be generalized. The United Kingdom’s outward FPI and FDI and inward FPI and FDI followed a path distinct in its characteristics and proportions from that of the United States.<sup>49</sup> Indeed, the global composition of outward and inward FDI and FPI differed by net capital-exporting and net capital-importing countries

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<sup>47</sup> On pre-1914 years, Lewis (1938, p. 605) and Wilkins (1970, p. 201 and *passim*). Lewis (1938, p. 605), puts the level of outward United States private FPI in 1929 as slightly greater than outward United States FDI. Other United States data show the level of (the position of) outward FDI as larger than outward US private FPI in 1929. Wilkins (1974, p. 54) gives the various statistics that have been provided. Both Lewis and Wilkins dealt with only private investments; thus, neither included inter-allied debt as a United States portfolio investment (this was an obligation of foreign governments to the United States Government). Were this to be included, then as of 1929 the level of outward United States FPI would far exceed that of outward United States FDI.

<sup>48</sup> These concerns were responsible for the Treasury Department and the Federal Reserve deciding that they needed to monitor United States inward portfolio investments (stock market investments) on a weekly basis.

<sup>49</sup> Some of the United States patterns will be traced in Wilkins (in process). Yet her story is only on inward United States investments. Other interconnections were different. For example, in less developed countries, foreign direct investors would lend monies (FPI) to host governments in exchange for mining, oil or agricultural concessions; interest and loan repayments would be made by the government out of the companies’ royalties or taxes due to the host country. See, for example, Wilkins (1974, p. 101).

<sup>50</sup> Based on the author’s unpublished work; when I have made attempts to develop ratios of outward and inward FDI and FPI from different countries, the result is the discovery of an enormous variety not only on a longitudinal basis, but at any point in time from one country to the next. For some of the 1920s complexity on FDI and FPI, see Wilkins (1999).

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and in no way corresponded to the pre-1914 conditions.<sup>50</sup>

### **Capital movements: the observers**

In the 1930s, a sizable literature emerged on business over borders but it did not explicitly discuss capital movements per se. Examples are Frank Southard, *American Industry in Europe* (1930), Robert Liefmann, *Cartels, Concerns and Trusts* (1932) and Alfred Plummer, *International Combines in Modern Industry* (1938). By the 1950s, such archive-based business histories as Ralph Hidy and Muriel Hidy's history of Standard Oil of New Jersey - Exxon (1955) and Charles Wilson's *Unilever* (1954) had appeared. Observers of business over borders also included lawyers, for example, Kingman Brewster's *Antitrust and American Business Abroad* (1958). This set of writings lacked theory. The term FDI was not used. Yet that literature anticipated in an important manner the later work that evolved on the history of TNCs. The histories of individual firms revealed their strategies and motivations when investing abroad. A rich business history literature would subsequently evolve, helping to explain the nature, structure and growth of international business enterprises.<sup>51</sup>

### **Capital movements: the Bretton Woods tradition**

When the International Monetary Fund was formed, its goal was to develop an international system that provided for the elimination of current account restrictions. There was nothing that favoured liberalization of capital accounts. One of the two most important participants in the establishment of the Bretton Woods system in 1944 was John Maynard Keynes, who favoured controls on capital movements. Where the Bretton Woods system differed dramatically from the pre-1914 gold standard was that domestic

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<sup>51</sup> The first business history dedicated solely to international business history was Wilkins and Hill (1964); it was based on data in the Ford Motor Company archives in the United States and abroad.

<sup>52</sup> See Crotty (1983, p. 63), who cites a 1942 letter from Keynes replying to one of Roy Harrod (Harrod had written that in the years after the Second World War the control of capital movements might be unnecessary; Keynes vehemently disagreed); see also, Meltzer (1983, p. 77); James (1996, p. 87) in his history of the International Monetary Fund refers to "capital account movements" as having been "demonized in the academic discussions...."

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economies were *not* to be left at the mercy of globalization. Governments could (and were expected to) develop fiscal and monetary policies to aid their own economies. Keynes felt that “capital controls” were a corollary to doing this.<sup>52</sup> Harry Dexter White, who, with Keynes, was a principal framer of the Bretton Woods plans, had in 1943-1944 been in the environment of the United States Treasury Department, where its Foreign Funds Control Department was uncovering all kinds of “nefarious” capital transfers (Wilkins, in process).<sup>53</sup> Nothing in the International Monetary Fund’s articles endorsed capital liberalization.

If the distinction between current account liberalization and capital account controls was clear in Keynes’s mind, in practice, it rapidly became muddled. In the balance-of-payments tradition, it was accepted that once current accounts began to be opened up, trade finance would be used as a conduit for the movement of capital, and a freeing of the current account would imply a liberalization of the capital account (James, 1996, p. 92). From the start, within the International Monetary Fund, there were deliberations on capital movements: for example, “did an inappropriate exchange rate contribute to capital flight?” (James, 1996, p. 92). Indeed, exchange rate adjustments to cope with exports and imports, it was realized, would affect the movement of capital; they were not separable (James, 1996, p. 112).

Bretton Woods’ considerations of capital movements evolved not from the pre-1914 thinking, but from the experiences with capital movements in the inter-war years, a period that had witnessed capital controls, allied debt obligations and reparations, the futile attempt by the United Kingdom to return to the gold standard, a vast expansion in the last part of the 1920s of FDI and FPI, followed by bankruptcies and defaults, new capital controls, and then chaotic, fluctuating exchange rates and numerous barriers to trade, as well as to capital flows. That FDI had been important in the inter-war years

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<sup>53</sup> Foreign Funds Controls were first imposed in the United States in 1940, to cope with the problems of German military actions in Europe – and the effects on the assets of occupied countries. In the United States Treasury Department from 1940 through 1945 attention was paid to “cloaks” disguising German capital, “looted capital” from occupied territories, and the like.

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(particularly in the 1920s) in the global spread of public utility services and electrical, chemical, automobile and oil industries was far from the frame of reference at Bretton Woods. Likewise, there was no attention to the impact of the expropriations in the oil industry (in Bolivia in 1937 and in Mexico in 1938). Instead, economists schooled in the United Kingdom and United States Treasury departments concentrated on macroeconomic questions such as how policy makers could aid employment and economic growth within individual nations, while not being subject to the vagaries of mobile international capital.

The Bretton Woods system, which sought to achieve stable exchange rates to restore trade and payments, came to an end in 1971 when Richard Nixon closed the gold window; after 1973, the world moved to floating exchange rates. The International Monetary Fund took on a new role. By the end of the 1980s, major trading countries had removed capital controls, and in September 1997, the International Monetary Fund was considering an amendment of its Articles to favour the eventual movement by all its member nations to capital account convertibility (Bhagwati, 1998, p. 7 and IMF, 1998b, p. 4).<sup>54</sup> The International Monetary Fund had not adopted this amendment at the time of writing. There continues to exist substantial opposition within the international community to free capital mobility. Thus, Jagdish Bhagwati (1998, p. 10) has argued that free capital mobility is assumed by some to be “enormously beneficial,” but this failed to evaluate “its crisis-prone downside”. And, then, he added something that had been omitted from much of the debate: “Even if one believes that capital flows are greatly productive, there is still an important difference between embracing free portfolio capital mobility and having a policy of attracting direct equity investment. *Maybe* the amount of direct foreign investment that a country attracts will be reduced somewhat by not having freedom of portfolio capital flows, but *there is little evidence for this assertion*” (emphasis added). Several points concerning Bhagwati’s statement are important for the purposes of the present article: (i) he assumes a complementarity between openness of capital markets and openness to FDI; and (ii) he points out the absence of evidence on the connections between

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<sup>54</sup> Capital controls had existed for the United Kingdom and Japan until 1979 and for France and Italy until 1986 (Frankel, 1992, p. 201).

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## FDI and FPI.

At the Bretton Woods meeting in 1944, when the International Monetary Fund was established, so too was the World Bank. It was to provide funds for the reconstruction of Europe and also for development purposes. In the period after the Second World War, both bilateral and multilateral government foreign aid and concessionary lending supplemented private capital. More than ever in history, governments became actors in international capital movements by providing capital directly, as well as by borrowing, taxing, regulating and supervising.

### **Capital movements: the economic development tradition**

Every economic development textbook has a section on the role of foreign capital in development. In a recent essay titled “A reconsideration of import substitution,” Henry Bruton (1998, p. 907) wrote that in the years after the Second World War, development economists believed that capital formation was the source of growth, that capital within developing countries was inadequate, and that “the savings of the poor countries had to be supplemented by foreign savings if acceptable growth rates were to be achieved” On the one hand, the need for “foreign savings” was seen as an argument for foreign aid. On the other hand, there was wariness about private foreign capital. FDI in raw materials was perceived by development economists as having created dependency: foreign companies had set up enclaves within host countries that had (in the minds of development economists) benefited the investor at the expense of the host country (Singer, 1950, pp. 473-485). Development economists argued that the terms of trade were going against developing countries, and they would continue to do so were developing countries to maintain economies based on primary commodities. Countries needed to industrialize. Some development economists were prepared to accept FDI in manufacturing, but TNCs were perceived as suspect. In addition, a literature on foreign investment and “immiserating growth” began to develop.<sup>55</sup>

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<sup>55</sup> There were many studies on immiserating growth, mostly dating from the late 1970s and early 1980s. See, for example, Brecher and Bhagwati (1982, pp. 353-364).

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Many developing countries took over the railroads, public utilities, mines, oil properties and agricultural lands once owned by direct investors, and there were few (if any) admonitions from development economists.<sup>56</sup> Foreign aid had been expected for development purposes to assist in capital formation. In the 1970s, when there was vast capital availability from banks based on the recycling of the Organization of the Petroleum Exporting Countries surpluses, developing countries rushed to borrow. At that time, most development economists (and developing country governments) believed that borrowing (sovereign debt) was superior to FDI, because control would lie in the hands of the borrower. Every student of economic development studied the “debt crisis” in the 1980s. The debt was to foreign banks; it was not a securitized debt. It was FPI, although it is seldom called that.<sup>57</sup>

As the debt crisis unfolded, many development economists began to reconsider the role of FDI and to consider such investments more sympathetically as an alternative to debt. The *World Investment Report* series coming from a group once hostile to TNCs was calling FDI “an engine of growth” in the early 1990s.<sup>58</sup> At the same time, there was a growing awareness of large amounts of “flight capital” from developing countries. What did the latter do to the economic development process?<sup>59</sup> Flight capital was liquid, portfolio monies. Liquidity and portfolio investment were equated. Then, in the mid-1990s, developing countries began to borrow anew just as the debt crisis problems seemed to recede (Obstfeld, 1998, p. 23). In many developing countries, there were cross investments with inward FDI and FPI in varying proportions and a very high outward FPI/FDI ratio.

Often in the economic development literature, there was little understanding of the dissimilarities between types of capital, although lip service was given to the differences. Thus, Felipe Pazos saw equity capital (which in this 1988 paper he defined as direct

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<sup>56</sup> See, for example, Kennedy (1992, p. 73) (much of this summary of less developed countries’ takeovers of FDI is based on the work of Stephen Kobrin).

<sup>57</sup> Stallings (1987) did use the term “portfolio investment,” as did some other writers.

<sup>58</sup> UNCTAD (1992). New North-South models were prepared with cross-regressions that demonstrated FDI did not have adverse growth consequences. See, for example, Dutt (1997, pp. 164-191).

<sup>59</sup> See the marvelous book by Mahon (1996).



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investment; Pazos, 1988, p. 18) and loan capital as playing “supplementary” roles; he understood that FDI was “an entrepreneurial activity more than a financial transaction”. But then he made the remarkable statement: “Direct investment brings to a country what we might call ‘prefabricated’ industries, ready for use and guaranteed to operate satisfactorily” (Pazos, 1988, p. 18). It was an illusion: there were never guarantees with FDI, as every student of TNCs knew.

What seems evident to the present author is that in the literature on economic development, the accent on measuring the size of capital flows often resulted in the neglect of an understanding of the crucial differences between FPI and FDI in the development process, how different the investors, their motivations, the conduits, and the consequences of FDI and FPI have been, are, and will be, and what was (and is) the relationship between FDI and FPI. This brings us to “theory”.

### **Capital movements: formulating the theoretical distinctions**

There is a long history-of-thought tradition attempting to explain capital movements. John Stuart Mill, for example, believed that over time there would be diminishing returns at home; capital would go abroad to get better returns, which would raise interest rates at home. A short article cannot do justice to the abundant theoretical literature and to the contributions, for example, of Bertil Ohlin, Carl

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<sup>60</sup> Bertil Ohlin’s seminal work, *Interregional and International Trade*, was published in 1933; his early work on trade theory went back to 1924. Ohlin’s concepts became part of the literature as “Heckscher-Ohlin,” since Ohlin developed ideas suggested by Eli Heckscher. While Heckscher-Ohlin dealt with international trade (labor and capital were immobile; trade over time would tend to equalize returns to labor and capital), Ohlin also considered factor movements and the mechanisms of international capital movements. The assumption was that capital would move to locales where the returns were highest. Carl Iversen (who has been very much forgotten in the textbook renditions of international economics, but who was influenced by Ohlin) wrote a most interesting book in 1935 on *Aspects of the Theory of International Capital Movements*. He looked at the nature, causes, and effects of international capital movements; like Ohlin he was interested in the relationships between the movement of commodities and of factors, namely capital. Heckscher-Ohlin-Samuelson refined trade theory. Kemp-Jones is included in current international economics texts.

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Iversen, Heckscher-Ohlin-Samuelson, and Kemp-Jones in attempting to explain international capital movements.<sup>60</sup> Ohlin and others, who wrote in the 1920s and 1930s (and subsequently), were well aware of the barriers to the free movement of capital present in the inter-war years. Their assumption was, however, that absent these many impediments, capital would go where the returns were highest; the notion of diminishing returns at home, present in Mill, was generally not seen as a necessary condition. The framework was efficient markets allocating resources globally.

Indeed, the flows of capital that had come to the United States in the 1930s were perceived as “abnormal” (Feiler, 1935, pp. 63-73; Fanno, 1939; and Bloomfield, 1966). As more than 50 years later, in the 1980s and 1990s, literature on capital flight from developing countries to developed ones, economists expected capital to move from rich countries to poorer ones, to places where the return would be higher because of capital scarcity. In the 1930s, with banking crises, war scares, exchange controls, and great uncertainty in Europe, monies flowed to the United States in search of security. The actors (individual investors and their financial representatives), the conduits (through stock markets), and the motives were identical to today’s “flights to safety”.

Economists considered the relationships of debt and equity in domestic and international transactions and saw the equalization of returns. They discussed government finance and taxation, domestic debt and external debt.<sup>61</sup> They talked about “optimal taxation” of internationally mobile capital. Growth theory included treatments

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<sup>61</sup> For example, Diamond (1965, pp. 1126-1150), discusses internal and external debt and their effect on growth. See also Bierwag, Grove and Khang (1969, pp. 205-210).

<sup>62</sup> Within macroeconomics, in the late 1960s to the early 1970s, the entire Keynesian framework came under challenge; at the same time, there came to be among some economists more sympathy towards freer capital flows than had been the Keynesian view. Since the consideration was of aggregates, little attention was paid to types of capital flow, although there was always the recognition that there were different types of capital that moved over borders. The concern among students of open economy macroeconomics with the relationships between current account deficits, capital flows and national savings/investment ratios deflected attention from the relationships between the types of capital flow.

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of capital movements, as did open economy macroeconomics.<sup>62</sup> In the years after the Second World War, as the barriers to capital movements crumbled, authors still felt a need to explain imperfect capital mobility.<sup>63</sup> Martin Feldstein and Charles Horioka (1980) argued that under conditions of perfect international capital mobility there should be no correspondence between domestic savings and domestic investment, which they found continued to exist.<sup>64</sup> Other authors observed that real interest rates were far from uniform across countries; perfect international capital mobility would wipe out differences.<sup>65</sup> Still others considered “home bias”, finding that investors held a large share of domestic assets in their portfolio – which would not be the case if capital were fully mobile. Kenneth French and James Poterba (1991, p. 222) wrote: “The benefits of international diversification have been recognized for decades. In spite of this, most investors hold nearly all their wealth in domestic assets”. Why, they asked? They answered that: “The lack of diversification appears to be a result of investor choices, rather than institutional constraints”.<sup>66</sup> Increasingly among economists, capital movements attracted attention.<sup>67</sup> There were gains from capital movements, just as there were gains from trade.<sup>68</sup>

Meanwhile, however, back in the late 1950s when United States

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<sup>63</sup> This is discussed in Gokkent (1997).

<sup>64</sup> Feldstein and Horioka (1980, pp. 314-329). Over 10 years later (in 1992), Frankel (1992, p. 201), argued that with United States borrowings in the 1980s, “the traditional ‘Feldstein-Horioka’ finding of a near-unit correlation between national savings and investment has broken down”. Yet, a correlation between national savings and investment did continue.

<sup>65</sup> Mishkin (1984, pp. 1345-1357) and Jorion (1996, pp. 105-126). I am indebted to Giyas Gokkent for these references.

<sup>66</sup> See, for instance, French and Poterba (1991, pp. 222-226, especially p. 222). See Gokkent (1997), for a summary of the home bias literature, the literature that seeks to explain why in most countries investors hold the vast bulk of their wealth in domestic assets. Lewis (1999, forthcoming) has a splendid discussion of the home bias phenomenon.

<sup>67</sup> The IMF hosted a seminar in March 1998 to get views on capital liberalization. Its interpretation of the outcome was that “Seminar participants agreed that the Asian crisis confirmed the importance of orderly and properly sequenced liberalization of capital movements, the need for appropriate macroeconomic and exchange rate policies, and the critical role of a sound financial sector.” (IMF, 1998b, p. 4). The term “financial sector” covered both banking and stock markets.

<sup>68</sup> Obstfeld (1998), p. 10, summarizes the gains, while also dealing with some of the perils.

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business abroad was becoming highly conspicuous, there arose among students of business over borders a discontent with the perception of capital mobility in terms of factor movements, residuals in the balance of payments or the search for a higher return abroad. Capital was not homogeneous. Stephen Hymer pointed out that companies did not go where the interest rate was highest; there were cross investments, and companies in different industries behaved differently. He took issue with the framework of efficient markets. Existing theory did not seem very helpful.<sup>69</sup> Readers of *Transnational Corporations* have grown up in a literature in which Stephen Hymer, John Dunning and Raymond Vernon are household words, as are the younger generation of Louis Wells, John Stopford, Mark Casson, Peter Buckley, Jean-François Hennart, Alan Rugman, Robert Stobaugh, David J. Teece and Edward M. Graham. The links of this group to economics for years went in large part through industrial organization theory (via Charles Kindleberger and Richard Caves), rather than through international economics and international trade. Finally, in the 1990s, international trade theorists have been incorporating the findings more frequently of the TNC literature.<sup>70</sup> Students of TNCs recognized, for example, that FDI could be spurred by barriers to trade: when companies could not reach markets through exports, they undertook FDI to circumvent the trade barriers so as to be able to operate within a particular market. Such a motive would not apply in a discussion of FPI.<sup>71</sup> The theoretical work on FDI was more akin to the Southard, Liefmann and Plummer tradition than to the balance of payments heritage. Yet, an important aspect of this literature separated it from the Southard, Liefmann and Plummer foundations, namely, its increasing awareness that the focus should be on the TNC

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<sup>69</sup> John Dunning and John Dilyard argue in their paper in this issue, "Towards a General Paradigm," that "until the early 1960s, the theory of foreign investment was essentially a theory of international portfolio...capital movements." I would agree.

<sup>70</sup> See, for example, Bhagwati, Dinopoulos and Wong (1992, pp. 186-190); Markusen (1995, pp. 169-189); see bibliography therein. Strategic trade policy does deal with FDI. I wrote this before I read Raymond Vernon's presentation to the AIB Vienna conference. He too makes the point that recently "the near-silence among trade and investment theorists on the overwhelming role of multinational enterprise has finally been breached."

<sup>71</sup> This type of "defensive" investment was only one of many motives for FDI.

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as an entity with specific organizational competencies, that is, an entity that serves as a repository of knowledge, embodied in operational routines.<sup>72</sup> What has become ever more recognized is that the activities of the firm include FDI as only one aspect, one part of the business of the TNC.<sup>73</sup> With the understanding of FDI as a function or as an activity of a TNC, the disjunction between FPI and FDI is brought to the fore.

Yet, both FPI and FDI do involve capital movements. In reuniting the literature on FPI and FDI for comparative purposes, it is useful to look at the participants in FPI, as well as those in FDI. If we consider who makes FPI and the motivations, conduits and investor choices, then comparisons between FPI and FDI become more meaningful. To a large extent, the reason for the divergence in the literature is that statistics warped our views: scholars thought they were talking about the same things, namely, the flow of capital over borders, but, in point of fact, writers on FDI were discussing firms' operations over borders (including more than the finance function), and only secondarily how capital spread across borders and was accumulated in the process of national growth.

Business history, which looks at a firm's records and the strategies of individual firms over time, helps us understand the "longitudinal" activities of the international firm, the entire firm, and its activities (processes) in expansion, restructuring and sometimes contraction. From the earliest of modern TNCs dating from the late nineteenth century, firms raised capital where it was available or cheap. The TNC has a tissue of business over borders, and to consider solely bilateral capital flows distorts an understanding of its role. The firm is a mobilizer of capital that it devotes to the production of goods and services. It must be considered as a business, with all the

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<sup>72</sup> See Coriat and Dosi (1998, p. 103). This is not by any means true of all the new theoretical contributions, but it would seem to reflect the "mainstream approach." For a rather neat summary chart on the "historical evolution of foreign direct investment theory," indicating the broad variety of different contributions to theory, see this issue Casey (1998, p. 20), and of course, see Dunning and Dilyard (1999) for OLI.

<sup>73</sup> The recognition of this is general, but it is *not* reflected in much of the *vocabulary* still present in the literature. Thus, Markusen (1995, p. 170), writes in the traditional manner: "The terms 'multinational enterprise' and 'direct foreign investment' will be used fairly interchangeably."

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business attributes (including production, engineering, research and development, marketing, purchasing, and most important the management of these resources). Its participation in business over borders has continuities; it is not simply taking part in a one-time source-host country flow of capital (indeed, there may be no capital flow at all if TNC assembles capital in the host country and puts it to productive use). The provision of capital is only a small part of what a TNC does. The firm stimulates information flows on new products, processes, forms of organization, methods of purchasing, types of marketing. It provides the basis for innovation; its impact lies in its broadly defined technological contribution as much as in capital per se. The TNC looks to the return on the composite of its assets (experience, processes, products, etc.) that are managed within the firm.

Where does FPI fit into this story line? Who are the investors, what are their motives and what are the channels for investment? We return to our initial distinctions: in the case of FPI, the investors are individuals, financial intermediaries acting on their behalf, financial institutions, and non-financial firms, making passive investments not part of a business operating strategy. Investors can come from the public or private sector. Most investors seek better returns than they would obtain with a purely domestic portfolio; they look to financial returns tempered by evaluations of uncertainty and risk (commercial, political and exchange rate risk); in the main, their motives are financial. I write of “most portfolio investments”, for governments may invest abroad to stabilize currencies; foreign concessionary loans may also be made with political goals. However, in recent years government pension funds have become large international investors, and their managers’ motives resemble those of their counterparts at private pension funds, albeit some of the former may be more conservative in their purchases of foreign securities.

The point has been made that the financial investor allocates resources with the goal of profitability, but profitability on the individual investment rather than on “the package” of resources as is the case with the TNCs. This may not be entirely accurate since mutual funds and pension funds undertake financial diversification of their portfolios. Such institutional investors allocate their diversified portfolios in a safe as well as profitable manner. Channels

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for FPI involve initial public offerings, stock market transactions and direct activities.

The portfolio investor operates in imperfect markets. Individual portfolio investors have limited (and different) information. There are often gaps in information, in quantity as well as quality. Users need to sort and to evaluate a flood of data. Portfolio investors frequently fail to share the same perceptions and expectations. Unpredictable fluctuations in exchange rates and interest rates alter the value of investments. Uncertainties abound. As a result, it should be of no surprise that there is home bias (more investment in the familiar home market than abroad), no surprise that there are cross investments in FPI (as in FDI), and no surprise that there are sectoral differences in FPI (as in FDI).<sup>74</sup> A number of the points that Stephen Hymer made in distinguishing FPI from FDI do not hold (they apply to FPI as well as FDI). Yet, out of the theoretical discussions there have surfaced clear and important distinctions between FPI and FDI related to actors, motives and channels.

### **Capital movements: the actors and the concept of control**

At the beginning of this article, I accepted the distinction between FPI and FDI as associated with the notion of control: the direct investor has the potential to control, to manage foreign assets. The portfolio investor does not intend to exercise control over the acquired foreign assets. Although, in the main, this distinction between FDI and FPI seems simple, complications and ambiguities abound with the inevitable delegation of control in the case of FDI.

With FDI, parent company control is always tempered; even with 100 per cent ownership, local managerial staff may effectively

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<sup>74</sup> See McKinnon (1991, pp. 115-116) (“on market failure in the adjustment of international asset portfolios”).

<sup>75</sup> For some of the problems in defining “the nature of control,” see Wilkins and Schröter, eds. (1998), *passim* (the contributions of Wilkins, Mark Casson, Jean-François Hennart, T.A.B. Corley, Natalia Gurushina, and Ben Gales and Keetie Sluyterman all deal with this matter); see also Wilkins (1986, pp. 80-95). The three cases early in Dunning and Dilyard (1999) deal with some of the ambiguities related to business strategies and “control.” Case 3 provides circumstances where 100 per cent ownership did not carry management, albeit in that case, as in the illustration I used, managerial authority could be exercised.

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“control” an affiliate, although the parent can, if need be, remove the affiliate’s top management and install a new team.<sup>75</sup> I prefer the phrase “potential for control” rather than control, for in TNCs control is likely to be in differing degrees decentralized, delegated to “agents”, and may not be effectively exercised.

When the Canadian company, Seagrams, had an equity investment (over 10 per cent) in Du Pont, Commerce Department definitions notwithstanding, some economists saw this as FPI, since it was unrelated to Seagrams’ business. I believe it should be categorized under the rubric of FDI, as part of Seagrams’ business strategy (Seagrams’ representatives on the Du Pont board did, by all reports, have influence). At times, linked with a business strategy, TNCs may make small minority equity investments, often for information purposes; in those cases, there is no intention to run the business, to manage the activity, or to install new management, although in some cases there may be aspects of control or influence.<sup>76</sup> Sometimes such minority interests exceed 10 per cent (other times they are less); sometimes they involve board representation, or sometimes board representation is nominal (i.e. the board member does not attend or participate). Historically, minority stakes have been numerous.<sup>77</sup> For any particular TNC, I would call such investments – direct investments because they are part of the firm’s business strategy.<sup>78</sup>

Control can be seen in tiers: investors (domestic and foreign) in General Motors (GM) do not exercise control (in the main, the out-of-country investors have inward FPI in GM); GM in turn has outward FDI.<sup>79</sup> Yet, Seagrams had (in my view) inward FDI in Du

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<sup>76</sup> With alliances, enterprises may want to have influence on the behaviour of an ally; this was certainly true with minority interests in inter-war international cartels. Companies often have minority interests in suppliers, just to keep track of what is happening.

<sup>77</sup> On minority interests, see the fascinating discussion in Hennart (1998, pp. 68-74).

<sup>78</sup> For example, in Wilkins (1997a, pp. 49-50), I provide information on an ICI minority investment in GM stock, a financial investment, albeit part of the business strategy of ICI.

<sup>79</sup> In the main, foreign investors in large American companies would have FPI, albeit investments could be *for the foreign investor* a FDI if it were part of a business strategy (as in the previous note 78).



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Pont, while Du Pont undertook outward FDI as a TNC. Should Du Pont's outward FDI then have been considered as a Canadian investment passing through the United States firm? We are talking here about defining a firm, as well as defining firms within a firm -- the rough edges of the firm.<sup>80</sup>

Perhaps in delineating motives for FDI and FPI what is key is the concept of "business strategies" versus "investment strategies", the focus being on the individual investor, the actor. A business (as an investor) has an overall strategic programme and its investments must fit together. Expected return are calculated on the financial, technological and managerial "package". Interventions in changing management and obtaining appropriate information are what businesses do. By contrast, the intent of the foreign portfolio investor is generally financial (with the exception of certain outward FPIs by governments). Information is required to make the best choices. The foreign portfolio investor, however, does not want to intervene, nor plan to do so; while the investment may round out a "portfolio", the motives are not the same as those of the foreign direct investor.

In privatization processes, consortiums involving bankers (who arrange to have securities of a newly privatized company issued, priced and marketed) and direct investors coexist and complement the activities of one another. The banker may bring in the TNC with its special expertise (rather than the TNC seeking out the banker). In such cases, FPI by the banker, or by other investors (if there is an initial public offering) complement FDI in the same activities. FDI and FPI seem, at least conceptually, to be separable.

Yet, the purity of the distinction is absent. Foreign portfolio investors may be large enough so that they are not price takers in the market place. A big mutual fund, pension fund or insurance company that decides it does not like the performance of a security in its portfolio may depress the price of that security by selling it and thus have influence on the underlying firm.<sup>81</sup> When borrowers default,

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<sup>80</sup> I discuss this in detail in Wilkins (1986).

<sup>81</sup> There are discussions now on whether mutual funds *should* vote their stock, intervene to replace deficient management, and take an active role, rather than sell at a depressed price.

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historically, creditors have intervened to restructure loans. Thus, while a portfolio investor would prefer to stay aloof, this may not be optimal. Nonetheless, these are FPIs because of the actor's basic motivation and intent.

There are, however, even "muddier" cases. How does a focused "holding company" with large interests in affiliates abroad differ from a mutual fund or holding company with a specialized financial portfolio of securities?<sup>82</sup> Also, what happens through time may permanently alter control relationships: FDI can change into FPI, through the dilution of ownership and loss of all possibility of "control". Similarly, FPI can turn into FDI through loan defaults (and the need "to rescue" what had been a purely "financial" investment; temporary restructuring can turn to a full "control").

If there can be a blurring between business and financial strategies, other kinds of relationships seem more readily demarcated. Firms have financial managers who put surplus funds temporarily into foreign securities unrelated to a business. These are FPIs made by TNCs. Are they a substitute for FDI? I do not think so – at least the trade-off is generally not between the two choices mentioned above. There are other options too: the monies could be invested domestically (within or outside the company), or they could go into short-term investments. The motives of a non-financial firm for FDI (overall company strategy) and for FPI (usually temporary use of funds) are discrete and related. Also, it is easy to view banks and other financial institutions as TNCs: they undertake FDI when they invest in doing business abroad; they make FPI when they invest in foreign stocks or bonds on behalf of clients, or when they engage in long-term international lending. There is also the case of transnational

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<sup>82</sup> Were investments of a diversified company such as Hanson FDI or FPI? Hanson's stake was usually well above the 10 per cent cut-off; it had an overall strategy in its investments; I would call its interests FDI. But, what about a financial holding company or a mutual fund that invested only in public utilities – less than 10 per cent – but virtually all in a familiar known industry? In one particular case that I have in mind, these were financial investments; I would call them FPI. In order to define the distinctions, one needs to know the business history, yet even knowing the business history may not remove the definitional and classification problems.

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insurance companies, which invest in portfolios of securities within a host country – an actor that combines both FDI and FPI.

In separating FDI from FPI, some scholars have considered the matter of information, arguing that through FDI and resulting “control”, the foreign direct investor has better information than the foreign portfolio investor. I am not certain that this is a legitimate distinction. With FDI, there are principal/agent problems within the enterprise. A foreign affiliate head may have separate interests (or may, for other reasons, provide partial or inaccurate information to the home office). Emerging nation funds have “experts”, who evaluate investments. Investment banks and others, which price “new issues”, collect substantial information. With both FDI and FPI there is asymmetric information and imperfect contract enforcement. What seems important is that the mechanisms (the channels) for obtaining information, and sometimes the kinds of information sought about investments are likely to be different for FDI and FPI.

In sum, the line between the actors engaged in FDI and FPI is not always sharply delineated, but the overall separation between the firm (the actor) that makes FDI as part of a *business* strategy, compared with the investor whose motives are financial returns with no intent (or desire) for influence or control seems a valid and fundamental distinction (except in the case of some government outward FPI). In general, with FDI and FPI, the conduits for investment are different (FDI goes through the firm; normally FPI involves bankers, brokers, stock markets). Interestingly, when there is an ambiguity in the “divide” between FDI and FPI, the relationships seem to suggest complementarity in most situations rather than substitution.

## **Secondary markets: the conduits**

FPI can go directly to a foreign producing activity, when there is a bank loan or an initial public offering of corporate shares or bonds. However, if the FPI goes to a government loan, either securitized or not, what the government does with the borrowings

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<sup>83</sup> Fishlow (1985, pp. 383-439), discussed the debt crisis of the early 1980s in the context of earlier debt crises. His essay is important in discussing the nature and locales of international investment and whether foreign capital went into productive activities. He does not deal with secondary markets.

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may or may not go to a productive activity.<sup>83</sup> With a new security issue (an initial public offering, an IPO), the monies raised goes to the recipient, minus the transaction charges by the financial intermediary. Lending to a government is designed to go directly to the recipient. But, much of FPI involves *traded* securities, purchases and sales of financial assets, and FPI has often been perceived as involving “financial assets” rather than “real property”. Yet, financial assets provide the basis for the “real” asset. Stock markets are important as allocators of resources. Still there are clear differences between FPI that goes directly to an economic activity (or to a government borrower) and FPI that goes through stock market transactions. Where there are securities involved, the presence of stock markets are critical to the private (and sometimes the government) investors’ strategies; foreign portfolio investors want to have the ability to divest, to have liquidity.

FDI can comprise new investments (“greenfield” ones) or acquisitions and mergers. When acquisitions and mergers occur, there may be stock market transactions and once again a reallocation of resources. The differences between FPI and FDI in this connection are linked with “lumpiness” and indivisibility. FPI in traded securities on secondary markets tends to be volatile. With acquisitions and mergers by TNCs that include the purchase of previously traded securities, there are corporate negotiations and the securities are acquired in a block. In addition, when a foreign direct investor has *partial* ownership of an affiliate, the non-owned portion might be traded on the stock market (involving domestic portfolio investors – and possibly FPI). The activities of the foreign direct and foreign portfolio investors involved in traded securities are different. Stock markets are a principal conduit for FPI, but an auxiliary one for FDI. The associations of FDI and FPI in secondary markets add a layer to the puzzle as we evaluate the different types of investment.

### **Capital movements: the era of fluctuating currencies**

Much of the earliest thinking about international capital movements occurred at a time when major currency exchange rates were fixed (in the gold standard era), or in the inter-war years and in most of the so-called “Bretton Woods period”, when there was the

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assumption that fixed rates or stable currencies would or should exist. Only after 1971 have fluctuating currencies become the “norm”; even though many traditionalists have had a “hankering after fixed rates”, the introduction of the *Euro* is seen as a way of creating regional stabilization, and certain countries have managed for brief periods to fix their currencies against the dollar or other major currencies. Nonetheless anyone writing on international capital movements in the last quarter of the century has had to take into account sharply fluctuating exchange rates.<sup>84</sup> What has in part helped to unify the FPI and FDI literature is the universal discussion of imperfect markets and uncertainties. Both types of literature now deal with information asymmetries. If rates are fixed, it does not matter in what currency obligations are denominated; with floating exchange rates, the currency denomination of the obligation makes an immense difference. All international investors must deal with this, but the methods available to the foreign direct and foreign portfolio investor tend to differ along with the conduits: a TNC probably has more alternatives at its disposal to hedge on fluctuating rates than a foreign portfolio investor.

The recent changes in FPI have been more dramatic than in FDI. The emergence of some 90 stock exchanges around the world, with securities denominated in national currencies, creates new complexities. With Internet and electronic transfers, decisions can be executed with unprecedented speed. Mutual funds and pension funds have multiplied – and many of their managers have assumed (perhaps incorrectly) good knowledge of “emerging nation” opportunities. New financial instruments have proliferated, furnishing more opportunities for risk management (and speculation) on an international scale.<sup>85</sup> The world of floating exchange rates added to interest rate fluctuations has encouraged hedging operations. New kinds of FPI evolved with derivatives and other money market

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<sup>84</sup> For the impact on thinking about FPI, see for example, Frankel (1992, pp. 197-202). For the impact on thinking about FDI, see, for example, Froot and Stein (1991); Froot (1993); and Aliber (1993, chaps. 3 and 5). For the more general impact on international capital movements, Obstfeld (1998, pp. 14-18).

<sup>85</sup> The new instruments were seen as serving to stabilize markets, to drive “the financial system toward greater economic efficiency.” See Merton (1998, p. 340). Whether they, in fact, decreased or increased risks to the investors is an open question.

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instruments. Hedge funds, such as Long-Term Capital Management Fund, came into being. Long-Term Capital Management Fund was a hedge fund involved in bond (and equity) arbitrage, that is, taking advantage of the differences between bond (equity) prices of different securities to make profits. The Fund's investors have been domestic and international (inward FPI) and its investments have been global in nature (outward FPI). Long-Term Capital Management Fund represented a combination of inward FPI with outward FPI.<sup>86</sup> In the fall of 1998, when Long-Term Capital Management Fund was in deep financial trouble, the New York Federal Reserve assisted a 14-bank consortium (made up of United States and foreign banks) to take "control" of the fund and to provide it with \$3.6 billion of new equity. The foreign banks' FPI was thus transformed into FDI.<sup>87</sup> Where do such funds and the banking participants fit in the discussion of "long-term capital" flows? Do such hedge funds not make a parody of traditional definitions of long- and short-term?

### **The statistics: the evidence**

In part because of deficiencies in the collection of comparable statistics, elusive definitions, lack of understanding, buying and selling on secondary markets, and floating currencies in recent decades, meaningful efforts notwithstanding, the statistical evidence covering FDI and FPI over lengthy periods of time is nothing short of frustrating. This was true even before the problems became compounded in a world of fluctuating currencies. There exist numerous data sources: national and international, but as yet no uniformity in the assembly of data on FDI and FPI. Moreover, to

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<sup>86</sup> There is nothing unique about hedging *or* hedging in international transactions. The scale and the instruments in this case were, however, very unique. The inward/outward mix of FPI also lacked uniqueness: the "international relationships" as such were not unlike that of international investors in any mutual fund – inward FPI – while that fund made outward FPI – i.e. a combining of inward and outward capital flows.

<sup>87</sup> The "bail-out" deal was signed on Monday, 28 September 1998, and the banks took control the next day; *Financial Times*, 30 September 1998. The earlier matters that I discussed on "control" seem germane; the 14 financial firms agreed to retain John W. Meriwether and his management team "intact." Thus, although the investors assumed "control," they delegated managerial authority to Meriwether and his original partners. *New York Times*, 3 October 1998. The "control" involved watching him more carefully.

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improve the data, international tabulations are regularly revised, so past statistical trends through time look different in light of the new series.<sup>88</sup> Likewise, data from different sources often tell different stories.

Data are further complicated by confusions over “new” international flows and changes in foreign ownership. Thus, for example, if there is an issue of United States Government debt and; (i) foreign investors pick up a certain share; (ii) over time, those foreign investors sell to one another; or (iii) sell back to United States person; and (iv) United States persons may in time sell the securities to foreign investors. The initial foreign purchase of a new debt issue:

- Clearly involves an inward flow of monies.
- The sale of such debt securities to another foreigner keeps the level of foreign investment the same, albeit the individual investor changes, hence, the nationality of the foreigner may also change.
- The sale back to United States persons involves a divestment by foreigners and a change in ownership of the national debt; it does not alter the size of the national debt in any way.
- So, too, the United States persons’ sale of the national debt back to foreigners means new foreign monies flowing into the United States; the ownership of the national debt moves from domestic to foreign, but the overall debt obligation does not change in any way (but the interest payments on the debt and the debt itself are now once more a foreign rather than a domestic obligation). United States Treasury bonds are a dollar obligation, so there is no confusion in relation to United States accounts. On foreign books, however, these obligations alter

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<sup>88</sup> For example, compare the *trends* in global inward and outward FDI flows (1984-1995; 1985-1996) as provided in the UNCTAD (1996, pp. 227, 233), and the UNCTAD (1997, pp. 303, 308). The 1996 Report showed a jagged course of FDI inflows and outflows, rising to a peak in 1990, falling in 1991 (for inflows) and 1991-1992 (for outflows), and then rising to a new peak in 1995; by contrast, the revised figures in the 1997 Report show a steady rise in FDI inflows and outflows 1985 to 1996. Total inward and outward FDI flows should be roughly identical (the differences explained by January and December disparities). None of these global figures is adjusted for global inflation.

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with currency fluctuations.

When data are available, it is often not clear how to interpret them. Roy J. Ruffin and Farhad Rassekh charted United States private assets abroad (position data) -- both FDI and FPI -- in constant dollars for the period 1970-1983. The results are striking. United States outward FDI exceeded FPI during the period 1970-1976, increasing gradually during those years, barely rising during 1977-1979, and then declining gradually. In the same period (1970-1983), United States outward FPI rose steadily (albeit at times with a jagged course), surpassing FDI in mid-1976, and then soaring upward.<sup>89</sup> John Dunning and John Dilyard in this issue have assembled a set of international statistics on inward FDI and FPI (flow data) covering the period 1980-1995. In their Appendix 1.1, they used IMF definitions and IMF balance of payments data.<sup>90</sup> Their findings are extremely useful, but cannot be generalized for any period beyond these 15 years. Their data show that global FPI inflows (with the exception of the years 1981, 1982 and 1987) have exceeded FDI inflows. By contrast, these same inflow figures indicate (in Appendix 1.2) that the pattern was quite different for developing countries, and that in every year except 1992, 1993 and 1994, developing countries received more FDI than FPI. Taking data from the World Bank, which uses different definitions (in Appendix 2), Dunning and Dilyard show that for developing countries, in 1980 and 1981, inward FPI flows exceeded FDI flows, while the opposite was true for the period 1982-1995. Indeed, the figures show negative inflow figures (i.e. net outflow figures) for FPI in the period 1985-1988.<sup>91</sup> Their story line for developing countries during 1980-1995 is that inward FDI generally exceeded inward FPI. But if the reader looks at Michael

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<sup>89</sup> Ruffin and Rassekh (1986, pp. 1126-1130), and back-up data sent to Wilkins by Roy Ruffin, 13 January 1987. Ruffin and Rassekh included in the category FPI all United States private assets abroad except FDI, thus including short- as well as long-term investment. The authors used dollar denominated data from the *Survey of Current Business*. Their conclusion on the relationships between outward FDI and outward FPI: "Within the framework of a modified portfolio-balance model, we have not been able to reject the hypothesis that foreign direct investment displaces an equal amount of portfolio investment" (p.129). See also note 112.

<sup>90</sup> The flow data on inward FDI is the same as in UNCTAD (1996).

<sup>91</sup> Dunning and Dilyard this issue. The 1985-1988 figures for FPI would reflect flight capital.



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Twomey's figures (who used stock rather than flow data) comparing FDI to foreign investment in general in developing countries for the years 1980, 1990 and 1995 FDI represented 23 per cent, 26 per cent and 38 per cent of total foreign investment, i.e. in each case, inward FPI exceeded inward FDI.<sup>92</sup> Twomey's figures are not easily reconciled with the Dunning and Dilyard findings (Twomey's data, moreover, go further back in time; he found that in earlier years the FDI/foreign investment ratios in developing countries were higher not lower, e.g. in 1971, FDI accounted for 48 per cent).<sup>93</sup> When Dunning and Dilyard looked at East Asia and Latin America separately during 1975-1995, they found that the FDI/FPI pattern of flows to each region varied, albeit in each case the ratios of FDI to FPI were the lowest during 1975-1981, and the highest during 1982-1988, before declining during 1989-1995.<sup>94</sup> One reader of this paper (Peter Gray) asked how government flows of FPI (government lender/government borrower) relate to private FPI and FDI. What is their influence on the overall FPI/FDI ratios? Do they have the same sign as private FPI and FDI? I have seen no research on these important questions.<sup>95</sup>

As we grope with the fundamentals in measuring and understanding FPI and FDI we have to view existing global statistical data with a highly critical eye. Our void in knowledge (and in interpretation of the knowledge we have) remains deep. It would be useful to have reworked statistics over long periods with uniform definitions and methods of collection that provide international data which could help us gain insights into any patterns that may exist on the relationships between FPI and FDI. We will probably want to use flow and stock data – assuming accuracy – for different purposes and in response to different queries. For the present, despite the many splendid efforts at data collection, there continues to be profound weaknesses in the statistical evidence on which to base solid

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<sup>92</sup> Twomey (1998).

<sup>93</sup> John Dilyard suggests that part of the difference might relate to the fact that Dunning and Dilyard were only dealing with private flows, while Twomey's work was more comprehensive [Dilyard to Wilkins, (e-mail), 13 November 1998].

<sup>94</sup> Dunning and Dilyard (1999). It would be useful to have such figures over a longer period to see if there was a consistent alternation.

<sup>95</sup> Gray to Wilkins, 26 October 1998.

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conclusions on the detailed relationships between inward and outward FDI and FPI over time and by country.

### **Conclusions and policy implications**

Data problems notwithstanding, some points do stand out. First, it seems worthwhile to try to understand the differences (and similarities) between FPI and FDI, since both are associated with the large contemporary capital flows.<sup>96</sup> The historical evidence makes it clear that FPI and FDI have long coexisted and their proportions -- outward and inward -- have not been consistent through time. To repeat, FDI is undertaken by TNCs as one of their many activities. There are multiple ways of financing TNC operations and corporate staff (with different degrees of sophistication) take advantage of the flexibility available to large TNCs. The flows of FDI must, therefore, always be seen in the context of the overall operations of TNCs. Accordingly, neither capital flow nor stock data on FDI may be the best measure of the economic impact of TNCs: more may be revealed by other yardsticks of the affiliates' activities, such as sales or revenues, employment, size of payroll, volume of purchases, and fixed capital investments in a particular country, as well as exports, independently or in comparison with other firms in the particular country.<sup>97</sup> Which measure is employed depends on what questions we are trying to answer.

With FPI flows, until we get an accepted set of definitions, not only our statistical data, but also our analysis will continue to be tentative and qualified. In these conclusions, I am using the definitions I provided at the start of this article. To reiterate, I am paying attention

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<sup>96</sup> The size of the capital movements in the 1990s has no historical precedent. In 1998-1999, with electronic instructions taking seconds, with 24-hour global markets and average daily worldwide financial transactions estimated to surpass \$1 trillion, with individual multinational enterprises' providing a range of products, with different processes, needing more varieties of inputs, and operating in more countries, there is a greater speed and volume in transactions and more market and intra-company linkages on a global scale than ever in history. The extent of this international integration is very new. Calculations on the level of foreign investment in the United States (at yearend) as a percentage of United States GNP provide one indicator of the dramatic change: in 1996, foreign investment in the United States as a percentage of United States GNP came to 40.5 per cent! As recently as 1990 the same figure was 25 per cent, which was not much higher than the almost 20 per cent figure of 1914. For details on the way I calculated these percentages, see Wilkins (forthcoming).

<sup>97</sup> Lipsey (1993), made some of these points.

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to long-term investments only (defined by the instrument) and for me, FPI can be in debt -- securitized or non-securitized -- or equity; all long-term investments that are not FDI are FPI. Whereas daily measures of FDI flows are not meaningful (much less needed), with FPI flows, such measures do help us understand economic impacts.

The separation in thinking about FDI and FPI that has arisen in the literature has not been capricious. The actors are different. There are different motives. The conduits are different. Data must be collected from different sources to understand the nature of each type of investment. From the recognition that the actors' motivations and behaviour -- the actors' intentions -- are different, it follows that the consequences of each investment are also likely to be different and have distinct policy implications. This is a key justification for analysing the relationships between these two types of investment. (Perhaps, also, it may be appropriate to disaggregate further and not treat all types of FPI as a single category.)

Second, although all of the above is true, some of the past distinctions between FDI and FPI stemming from the work of Hymer seem vulnerable. Both FDI and FPI occur in world markets where capital does not flow freely.<sup>98</sup> Markets are imperfect. Exchange rate and interest rate differentials persist. Full information is absent. Information is asymmetrical (and limited in quantity and quality). There is imperfect contract enforcement. Legal and tax regimes are different. In both the case of FDI and FPI, attempts (by investors or their agents) are made to alleviate the problems apparent in imperfect markets. In both cases, capital does not go where interest rate are the highest, even though FPI may be said (see Dunning and Dilyard, this issue) to be "primarily prompted by higher foreign [real] interest rates" - adjusted for risk, and in the case of portfolio equity, asset appreciation as well. With both FDI and FPI, there are many documented cross investments. In both cases, all sectors and industries are not equally interesting to investors.

At the same time, the substantial differences between FDI and

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<sup>98</sup> There is probably a freer flow of capital in the 1990s than at any time during the period after the Second World War, but threats of government intervention to temper the free flow at once will send capital into flight. No one now assumes markets will by necessity remain without interventions of various kinds.

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FPI are evident. Not only are the actors and general motivations different, but also the actors respond to market imperfections very differently. So, too, there are differences in the sources and applications of information. Bilateral obligations are structured differently; considerations on what currency an obligation is denominated may well be different in the case of FPI and FDI. The motivations behind cross investments are also different. Public sector/private sector relationships are distinct. The public policy implications of these differences are multiple.

With FDI, the actors are TNCs and their decisions based on business opportunities (associated with economic conditions), political circumstances in a host country, familiarity (how far away geographically, culturally and politically a country is), third country considerations, and corporate experience.<sup>99</sup> Transnational corporations have core competencies. The financial structure of the unit abroad is determined within the context of the TNC. Cross investments have long existed, and there is global competition within many key industries. The TNC in its conduct of business across borders has numerous and various specific relationships with governments.

In the case of FPI, the key actors and conduits are individuals, institutional investors, banks, brokers and stock markets. The intermediaries involved in such investments are typically different from those involved in FDI. FPI may go directly to the recipient (when the latter borrows directly, or when there is a new issue of bonds or equity), or it may be in traded securities. Thus, the ways in which the monies are translated into productive or non-productive activities are separate from those of FDI, as are the obligations entailed. Financial considerations are generally uppermost in the case of FPI. These investments are usually more liquid and more volatile than those made by TNCs, albeit that is not the case with certain FPIs. Security (the search for quality, the avoidance of risk) may be an important factor in FPI -- tempering in a critical manner the overall flows to higher foreign interest rates. International portfolio investors, like domestic ones, invest in growth businesses, often looking to an appreciation in the value of their investment

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<sup>99</sup> On these five "parameters" of decision-making, see Wilkins (1994, pp. 33-40).

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security (rather than high dividends). Cross investments in the case of FPI are related to portfolio diversification and the search for safety as well as to varying expectations by investors. Investments in government debt have always been an important part of FPI; governments are also, however, significant in the outward flows of FPI. Regulatory and tax considerations are not the same for foreign portfolio and foreign direct investors.

The impact of inward FDI and FPI on host economies is markedly different. Capital is *not* homogeneous. Its use is what matters. As I have many times noted, a TNC transfers core competencies and expects return on the whole package, not only on the capital provided and mobilized. The host country that attracts TNCs obtains a business (with its know-how, technology, management, marketing outlets, etc.), not only the funding for that business, and the investor expects the business to perform and takes part in its management. The “visible hand” of the firm allocates the resources to productive use. By contrast, the foreign portfolio investor expects generally to leave the management of the business (or government) to the recipient, or in the case of the volatile portfolio equity investments of recent years, the management of the underlying asset is in place. Incentive structures in the use of FDI and FPI funds are entirely different. The responses to inadequate performance of the investment can be expected to be different with FDI and FPI. The impact of FDI on stock markets tends to be indirect.<sup>100</sup> When FPI involves host country securities (stock or bonds), it becomes associated with the functioning of national stock markets and can have a major impact on stock market performance, especially if markets are “thin”.

There are different foreign exchange requirements in servicing various kinds of foreign obligations.<sup>101</sup> With FDI, there is no service requirement, unless there are profits (for the equity); for the debt component of FDI, this is controlled by the TNC, and obligations can be shifted. Bank debt and bonds require set servicing (whether or not the underlying enterprise makes profits). Portfolio equity that is traded in the local currency will need to be translated into the

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<sup>100</sup> As noted, less than 100 per cent TNC ownership of an affiliate can involve complementary stock market listings; these probably enhance the working of stock markets.

<sup>101</sup> Peter Gray made this point.

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investor's currency when sold. In short, FDI and FPI represent diverse kinds of claims on foreign exchange.

Whereas with FDI managers allocate resources and their activities provide direct and indirect benefits, with FPI it is assumed that the "invisible hand" of the market will channel resources into their most productive uses and, accordingly, raise economic growth and welfare -- nationally and internationally.<sup>102</sup> FPI may serve "to discipline, imprudent government policies".<sup>103</sup> However, FPI can also "exacerbate financial crises that threaten the stability of the international monetary system".<sup>104</sup>

Third, on the sequence of FDI and FPI: I am not satisfied that there is any discernible sequence in global FDI and FPI over the past decades, much less century (centuries). The two types of foreign investment have long existed side by side, albeit in different ratios in different countries and in different periods. Whether we are measuring inward or outward investments, there seem to have been variations in sequencing, proportions, and inward/outward ratios.<sup>105</sup> Indeed, in studying the relationships between these two types of investment, two of my most striking conclusions are the variety in

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<sup>102</sup> This of course has been the justification for open capital markets. See comments of Michel Camdessus (IMF 1998a).

<sup>103</sup> This point is made by Obstfeld (1998, pp. 10 and 24), in relation to "global financial trading." His view, however, is that "unwise policies make countries vulnerable to crises" that might not occur "without the impetus of international capital outflows" of domestic as well as foreign investors.

<sup>104</sup> Comments of Lawrence Summers (IMF, 1998; Obstfeld (1998, p. 24), would agree. When a financial crisis occurs, the response of foreign (and domestic) investors might well be capital flight. Weak banking institutions become vulnerable. In a global economy the impact is not purely national, but far broader and the reverberations can affect the entire international monetary system.

<sup>105</sup> The research on these relationships is in its infancy, and it is far too early to make many generalizations. Some can be made, such as in the years 1900-1914 debtor nations such as the United States, Japan, and Sweden, all of which had "cross investments," appear to have had high inward FPI/FDI ratio levels but even higher outward FDI/FPI ratio levels. The varieties in the mixtures are extraordinary. Thus, the United States today is a net capital importer, but the level of its outward FDI exceeds the level of its inward FDI as has been the case as long as records have been kept. Other countries (less developed countries) that historically have been net capital importers had capital outflows more in terms of FPI (or FDI in real estate).

<sup>106</sup> There may be some discernible patterns in sequencing in particular country investments -- with some alternation in inward flows of FDI and FPI; this needs more far investigation; this is suggested in some of the data supplied in Dunning and Dilyard (1999). Twomey has discussed a U-sequencing pattern in FDI/FPI inward ratios in third world countries in the twentieth century (Twomey, 1998). The different patterns cry out for interpretations.

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the inward/outward ratios over time, and the need for further study on the meaning of this diversity.<sup>106</sup>

Fourth, I remain unconvinced of a systematic relationship between the two types of investment, but find instead many relationships. John Dunning and John Dilyard (1999, this issue) seek to offer a general paradigm for FDI and FPI. They suggest that a common paradigmatic approach can be used to explain all kinds of *private* capital flow. In their thoughtful and provocative presentation, they maintain that FPI can be viewed in the same way as arm's length trade in technology, and that many tenets of internalization theory can be applied to explain the intra-company exchange of financial assets. I find their argument ingenious; it is certainly very attractive in interpreting some of the relationships between FDI and FPI, and can be extended to some FPI. I am not sure, however, that it explains the ratios, the unevenness of the relationships between the two types of investments, the role of stock markets in the recent soaring FPI or the different consequences of each of these kinds of investments. Moreover, Dunning and Dilyard confine themselves to private capital flows; if we are to understand long-term capital flows and the relationships between various types of long-term capital flows, we must deal with governments and government officials as investors (either in their public functions – such as lending to “friendly” governments, placing government pension funds and government reserves in “safe” securities abroad, investing in foreign securities to stabilize currencies, etc. – or as corrupt individuals dispatching monies outside the country) and governments as recipients (as issuers of bonds, as guarantors of publicly owned companies, etc.). We also have to take into account the role of the International Monetary Fund and the World Bank as lenders and regulators in world capital markets. While the Dunning and Dilyard approach adds new richness to our thinking about capital flows, I rather doubt that it offers a general paradigm in dealing with all the multifaceted relationships between FDI and FPI. It is only a beginning.

Dunning and Dilyard are convinced that the two kinds of international capital flows are different, and public policy makers seeking to enhance their economic objectives need to attract “the right kind” of FPI and FDI. What is the “right kind”? Perhaps more understanding of the differences and an exploration of what I see as

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the “unsystematic” relationships may help in answering that question.

Fifth, there does appear to be a “framework complementarity” between *inward* FDI and FPI. By framework complementarity, the suggestion is that *ceteris paribus* in the absence of capital controls, the more open an economy, the more prosperous and healthier the economy, the more attractive it will be for both inward FPI and FDI, each complementing the other and both growing together.

While plainly a controversial matter, recent research has shown that ease in and a high volume of financial intermediation proves to be a good predictor of long-run rates of economic growth, capital accumulation and productivity growth, and liquid stock markets (where trading equities is inexpensive) tend to encourage investments in longer-run, higher-return projects.<sup>107</sup> It has long been established that “good” economic conditions encourage FDI. Thus, a general complementarity between FPI and FDI would be expected.

On the other hand, I find little qualitative evidence for a “framework substitution”, whereby attractive (or unattractive) host countries gain (or lose) FDI/FPI, with a trade-off present between FDI and FPI. The statistical data as presently available seem inadequate to test this proposition, but studies of investors’ motivations offer little confirmatory evidence.<sup>108</sup>

Dunning and Dilyard’s article (Dunning and Dilyard, 1999) shows a number of specific inward complementarities, for example, those associated with financing hotels globally. Other very specific complementarities exist when banks have been allied with direct

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<sup>107</sup> King and Levine (1993, pp. 717-738), and Levine and Zervos (1998, pp. 537-558).

<sup>108</sup> This would be the case if investors were indifferent as to whether to undertake FPI or FDI and would look solely at the overall investment climate. This conclusion does not seem legitimate, since foreign portfolio investors and foreign direct investors are different and differently motivated.

<sup>109</sup> Dunning and Dilyard (1999) point out the absence of estimates made on “complementary” lending in the case of hotel chains. Similarly, I know of no estimates that deal with the related, complementary FPI during the privatization process, nor similarly the related complementary FPI investments that have for years taken place when large mining consortiums undertake big projects.



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investors in privatization ventures,<sup>109</sup> and when foreign banks during the debt crisis called on foreign direct investors to provide core competencies to ailing host nation enterprises.<sup>110</sup> It is hard to demonstrate specific inward substitutions.<sup>111</sup> On the other hand, the largest volume of FPI appears *not* to be directly linked with FDI, i.e. there is a separation in participants and conduits.

To the extent that there is complementarity between inward FDI and FPI, whether of a general or specific nature, countries seeking to attract one would do well not to have policies that are damaging to the other. Such consideration of these relationships have profound public policy implications. If, for example, a country introduces new controls on capital outflows designed to cope with FPI divestments, it may find foreign direct investors worried lest their abilities to remit earnings be curtailed.

Sixth, the available data do seem to indicate that Robert Aliber may be right in the broadest sense that countries with low interest rates and strong currencies tend to be the predominant *outward* foreign portfolio and foreign direct investors, but this level of generalization (the similarity between FPI and FDI behaviour) seems to obscure the direction of the outward FPI and FDI (which is not *to* countries with the highest interest rates or the weakest currencies), the ongoing presence of cross investments for both FDI and FPI, the different sectors attracted by outward and inward FPI and FDI and the different policy consequences. It does not explain to my satisfaction whether

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<sup>110</sup> With the debt equity swaps in the bailouts, I heard a good deal about banks trying to attract transnational corporations to take the equity and to introduce modern managerial methods. My evidence is completely “qualitative,” and I do not know how often this was done. United States banks had regulatory difficulties in holding equity, so the equity divestments could have been for reasons other than “finding the right management.”

<sup>111</sup> The example in note 110 could *possibly* be seen as a specific substitution. The development literature often suggests that FDI and FPI substitute for one another. I wonder whether there are cases when host governments have tried to attract both FDI and FPI and weighed specific alternatives in relationship to the same investment. Dunning and Dilyard (1999) found that much of the United Kingdom FPI now directed to the United States is not directly substitutable for FDI. This coincides with my more general findings.

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there is a substitution or a complementarity in outward and inward FPI and FDI flows. While Aliber suggests substitution in the outward flows, qualitative material does not seem to confirm this.<sup>112</sup>

Seventh, as noted, it seems very evident that with both FDI and FPI that there are cross investments. Sometimes these investments are very separate with outward “flight capital” (FPI) going in the opposite direction from inward FDI. Sometimes they are connected, with inward foreign direct investors arranging for outward FPI, or inward FPI providing the basis for outward FDI. The global spatial dispersion (bilaterally) of FDI and FPI lacks consistency (that is source country A does not seem to have the same or even similar set of FDI/FPI ratios to countries B and C, etc.). Once again, the data are inadequate. Yet because of the differences in the specific motivations for cross investments with FDI and FPI -- with the different actors and motives -- one might not expect to uncover a systematic pattern in the ratios.

I started this paper with six examples on relationships between FDI and FPI. The first dealt with FPI and FDI going in the same direction and a general distrust of FDI and FPI. It was designed to point out that all outsiders’ capital is subject to suspicion (and this is universally true in varying degrees); all foreign investment is, at least in some very limited sense, beyond the control of national sovereign states. Here there is a commonality. Nevertheless, in the course of writing this article I hope that I have made clear that FDI and FPI have different characteristics: both are and can be subject to regulation; yet there are different costs and benefits in placing controls on each because of the underlying differences in these types of investment. Policy makers would do well to understand the

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<sup>112</sup> On the other hand, in 1986, Ruffin and Rassekh (1986, p. 1126), wrote that the purpose of their article was to test the hypothesis that “foreign direct investment and foreign portfolio investment are perfect substitutes. In other words, capital may be perfectly fungible.” They did conclude that their “empirical results are consistent with the hypothesis that every United States dollar. FDI results in one less dollar being invested in foreign portfolio investment”. Ruffin and Rassekh never did anything further on this topic. Aliber argued that the flows of FDI “parallel flows of long-term portfolio capital ...the larger the premium demanded by portfolio investors for incurring the risks of foreign investments, the higher the ratio of direct foreign investment relative to both licensing and portfolio investment....” (Aliber, 1993, pp. 203-204, chap.5).

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relationships in crafting appropriate measures. The second example gave two theoretical alternatives that suggested that FPI and FDI went in the same direction and were different sides of the same coin: FPI could be seen as international portfolio diversification in the market place and FDI as international portfolio diversification within the firm. This is, indeed, one way of looking at the patterns. And it once again reflects the notion that FPI and FDI have many things in common. Both FPI and FDI are means by which savings in one country are transferred abroad. Yet, to repeat our arguments, the similarities notwithstanding, the portfolio diversification within the market place is very different from the FDI that moves abroad concentrated and administered within the boundaries of the firm. In the latter case, the firm provides a tissue of many activities extended over borders; the firm distributes and generates internationally technology of products and processes, research and development, general knowledge, ways of doing things, supplier arrangements, marketing outlets, information delivery structures, corporate learning, as well as managerial organization. Its network linkages are both intra- and inter-firm. All this is far more than finance, and far more than the movement of capital over borders or the accumulation of capital within the host country, or the attracting of capital from third countries. International market portfolio diversification and movement of capital within the firm have different consequences. From a policy standpoint, FDI should be seen as carrying with it many additional attributes. In an open economy macroeconomic approach, the FDI shifts the cost curves downward as it transfers technology and managerial expertise; FPI does not. Also, tax policies towards FPI and FDI ought to be fine tuned to accommodate the differences between FPI and FDI (a foreign portfolio investor may not invest in an adverse tax environment; a foreign direct investor might have options whereby it could move its profits to a lower tax jurisdiction).

The third example involved normative evaluations of bad and good: financial capital that went through stock markets subject to worry, while TNCs invested in bricks and mortar. While the third example did focus on the differences between various types of investment, its value judgements are oversimplified. Market reallocation of international financial resources has benefits; those

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benefits, however, differ from the benefits of FDI. The fourth example did indicate cross investments: inward United States FPI and outward United States FDI. This article has shown that many cross investments of different kinds seem to exist, and any understanding of the relationships between FPI and FDI must take them into account. The fifth case demonstrated a complementarity between FDI and FPI, again of the sort that we have found to be not at all uncommon. And, finally, the last example, suggested that the distinctions between FDI and FPI were blurred, since direct investors could employ “financial engineering techniques to convert” FDI into FPI. In this case, the insight seems to have little validity; as we have pointed out, the finance function within a TNC is a given; to perceive this as a “blurring” turns the discourse away from the fundamental demarcations between FDI by TNCs where the return is on the managed “package”, and FPI where the intention, method and motive is to engage in financial rather than business transactions. In one case, the host country obtains a “managed” business; in the other case, with FPI, the host country must find those who can put (and pay the costs of putting) the capital to productive use -- a task that is far from automatic.

In short, while the actors participating in foreign investments share certain attributes, FDI and FPI are very different, the motives are separate and the conduits unlike. Accordingly, the respective impacts on host countries are not identical. Both kinds of investment coexist. In the future, it may be possible to develop a general paradigm on the relationships between FPI and FDI, but as yet it is too early. I found no discernible neat, much less uniform, association between FPI and FDI but rather a wide variety of relationships (and lack thereof), along with sharply different FPI/FDI inward/outward ratios across countries and through time. The policy implications are that government officials should be cognizant of the substantial differences between FPI and FDI, should consider where and when the two types of investment converge and are interrelated, and in what manner they are unique, should recognize that the impacts of FPI and FDI are likely to be dissimilar, and should take these considerations into their deliberations as they formulate regulatory, tax and other policies. ■

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## ARTICLES

### **Where do Japanese manufacturing firms invest within Europe, and why?**

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**Stuart Ford and Roger Strange\***

This article investigates the factors Japanese firms have taken into account when deciding upon the location of their manufacturing affiliates in Western Europe. Many surveys have been undertaken on this subject, but there have been very few rigorous statistical analyses. The data set used in this article comprises 520 affiliates established between 1980 and 1995, and located in the seven most popular host countries, viz: the United Kingdom, France, Germany, Netherlands, Italy, Spain and Belgium. A conditional logit model was used to model the location of each affiliate as a choice among the seven alternatives. This choice is determined by various attributes of each host country at the time of the affiliates' establishment. The results show that national gross domestic product per capita has a significant positive effect upon choice of location, notwithstanding European integration. Agglomeration economies, local industry output, educational attainment and English language ability also have significantly positive effects, whereas wage levels, unionization, and local industry productivity all had significantly negative effects.

#### **Introduction**

During the 1980s and early 1990s, there was a surge of Japanese manufacturing investment in Western Europe reflecting both the increasing internationalization of the Japanese economy and the

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instigation of the Single European Market programme (Strange, 1993). The number of Japanese manufacturing affiliates in Western Europe rose from 173 at the end of 1983 to 711 at the end of 1995. But the geographical distribution was not uniform (see table 1), with the United Kingdom accounting for 30 per cent of the cumulative total at the end of 1995, followed by France (15 per cent), Germany (14 per cent), Spain (8 per cent), Netherlands (7 per cent), Italy (6 per cent), and Belgium (6 per cent). The other 11 Western European countries accounted for only 13.5 per cent of the cumulative total. This raises the question of what determines the choice of location for potential Japanese investors.

This article analyses the locational determinants of 520 Japanese manufacturing affiliates set up in the seven most popular host countries over the period of 1980-1995. These 520 affiliates

**Table 1. Cumulative numbers of Japanese manufacturing affiliates in Europe at the end of December 1995**

	Total affiliates		Affiliates established between 1980 and 1995
	Number	as per cent of total	
United Kingdom	214	30.1	194
France	108	15.2	97
Germany	100	14.1	76
Spain	59	8.3	46
Netherlands	48	6.8	39
Italy	43	6.0	37
Belgium	43	6.0	31
Sub-total	615	86.5	520
Ireland	35	4.9	..
Portugal	15	2.1	..
Sweden	13	1.8	..
Austria	11	1.5	..
Switzerland	7	1.0	..
Finland	6	0.8	..
Greece	3	0.4	..
Denmark	2	0.3	..
Luxembourg	2	0.3	..
Norway	1	0.1	..
Iceland	1	0.1	..
Total	711	100.0	..

Source: JETRO (1997), p. 5.

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account for 85 per cent of the total number of Japanese affiliates set up in the seven countries. Although there have been a substantial number of surveys on this topic, notably those carried out annually by the Japan External Trade Organization (JETRO), there has only been one rigorous statistical analysis. This was undertaken by Hideki Yamawaki (1991) who considered Japanese affiliates in eight Western European countries (the seven noted above plus Ireland) in August 1988, and found that the choice of location was related positively to local market size and technological capability, and related negatively to labour costs.

The current article improves upon this previous work in three main ways. First, it incorporates data on affiliates established up to the end of 1995, and thus covers the period both leading up to, and following, the completion of the Single European Market. Secondly, the international locational decisions of the Japanese investors are analysed using a conditional logit model. In the conditional logit model, it is assumed that each Japanese firm is faced with a set of alternative country locations for its European investment, and each firm compares all the relevant attributes of each location when making its decision.<sup>1</sup> Each decision – i.e. each affiliate – is thus the outcome of a discrete choice, and the relative importance of the various attributes may be inferred from the resulting geographical dispersion of the affiliates. The conditional logit model has been successfully applied to foreign direct investment (FDI) in other geographical settings,<sup>2</sup> but this is the first attempt to apply it to Western Europe. In contrast, Yamawaki (1991) set up a model to predict shares of employment in different industrial sectors across Western Europe. This inevitably biases the results in favour of the criteria used by large manufacturing ventures, whereas the conditional logit model treats all affiliates, large and small, as equally important. Thirdly, this article introduces a number of explanatory variables not

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<sup>1</sup> William M. Shapiro (1987) testifies to the systematic fact gathering of Japanese companies in their search for the optimal location for overseas affiliates.

<sup>2</sup> See, for example, Luger and Shetty (1985), Coughlin et al (1991), Friedman *et al.* (1992) and Friedman *et al.* (1995) on FDI in the United States; Woodward (1992) and Head et al (1995) on Japanese FDI in the United States; Woodward and Rolfe (1993) on export-oriented FDI in the Caribbean Basin, and Head and Ries (1996) on FDI in China.

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considered by Yamawaki, and allows for the fact that the relative attractiveness of different locations may vary over time.<sup>3</sup>

The structure of the article is as follows. The conditional logit model is first outlined, and the dataset from which the dependent variable has been constructed is identified. The following section details the explanatory variables incorporated in the model, and sets out the hypotheses about their likely impact upon the choice of location. The empirical results from several variants of the model are then reported, and the implications of these results are discussed. Finally, the limitations of the study are considered, and various suggestions put forward for future analysis.

### **The conditional logit model**

It is assumed that each Japanese investor will choose to locate its Western European affiliate  $i$  in country  $j$  on the basis of trying to maximize the expected future profits from its investment. Country  $j$  is one of  $J$  possible locations, where  $J$  is here equal to the seven countries under consideration. More formally, affiliate  $i$  will be located in country  $j$  if and only if:

$$R_{ij} > R_{ik} \text{ for all } k \neq j. \quad (k = 1, 2, \dots, J);$$

where  $R_{ij}$  = expected profit earned by affiliate  $i$  if it is located in country  $j$ .

It is further assumed that the expected profit from location in country  $j$  is a function of the (observable) attributes of the country and of a random disturbance term  $e_{ij}$ . This disturbance term reflects the unique advantages of country  $j$  to affiliate  $i$ . It differs across countries for any one firm, and across firms for any country. In formal terms:

$$R_{ij} = \beta X_j + e_{ij};$$

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<sup>3</sup> The explanatory variables in Yamawaki (1991) are all evaluated at one point in time.



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where  $X_j$  is a vector of choice-specific attributes for country  $j$  and  $\beta$  is a vector of parameters to be estimated. Let  $Y_i$  be a random variable that indicates the location chosen for affiliate  $i$ , then the probability of choosing a specific country  $j$  depends upon the attributes of that country relative to the attributes of the other seven countries in the choice set. Following D. McFadden (1974), the probability of locating in country  $j$  (assuming that the disturbance terms are independently distributed and that they follow a Weibull distribution) is:

$$\text{Prob}(Y_i = j) = \frac{\exp[\beta X_j]}{\sum_{k=1}^7 \exp[\beta X_k]} .$$

Estimates of  $\beta$  may be obtained through maximum likelihood estimation. If the explanatory variables have been entered linearly, then a small change  $\Delta$  in variable  $x$  leads to a change in the probability  $P$  that a firm will choose a particular location of  $\Delta P = \beta_x \cdot P \cdot (1-P) \cdot \Delta x$ , where  $\beta_x$  is the coefficient associated with variable  $x$ . The effect of  $\Delta x$  thus depends upon the initial probability of choosing location  $j$ , which in turn depends upon each attribute set (Greene, 1997, p. 919).

A measure of the overall significance of the estimated equations is provided by the test statistic  $\lambda$ , which follows a chi-square distribution with degrees of freedom equal to the number of restrictions imposed by the null hypothesis:

$$\lambda = 2[L(\text{max}) - L(0)] ;$$

where  $L(\text{max})$  is the log-likelihood of the chosen model, and  $L(0)$  is the log-likelihood of a constrained model where all the slope coefficients are set equal to zero. In this constrained case, the selection probability of each country is equal to  $1/J$ , and  $L(0)$  is equal to  $-n \cdot \ln J$  (Greene, 1997, p. 920).

The JETRO (1997) survey provided the data on Japanese manufacturing affiliates established in Europe over the period 1980-1995 for the dependent variable in the conditional logit model. Each

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of the 520 affiliates constitutes a separate observation, with the value 1 assigned to the chosen host country, and 0 to the other six countries.

## **Explanatory variables and hypotheses**

It is assumed that each Japanese firm makes its decision as to location on the basis of trying to maximize the expected future profits from its investment, and that profits depend upon a range of attributes which affect potential revenues and costs. Thus the decision about the optimal location within the European Union takes into account the attributes of the chosen location relative to those of the alternative locations.<sup>4</sup> In the context of the present study, the relevant attributes are as discussed below.

A positive relationship is expected between per capita gross domestic product (INCOME) and location choice. Notwithstanding the fact that the European Union<sup>5</sup> is a common market, it is suggested that Japanese firms will prefer *ceteris paribus* to locate their manufacturing plants in the richer national markets. Woodward and Rolfe (1993, p.128) also suggest that per capita gross domestic product/gross national product figures may also be good proxies for the general quality of infrastructure. Secondly, the growth of the local market (GROWTH) may also be relevant, in that faster growth provides more profitable opportunities.

It has been suggested that FDI will be attracted to areas with high densities of manufacturing activity, reflecting both the existence

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<sup>4</sup> There are a number of cases in the dataset where several European Union affiliates are owned by the same parent, and where these affiliates are located in different countries. The conditional logit model considers each of these affiliates as an independent decision, whereas it is possible that the Japanese parents are 'learning by experience'. Another is that the Japanese parents have made strategic decisions to spread their investment, and the benefits therefrom, throughout the European Union so as to minimize any potential resentment towards agglomerations of Japanese FDI in certain countries. For example, Strange (1993) has suggested that the Sony Corporation has made such strategic decision regarding the location of its European Union affiliates. Unfortunately, the information required to ascertain which (if either) of these motivations is correct can only be gathered through detailed case-study analysis, and no attempt is made here to capture either effect in the model.

<sup>5</sup> The European Community was renamed the European Union after the Maastricht Treaty came into effect on 1 November 1993. In this article, only the term 'European Union' is used to avoid confusion.

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of agglomeration economies and also opportunities to service existing manufacturers (Coughlin, Terza and Arromdee, 1991). Previous studies have typically used either total output or total manufacturing output as a proxy variable, but here we use the value added of the local industry of which the Japanese affiliate is part (OUTPUT). The JETRO survey breaks the company data down into 17 industrial categories, but only nine categories are used here in order to ensure an appropriate match with the European Union data (see table 2). This aggregation inevitably leads to some loss of detail, and the 'fabricated metal products' category encompasses a range of goods from electronic components to automobile manufacture. However, the current approach should still be an improvement upon the use of aggregate output data.

All firms are expected to prefer lower wage locations, though lower wages are only attractive insofar as they are not offset by lower productivity and/or overvalued currencies. Indeed, Jane S. Little (1978), in her study of FDI in the United States, has suggested that wage differentials are relatively more important for foreign than domestic investors. We therefore introduce the hourly manufacturing wage rate (WAGE) in a common currency and constant prices as an explanatory variable. Some studies correct for productivity variations by using unit labour costs, but here we use separate wage and productivity (PROD) variables (Cushman, 1987). Virtually all the previous empirical studies (e.g. Bartik, 1985; Coughlin, Terza and Arromdee, 1991; Luger and Shetty, 1985; Yamawaki, 1991) have found wage rates to have a significant negative effect on location choice. Friedman, Gerlowski and Silberman, (1992) concluded that wages were the most important variable in the choice of location of United Kingdom plants in the United States, and that wage and productivity elasticities were higher for Japanese firms than in their all-country model (Friedman, Fung, Gerlowski and Silberman 1996). Furthermore, 44 per cent of the respondents to the JETRO survey (JETRO, 1997) cited lower wage costs as a major consideration in the selection of a site for the construction of a new plant. Only a few studies (e.g. Friedman, Gerlowski and Silberman, 1992) have included productivity as a separate variable, and all have found it to have a significant positive effect on choice of location. Yet there is considerable anecdotal evidence to suggest that Japanese firms in Western Europe have tended to shy away from areas of strong local

competition, and consequently from areas of high productivity, particularly when establishing greenfield ventures. It is possible that Japanese investors may actually prefer 'low productivity areas', in the expectation that they will be able to introduce their own technology, work practices and management style and raise productivity accordingly. By way of example, consider the decisions of the three major Japanese automobile manufacturers (i.e. Nissan, Toyota and Honda) to locate their European assembly operations in the United Kingdom, rather than in the countries with powerful local manufacturers (e.g. Fiat, Peugeot, Renault and Volkswagen). Certainly improvements in productivity are uppermost in the minds of Japanese investors, with 82 per cent of the respondents to the JETRO survey (JETRO 1997) indicating that this was a priority for future management. It is therefore unclear a priori whether high productivity will stimulate or deter plant location.

**Table 2. Numbers of Japanese investments by industry in selected European countries, 1980-1995**

Industry	United Kingdom	France	Germany	Spain	Netherlands	Italy	Belgium
Food, beverages and tobacco	4	16	2	1	3	-	1
Textiles, apparel and leather	12	4	2	3	-	4	-
Wood products and furniture	1	1	-	-	-	-	-
Paper products and printing	2	-	1	2	1	-	-
Chemical products	32	22	15	13	13	10	13
Non-metallic							
Mineral products	3	2	2	1	-	-	3
Base metal							
Industries	1	3	1	-	1	2	1
Fabricated metal							
Products	129	47	52	24	19	20	10
Other manufacturing	10	2	1	2	2	1	3
Total	194	97	76	46	39	37	31

Source: JETRO (1997).

Many authors have suggested that Japanese firms are attracted to the same locations as previous Japanese affiliates.<sup>6</sup> This can be for a number of reasons: to serve these other companies; they share

<sup>6</sup> See Braunerhjelm and Svensson (1996) for a review of studies including agglomeration economies as an explanation for direct investment.

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the information and experience of these affiliates; because these sites provide the best infrastructure, etc.. Wheeler and Mody (1992) suggest that locational advantage once gained, tends to perpetuate itself – i.e. that history matters. James R. Markusen (1990) has pointed out that previous investments generate a demand for specialized services and help create finer divisions of labour, with consequent lower unit labour costs. ‘Accidents of history’ can thus give rise to industrial concentrations. B. Arthur (1986, 1990) has hypothesized that incentives<sup>7</sup> (even if since withdrawn) create a ‘ratcheting effect’ and provide positive signals to future investors. Thus minor regional advantages can be turned into substantial clusters of specialized industrial activity, though there are also costs attached to any ‘beauty contests’ between different government incentive programmes (Mudambi, 1995). Agglomeration economies may be particularly strong in the case of Japanese firms, in comparison to firms from other countries. Inter-firm linkages within Japanese business groups (*keiretsu*) may lead members to set up affiliates close to other vertically-integrated members (Head, Ries and Swenson, 1995). And horizontally-integrated members may wish to overcome their lack of overseas experience by grouping together to share information regarding market trends, recruitment, suppliers, etc. Perhaps more importantly, firms may wish their marketing to be handled by one of the trading companies in the *keiretsu* (Yamamura and Wassman, 1989). We use the stock of previous Japanese FDI in the host country as a proxy for these agglomeration economies, and expect to find a positive correlation with location. Two alternative measures are used: one (FDIVAL) related to the value of the direct investment, and the other (FDINO) related to the number of FDI projects.

It has been suggested that high levels of unionization raise labour costs and impede effective managerial control as the labour force is less ‘flexible’ (Glickman and Woodward, 1988). As Japanese firms only deal with enterprise unions at home, and as many foreign

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<sup>7</sup> Government taxes and incentives have been included in various studies of location within a host country. Some studies (e.g. Carlton, 1983; Woodward, 1992) have found them to have insignificant effects; others (e.g. Friedman, Gerlowski and Silberman, 1992; Mudambi, 1995) have found them highly significant. However, there is anecdotal evidence that taxes/incentives have little effect upon the choice of international location, and thus we have not included a variable to capture such an effect in this study.

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affiliates want the managerial freedom to introduce new production techniques and familiar labour practices, it may be hypothesized that high levels of unionization will discourage FDI. Timothy J. Bartik (1985) found empirical evidence to support this conventional wisdom, as did Douglas P. Woodward (1992) – the latter showing union membership to be a major deterrent with a one percentage point rise in the rate, provoking an estimated 9 per cent fall in the probability of FDI being undertaken. However, both Coughlin, Terza and Arromdee (1991) and Friedman, Gerlowski and Silberman (1992) found a positive effect of unionization. One explanation is that unionization may be positively associated with productive efficiency<sup>8</sup> (Beeson and Husted 1989). Both these models controlled for wages (and the latter also for productivity), whereas Woodward (1992) did not, and may possibly have generated specification bias. It is also the case that union power and effectiveness have diminished during the 1980s, and unions have been more willing to grant management operational flexibility, so any aversion to highly unionized areas may well have been reduced. However, we still include union density (UNION) as an inverse proxy for labour force flexibility, and expect it to have a negative, though possibly weak, effect upon location.

Many empirical studies have included proxies (e.g. highway and railroad lengths per square mile) for physical infrastructure. Though it is not contested that high-quality infrastructure is viewed as desirable in the FDI location decision, we have not attempted to capture this effect explicitly in our model for two main reasons. First, the various measures of ‘physical infrastructure’, which have been used in previous studies are very rough proxies at best, and are typically found to be insignificant or only weakly significant. Secondly, as noted above, the INCOME variable is likely to reflect the general quality of physical infrastructure, and thus the inclusion of an additional explanatory variable may well lead to multicollinearity problems.<sup>9</sup>

However, we do include two measures of human and knowledge capital. A well-educated workforce possessing both mental and

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<sup>8</sup> And also with manufacturing activity and various agglomeration effects.

<sup>9</sup> Perhaps this is why infrastructure measures have been found to be statistically insignificant in previous studies.

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manual skills is required by many Japanese firms that manufacture in the European Union technologically sophisticated products such as electronic equipment, machinery, and transportation equipment and instruments. Furthermore, Japanese firms are often looking to establish research and development capabilities in Western Europe, out of commercial necessity and because of political pressure (Kume and Totsuka 1991), and the importance of this activity is likely to increase in the future given the shortage of research and development manpower in Japan. Local personnel often ease the development of products suitable for the host country market as they are more acquainted with local tastes. Following Rajneesh Narula (1996), we use the proportion of the population in school (EDUF), and the proportion of the population in upper secondary school (EDUS) as alternative proxies for educational standards.<sup>10</sup> An associated variable, which measures innovative and technological capability, would be the number of patents granted (Yamawaki, 1991). Again, two alternative measures are provided: the total number of patents granted (PATTOT) in each country, and the number of patents granted to residents in each country (PATRES).

Last but not least, many surveys have pointed to the importance of the English language in the location decision (e.g. Culem, 1988). English is almost the only foreign language in which many Japanese can communicate with foreigners, and technical terminology is usually written in English and cannot be translated into other languages (Kume and Totsuka, 1991). For example, Hood and Truijens (1993) noted that ‘the presence of production engineers with international experience and English language ability was regarded as critical’. Studies of United States FDI have also shown that tighter cultural links and a common language were decisive factors in choosing the United Kingdom in preference to other Western European locations (Culem, 1988). In the current study, two alternative dummy variables were used to capture the English language effect. One (LANA) considers the United Kingdom, Germany, the Netherlands and Belgium to possess English-speaking ability. The other (LANB)

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<sup>10</sup> Different measures have been used by other researchers. Papanastassiou and Pearce (1990) used the proportion of scientists and engineers in total employment, whilst John H. Dunning (1980) used the ratio of salaried employees to production workers.

suggests that the United Kingdom is in a uniquely advantageous position to exploit this ability. Both variables are rather simplistic and LANB, in particular, may well pick up the effects of other special United Kingdom attributes.

Table 3 summarizes the explanatory variables included in the model, and their expected impacts upon the choice of location. Each variable is entered in the regression model with a lag of one year to capture the delay between the site selection process and the realization of the investment project. Thus, for example, the locations of affiliates established in 1986 are assumed to depend upon the relative attributes of the seven host countries in 1985.

**Table 3. Explanatory variables and expected impacts**

Variable	Definition	Expected Impact
<b>INCOME</b>	Gross domestic product per capita, at price levels and exchange rates of 1990, in United States dollars	+
<b>GROWTH</b>	Annual percentage growth in gross domestic product, at 1990 price levels, in home currency	+
<b>OUTPUT</b>	Value added in relevant industry per capita, at 1985 price levels, in United States dollars	+
<b>WAGE</b>	Compensation of manufacturing employees per wage and salary earner, at 1985 prices, in ECU	-
<b>PROD</b>	Value added in total manufacturing, at 1985 price levels, in United States dollars, divided by number engaged in total manufacturing	+ / -
<b>FDIVAL</b>	Cumulative value of Japanese FDI per capita at end of year, in United States dollars	+
<b>FDINO</b>	Cumulative number of Japanese FDIs per capita at end of year	+
<b>UNION</b>	Union density as a percentage of wage and salary earners (excluding retired or unemployed union members)	-
<b>EDUF</b>	Total number of pupils and students, as a percentage of the population	+
<b>EDUS</b>	Number in upper secondary education, as a percentage of the population	+
<b>PATRES</b>	Annual number of grants of patents to residents of country <i>j</i> , in country <i>j</i>	+
<b>PATTOT</b>	Total number of grants of patents, in country <i>j</i>	+
<b>LANA</b>	Dummy variable equal to one based on English speaking capacity (United Kingdom, Germany, the Netherlands and Belgium), zero otherwise	+
<b>LANB</b>	Dummy variable equal to one based on English speaking capacity (United Kingdom only), zero otherwise	+

*Source:* Authors' analysis.



The mean values for each of the quantitative explanatory variables over the period 1979-1994 for each of the seven countries are tabulated in annex table 1. Annex table 2 reports the correlation coefficients between these variables.

## Empirical results

Table 4 shows the coefficient estimates and t-statistics for the explanatory variables in seven variants of the model. Variant 1 is the basic model, whilst the other six equations contain either alternate variables or variables which have been found to be statistically insignificant.

**Table 4. Conditional logit model: coefficient estimates**

Variant	1	2	3	4	5	6	7	
<i>Variable</i>								
INCOME	0.472 E-03 (7.749)	0.474 E-03 (7.698)	0.472 E-03 (5.940)	0.471 E-03 (7.728)	0.467 E-03 (7.325)	0.291 E-03 (4.541)	0.138 E-03 (1.932)	
OUTPUT	0.709 (3.244)	0.707 (3.229)	0.708 (3.164)	0.707 (3.238)	0.550 (2.618)	0.697 (3.221)	0.783 (3.984)	
WAGE	-0.195 E-03 (-3.513)	-0.198 E-03 (-3.421)	-0.195 E-03 (-3.031)	-0.203 E-03 (-3.425)	-0.258 E-03 (-4.550)	-0.219 E-03 (-3.938)	-0.250 E-03 (-0.507)	
PROD	-0.080 (-5.695)	-0.079 (-5.476)	-0.080 (-5.694)	-0.085 (-4.480)	-0.112 (-8.832)	-0.057 (-4.060)	-0.034 (-2.119)	
FDIVAL	0.434 E-02 (2.618)	0.436 E-02 (2.625)	0.435 E-02 (2.502)	0.408 E-02 (2.299)	0.466 E-02 (2.896)		0.183 E-02 (1.070)	
UNION	-0.048 (-6.994)	-0.049 (-6.951)	-0.048 (-5.043)	-0.048 (-6.990)	-0.028 (-4.566)	-0.025 (-2.860)	-0.027 (-4.938)	
EDUS	0.531 (5.710)	0.532 (5.710)	0.531 (5.709)	0.501 (4.224)		0.114 (0.876)	0.070 (0.554)	
LANA	0.604 (3.173)	0.610 (3.166)	0.602 (2.360)	0.598 (3.132)	0.796 (4.583)	0.518 (2.739)		
GROWTH		-0.719 E-02 (-0.196)						
PATRES			0.019 (0.011)					
PATTOT				0.186 (0.409)				
EDUF					0.104 (3.898)			
FDINO						156.620 (4.452)		
LANB							1.489 (5.767)	
Log-likelihood	-903.900	-903.881	-900.919	-903.900	-903.817	-912.990	-896.837	-891.775
Chi-square	215.936	215.974	221.898	215.936	216.102	197.756	230.062	240.186

*Source:* Authors' estimates.

*Notes:* t-statistics are in parentheses. Sample size = 520. Number of possible locations = 7. Restricted log-likelihood = -1011.868

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The per capita income variable (INCOME) is strongly significant in all variants, and has a positive effect upon choice of location. Thus, despite increasing European integration, the state of the local market plays an important part in the location decision. This too may also reflect the importance of physical infrastructure. Market growth, in contrast, is found to have a negative effect on choice of location, though the effect is insignificant (variant 2).

The output variable (OUTPUT) is also strongly significant in all variants, lending support to the argument that FDI is attracted to areas of high manufacturing density. The stock of previous Japanese FDI is also found to have a significant positive effect upon location, whether the stock is measured in value terms (FDIVAL, variant 1) or in numbers of projects (FDINO, variant 6). Indeed the significance of FDINO in variant 6 is rather greater than that of FDIVAL in the other equations, possibly because the Netherlands is host to several large value investments for tax reasons. These results appear to confirm the importance of agglomeration economies for Japanese investors, and provide some justification for the attempts by several European Union Governments to lure Japanese (and other foreign) investors with various incentive schemes.

The significant negative coefficients for the wage rate variable (WAGE) accord with theory and previous empirical studies and indicate that, even when manufacturing sophisticated products in the European Union market, Japanese investors are still concerned about minimizing labour costs. That having been said, the Japanese investors are also interested in a skilled and well-educated workforce. The educational standards variable (EDUS) demonstrates a very significant positive effect upon location in most variants of the model, whilst the alternate proxy (EDUF) is significant in variant 5. As regards the effects of innovative and technological capability, both alternate variables (PATTOT and PATRES) had positive coefficients though both were statistically insignificant (variants 3 and 4). This contrasts with the conclusions of Yamawaki (1991, p. 22) who, in his study of Japanese FDI in Western Europe, concluded that...“Japanese MNEs are drawn to countries whose industries generate more patents and thus are leading in technology”. These contrasting findings probably arise for two reasons. First, Yamawaki used a different proxy

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measure, namely the cumulative number of patents granted in the United States to residents of the European country, on the assumption that the United States is the representative market also for technologies developed outside the United States. Secondly, and probably more importantly, Yamawaki did not include a variable (such as FDIVAL) in his model to capture agglomeration economies, and his patent variable may well be picking up this effect.

Union density (UNION) is found to have a negative and highly significant effect upon the distribution of Japanese FDI in Western Europe. This supports the view that Japanese investors desire a 'flexible' workforce in their overseas affiliates, and do not want their managerial discretion circumvented by strong trade unions. Rather more surprising, perhaps, are the negative and highly significant coefficients for the productivity variable (PROD). This conflicts with the results of Friedman, Gerlowski and Silberman (1992), who found a positive relationship when analysing United Kingdom FDI in the United States. As discussed above, this negative effect reflects Japanese investors' preferences for areas where there is little, or ineffective local competition and thus possibly where government incentives for inward investors are most generous. It would be desirable to test this explanation directly by incorporating a variable to capture the effects of government incentives, but there are two problems with doing this. The first is that incentives come in a variety of forms (e.g. tax holidays, capital grants), and it is not clear which variable is most appropriate to use or how a composite measure might be constructed. The second, and rather more fundamental, problem is that we would need not only data on the incentives offered to the Japanese firm to invest in the chosen location, but also data on the incentives offered by the other countries where the affiliates were not located. This comparative information is not available, unless we concentrate on a simple measure (e.g. tax rates) which would not be an adequate proxy.

Last but not least, both dummy variables (LANA, LANB) used to capture English-language ability were found to be statistically significant and positively related to choice of location in all eight variants of the model. Notwithstanding the simplicity of these measures, the fact that both variables generated the predicted results

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is reassuring and would appear to confirm the importance of the English language.

All the variants are highly significant ( $p < 0.01$ ) according to likelihood ratio tests where the constrained model restricts the slope coefficients to zero. The marginal effects of each of the explanatory variables depends, as noted above, upon the initial probabilities. To provide some idea of the magnitude of these effects, we can use the average probability of 0.143. Thus a \$1000 increase in a country's per capita GDP would be expected to lead to a 5.8 per cent increase in its locational probability. In contrast, a 1 per cent fall in union density would give rise to a 0.6 per cent increase in the probability of new plant location. The average marginal effects of the other variables can be similarly calculated, and country-specific effects could also be evaluated.

It is widely accepted that much Japanese FDI within Western Europe has been motivated by a desire to service the European Union market, notwithstanding the importance of the local host country market. Furthermore, this motivation has been reinforced by the initiation, and subsequent implementation, of the Single European Market programme. It is thus reasonable to hypothesize that membership of the European Union will have had a positive effect upon the desirability of a host country as a potential location for Japanese FDI within Western Europe. In order to test this proposition, a dummy variable was introduced into the basic model, which took a value of one if the host country was a member of the European Union, and a value of zero if it was not. Six of the countries in the choice set were members throughout the period of the study (1980-1995), but Spain's status changed in 1986 when it assumed entry. However, the estimated coefficient of this dummy variable was both negative and significant, rather than positive as was expected. Perhaps this is because Japanese investors considered Spain as a potential location for servicing the European Union market prior to its actual accession, particularly as it had already been granted many of the benefits of membership though tariff concessions on its exports to the European Union market. Upon accession, however, Spain became liable to EU regulations and for many central levies, and thus lost some of its locational attractiveness. This explanation clearly requires further verification.

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A further test was also undertaken to ascertain whether the passing of the Single European Act in December 1985 had any effect upon the determinants of location within the European Union. Two regressions were run for affiliates established during the periods 1980-1985 and 1986-1995 – i.e. before and after the passing of the Single European Act. The regression results for the earlier period were not significant, whilst those for the later period were similar to those for the complete sample. Furthermore, a likelihood ratio test confirmed that there had been no structural break – the estimated coefficients from these two regressions are thus not reported. Thus although the Single European Market programme undoubtedly had an effect upon the amount of Japanese FDI coming into the European Union, it appears not to have affected the geographical distribution of that investment within the European Union.

## **Conclusions and future research**

The results of this study have confirmed the importance of many of the variables which were hypothesized to be important factors in the decisions of Japanese firms regarding their manufacturing affiliates in Western Europe. The results have confirmed that per capita GDP in the local (i.e. national) market has a significant positive effect upon location choice, notwithstanding European integration. Agglomeration economies, local industry output, educational attainment and English language ability also have significantly positive effects; whereas wage levels, unionization, and local industry productivity all have significantly negative effects.

What are the policy implications of these findings? It is important to stress that this study simply considered the question of what factors Japanese firms take into account in deciding upon the location of their manufacturing affiliates in the European Union. There is a different, and no less interesting, set of questions as to whether inward investment by Japanese firms brings net benefits to the European Union host economies, how large those net benefits might be, and thus whether policy should aim to promote such investment. If, however, we assume that inward Japanese investment is desirable, then the econometric results suggest the following. First, Japanese FDI is attracted to areas of high densities of manufacturing in the

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appropriate industry and where there are major agglomerations of previous Japanese FDI. Both these findings suggest an active role for industrial policy. Secondly, Japanese FDI is attracted to countries where the workforce is well educated and where there are high levels of innovative and technological ability. These findings suggest an active role for education policy and the promotion of science and technology. Thirdly, Japanese FDI is attracted by low levels of union density and/or high labour force flexibility, suggesting an active role for labour market reform. Fourthly, the fact that Japanese investors favour areas where wage rates are relatively low and where local competition is less effective clearly should not be taken to suggest policies aimed at lowering wages and/or productivity. Rather we are controlling for the effects of both WAGE and PROD, rather than putting them forward as policy variables. Fifthly, the wisdom of any form of active policy depends crucially upon the scale of the net benefits from any inward investment, but that remains the subject for further study.

The analysis could also be extended in a number of other possible ways. First, data should be collected on affiliates established in other Western European countries, and on those established both before 1980 and after 1995. This would enable the effects of European Union accession to be more fully investigated. Secondly, the concentration of Japanese affiliates not only varies across European Union countries, but also varies widely across regions within each country.<sup>11</sup> There is considerable survey and anecdotal evidence to suggest that Japanese firms first make a decision about which European Union country to invest in based on one set of considerations, and then make a decision about where to invest within that country taking rather different considerations into account. Our analysis focuses on the first decision, though clearly the latter decision also merits investigation.

Thirdly, overseas affiliates may be created in a variety of ways: through the establishment of a greenfield venture, through the acquisition of an existing venture in the host country, or through

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<sup>11</sup> We are grateful to one of the anonymous referees for this point. See Yamawaki, Barbarito and Thiran (1998) for an analysis of choice of regions by United States and Japanese multinationals within European Union countries.

capital participation in an existing firm. The JETRO (1997) survey indicated that approximately 64 per cent of Japanese affiliates in Europe were greenfield ventures, 22 per cent were mergers and acquisitions and 14 per cent involved capital participation. These proportions varied substantially between host countries and between industries (see table 5).<sup>12</sup> Furthermore, the JETRO survey also indicated that the share of corporate acquisitions has been growing at a fast rate, and looks set to continue. Collis and Noon (1994) confirm that mergers and acquisitions and strategic alliances became much more widely used by Japanese manufacturing firms through the 1980s.

**Tables 5. Forms of investment by country and by industry, 1980-1995**

By country and industry	Form of investment (per cent)			
	Affiliate established	Acquisition	Capital participation	Other
<b>By country</b>				
United Kingdom	71.5	22.2	6.3	-
France	59.6	22.8	15.8	1.8
Germany	53.7	27.8	18.5	-
Spain	39.5	28.9	31.6	-
Netherlands	80.0	17.1	2.9	-
Italy	57.9	15.8	26.3	-
Belgium	86.7	19.0	14.3	-
<b>By industry</b>				
Food, beverages & tobacco	46.7	46.7	6.7	-
Textiles, apparel & leather	66.7	25.0	8.3	-
Wood products & furniture	-	100.0	-	-
Paper products & printing	80.0	-	20.0	-
Chemical products	63.1	29.1	7.8	-
Non-metallic mineral products	46.2	15.4	30.8	7.7
Base metal industries	50.0	12.5	37.5	-
Fabricated metal products	66.8	18.1	15.1	-
Other manufacturing	60.0	20.0	16.7	3.3

*Source:* JETRO (1997), pp. 18-19.

<sup>12</sup> The proportions also vary substantially within the 'fabricated metal products' group. For instance, 68 per cent of 'metal products' affiliates are greenfield ventures whilst only 8 per cent involve capital participation. In contrast, only 30 per cent of 'transport equipment' subsidiaries are greenfield ventures while 53 per cent involve capital participation.

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We made no allowance for these different entry modes in our regression model. Yet Friedman, Gerlowski and Silberman (1996) found that locational characteristics were relatively more important when firms were establishing greenfield ventures, as they could be expected to weigh up carefully the attributes of alternative sites before making their choices. Site characteristics were of smaller importance for mergers and acquisitions and strategic alliances as market power and diversification criteria were stronger and because, if capital markets can be assumed to be efficient, the relative advantages/disadvantages of a particular site will be capitalized in the price paid. These considerations are certainly of merit when examining the choice of location within a particular country [i.e. the United States in the case of the Friedman, Fung, Gerlowski and Silberman, (1996) study] but may be of less importance in the context of country choice in Europe. Nevertheless such an assumption merits analysis in future work.

Fourthly, many of the United States studies (e.g. Coughlin, Terza and Arromdee, 1991; Friedman, Gerlowski and Silberman, 1992) have suggested that the differences in the locational patterns of Japanese and European FDI may be due to the differing industrial compositions of that investment, and that further research was needed on the variability of locational determinants across industries. In particular, differences have been highlighted with respect to the effect of labour market conditions. Wheeler and Mody (1992) found that location decisions in the electronics sector were very sensitive to variations in labour costs, and Yamawaki (1991) reported that Japanese electronics and motor vehicle manufacturers were particularly sensitive to labour cost variations across European Union countries. Again further work is required on this topic, either by considering industries separately or by differentiating between low-technology and high-technology industries to see if there are differences in the relative importance of the attributes. ■



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**Annex table 1. Means of explanatory variables <sup>a</sup>**

Explanatory variable <sup>b</sup>	Units	United Kingdom	France	Germany	Spain	Netherlands	Italy	Belgium
<b>INCOME</b>	\$ per capita	15290	19466	19006	11207	17545	17493	17767
<b>GROWTH</b>	per cent per year	1.95	1.84	2.18	2.21	2.12	2.14	1.89
<b>WAGE</b>	ecu	16132	20919	19513	13042	22471	17407	20829
<b>PROD</b>	\$ per capita	24271	38888	35809	26259	38998	31444	37788
<b>FDIVAL</b>	\$'000 per capita	112.8	38.0	31.4	47.3	302.5	14.8	97.4
<b>FDINO</b>	per million capita	13.48	9.88	3.94	4.85	12.48	2.61	9.79
<b>UNION</b>	per cent	45.1	13.6	35.3	15.5	28.9	43.0	53.6
<b>EDUF</b>	per cent	21.3	20.6	15.4	22.8	25.0	18.0	21.0
<b>EDUS</b>	per cent	7.0	4.0	3.8	6.0	4.8	4.7	6.2
<b>PATRES</b>	per capita	0.088	0.155	0.179	0.034	0.051	0.034	0.070
<b>PATTOT</b>	per capita	0.542	0.584	0.435	0.257	0.865	0.307	1.042
<b>OUTPUT <sup>c</sup></b>	\$ per capita	24005	32879	39036	19152	4701	28350	30015

*Source:* Authors' calculation.

- Notes:*
- (a) The mean figures are average values for each country over the period 1979-1994, except for FDI VAL and FDINO where the figures relate to 1994.
  - (b) See table 3 for definitions of variables.
  - (c) The figures for OUTPUT are for the whole manufacturing sector in each country: industry figures were used in the regressions.

**Annex table 2. Correlations between explanatory variables**

Explanatory variable	GROWTH	WAGE	PROD	FDIVAL	FDINO	UNION	EDUF	EDUS	PATRES	PATTOT
INCOME	0.034	0.818	0.689	0.258	0.391	0.104	-0.429	-0.424	0.544	0.498
GROWTH		-0.067	0.089	0.013	-0.036	-0.041	-0.050	-0.011	0.016	0.021
WAGE			0.621	0.351	0.402	0.084	0.000	-0.390	0.334	0.609
PROD				0.478	0.440	-0.126	-0.109	-0.316	0.277	0.609
FDIVAL					0.738	-0.067	0.212	0.191	-0.078	0.651
FDINO						-0.082	0.220	0.371	0.151	0.687
UNION							-0.206	0.356	-0.180	0.172
EDUF								0.381	-0.496	0.136
EDUS									-0.449	0.198
PATRES										0.138

*Source:* Authors' calculation.

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## International codes of conduct and corporate social responsibility: can transnational corporations regulate themselves?

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Ans Kolk, Rob van Tulder and Carlijn Welters\*

Following an unsuccessful attempt in the 1970s by international organizations, such as the International Labour Organization, the Organization for Economic Co-operation and Development and the United Nations, to introduce international codes of conduct, interest in such has increased again in the course of the 1990s. These days, interest in codes of conduct is primarily the result of actions by consumer groups and other non-governmental organizations, and by managers of transnational corporations themselves. These actors have started to think about social responsibility and self-regulation in a more proactive fashion. Social and performance seem to be linked. More recently, governments and international organizations have also become involved again. This article examines 132 codes of conduct drawn up by four different actors: social interest groups, business support groups, international organizations and firms. The contents of the codes and their capacity to address the regulatory void left by processes of globalization is assessed. Complementary to the literature on codes of 'business ethics', this article's analytical framework centres on specificity and compliance mechanisms. The likelihood of compliance not only depends on the contents of the code, but is also heavily influenced by the *interaction* of various stakeholders in its formulation and implementation. The content analysis of a large number of codes drawn up by the four different actors, supplemented by two case studies, improves understanding about the dynamics and likely policy implications of codes of conduct. Voluntary TNC codes are showing clear potential in addressing unstable socioeconomic relations *provided* other actors do not step aside.

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## **Introduction: re-appealing a controversial issue**

At the session of the World Economic Forum in Davos in January 1999, United Nations Secretary General Kofi Annan addressed the danger of socioeconomic instability in international economic relations. Part of his speech covered an appeal to transnational corporations (TNCs) to cast universal principles in the areas of human rights, workers' rights and the environment in a voluntary manner. The Secretary General's appeal comes at a moment when corporate codes of conduct are (again) on the top of the agenda of international policy makers, business representatives and opinion leaders. The statement also shows that, despite the large number of codes already drafted around the world by representatives of firms, governments and non-governmental organizations (NGOs), the status of these codes is still unclear and their operationalization is probably inadequate to address the regulatory challenges of globalization. This article presents a first step towards a more comparative and comprehensive research on voluntary corporate codes of conduct, their contents and their impact.

It has been always disputed whether the behaviour of TNCs can be regulated through codes of conduct. The discussion attracted worldwide attention in the 1970s, when international organizations such as the International Labour Organization (ILO, in 1977), the United Nations Centre on Transnational Corporations (UNCTC, 1978) and the Organisation for Economic Co-operation and Development (OECD, 1976) almost simultaneously tried to design codes of conduct. Governments of both developed and developing countries which faced major inroads of TNCs in their economies showed interest in the debate. Critical social interest groups also pushed the discussion further. But the lack of international consensus about the function, the wording and about potential sanctions against non-compliant firms, in particular, moderated the original intention to make the codes mandatory. Instead, voluntary codes were agreed, which had only limited effects. The ILO code, for example, was adopted voluntarily by one firm, but after trade unions used this code in an industrial dispute with the firm's managers, no other firm dared to do the same.

In the 1980s, codes of conduct received rather scant attention. The codes of the ILO (the Tripartite Declaration of Principles



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concerning Multinational Enterprises) and the OECD (the Guidelines for Multinational Enterprises) performed an exemplary function (Getz, 1990). The boldest initiative was the UNCTC's draft code. But it never got rid of its 'draft' status. It was abandoned altogether in 1992,<sup>1</sup> due to the differences in interests between Northern and Southern countries (Van Eyk, 1995; WEDO, 1995). In the 1980s, the discussion on corporate codes of conduct was confined largely to 'business ethics', and was carried on primarily in the United States. United States firms' had traditionally been interested in business ethics for a number of national reasons, particularly related to practices of litigation. The international dimension of the debate, however, remained limited and attention to business ethics in other than United States firms was rather modest (Langlois and Schlegelmilch, 1990).

In the 1990s, efforts to formulate (global) standards for TNC conduct re-emerged. Besides international organizations, governments, social interest groups and firms themselves started to draw up codes in which they voluntarily committed themselves to a particular set of norms and values. They did this either individually, or under the coordination of particular business support groups, such as the International Chamber of Commerce (ICC) or sectoral organizations.

The discussion on how to regulate TNC activities usually centres around three themes. First, it is linked with the relocation debate or, more recently, the discussion on outsourcing of production facilities to low-wage countries with inferior labour conditions. In these countries, as an appropriate regulatory framework to protect workers may be either missing or not implemented, suppliers may resort to child labour, pay extremely low wages or deny workers basic rights such as freedom of association and collective bargaining. In 1992, Levi Strauss & Company was the first to develop a corporate code of conduct placing the management of ethics and labour rights in the context of international supplier relations (CEP, 1998).

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<sup>1</sup> Therefore, UNCTC's draft code is not included in this study, whereas UNCTAD's 1985 Draft Code on the Transfer of Technology is analysed as one of the 132 codes of conduct (see annex table 1).

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A second theme is cooperation with, or implicit support for, oppressive regimes. Ever since ITT's involvement in the 1973 Chilean *coup d'état*, has this question been on the agenda. In the 1990s, for example, Royal Dutch/Shell has been criticized for its relations with the Nigerian military regime, and various TNCs, including Carlsberg and Total, for their activities or plans to invest in Myanmar. In 1997, Shell became the first TNC to fully adhere – in its code – to the principles set out in the 1948 Universal Declaration of Human Rights.

The third theme has been environmental damage resulting from TNC operations (Kolk, 2000). In the 1970s, consciousness about the risks of industrial activities spiralled as a result of the Seveso dioxin leak and the Amoco Cadiz oil spill, followed almost one decade later by the explosion in the Union Carbide factory in Bhopal, the Rhine pollution by Sandoz and the Exxon Valdez oil spill. TNCs were also accused of relocating production facilities to developing countries to evade strict environmental regulations (the so-called pollution havens). From the late 1980s onwards, mounting public awareness of global environmental problems such as the destruction of the ozone layer, global warming and the destruction of tropical rainforests, has also led to renewed interest in this issue (Kolk, 1998). It turned out to be a breeding ground for a large-scale mobilization against the dumping of Shell's Brent Spar oil platform into the ocean and mounting distrust of oil TNCs in general.

As a result of these tendencies, at the end of the twentieth century, a plethora of codes and statements of corporate responsibility exists. Not surprisingly, an overview of their contents and soundness, let alone their impact, is missing. Inventories by international organizations of existing codes, especially at the level of business support groups or at the topical level, are starting to emerge (ILO, 1998; Nash and Ehrenfeld, 1997; UNCTAD, 1996, UNEP, 1998). In addition, a number of critical consumer organizations, such as the United States Council of Economic Priorities, has started to analyse the contents of a large number of company codes on the issue of labour practices (CEP, 1998). Furthermore, private investors have become more interested in corporate responsiveness, because they share the impression that it is not only more ethical to invest in 'just' firms, but that these firms' performance in terms of market

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capitalization is also better (cf. Van Tulder, 1999). In order to develop 'ethical' (or 'green') investment portfolios, attempts are being made to create indexes of responsive business.

However, there is no general agreement on how to create indicators to assess the social responsibility of enterprises (cf. Clarkson, 1995; Hopkins, 1997). Moreover, studies that systematically compare codes of firms *from different countries* are generally lacking. In addition, examinations of contents of codes *by different actors* – governments, social interest groups and firms themselves – are rather inadequate. Finally, the *policy challenges* created by the interaction of – often rival – codes is hardly addressed.

This article focuses on these four areas. The first part deals with the relationship between corporate social responsibility and codes of conduct. Subsequently, the characteristics, contents and significance of international codes of conduct, defined for this purpose as written guidelines, recommendations or rules issued by actors within society in order to enhance corporate responsibility, are considered.<sup>2</sup> Types of codes are delineated, distinguishing among the different actors active at the macro (governmental), meso (industry) or micro (firm) level. An analytical framework is developed and applied to 132 codes, which have been adopted at different levels in the past three decades. At the micro level, this encompasses 84 corporate codes of (large) TNCs, which will receive specific attention; at the meso level, 24 codes drawn up by business support groups and 13 by social interest groups; and at the macro level, 11 codes drafted by international organizations. In the analysis, specificity and compliance mechanisms are seen as the crucial elements which determine the likelihood of compliance. Clear variations exist between the different types of code. Finally, the concluding section discusses the policy implications of the present generation and proliferation of codes: asking if TNC codes alone can modify socioeconomic instability in the world economy.

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<sup>2</sup> The word 'international' is used because an international perspective has been taken, focusing on those codes which deal with international social and/or environmental issues and involve TNCs. This is a different approach than, for example, Getz (1990), who only includes international organizations.

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## Corporate social responsibility, performance and codes of conduct

The notion of corporate social responsibility appeared first in the beginning of the twentieth century in the United States (Frederick, Post and Davis, 1992, p. 33). It was initiated by wealthy businesspersons such as Carnegie, who believed that firms should not only be concerned with profit-making. The emergence of this idea was also furthered by concern over the imbalance created by the growing size and power of firms, which led to anti-trust legislation in the same period (Holmes, 1977, p. 433). These developments gave rise to the formulation of two general principles which can be seen as the roots of the modern concept of social responsibility: the charity principle and the steward principle (Frederick, Post and Davis, 1992, p. 33).

The *charity principle* is based on the idea that more fortunate people within society should take care of the less fortunate. In the late nineteenth and early twentieth centuries in the absence of a social security system, needy people depended on wealthier individuals. As demands for support grew rapidly, the charitable load started to be taken over by firms: individual philanthropy became corporate charity. Corporate philanthropy is not synonymous with corporate social responsibility because it is not based on a duty or obligation but on 'the desire to do good' (L'Etang, 1995, p. 130). Nevertheless, it can still be considered as one of the pillars of current thinking in this area.

According to the second principle, corporate managers, who run privately owned firms, are *stewards* or trustees able to act in the general interest rather than just serving their shareholders. Professional managers have been placed in their position by public trust and are, therefore, expected to act with a certain degree of social responsibility when making business decisions.

After its rise in the early twentieth century, interest in social responsibility diminished during the Great Depression of the 1930s and the Second World War, to re-emerge in the mid-1950s. It has since continued to be an issue, framed as corporate social responsibility, corporate social responsiveness or, in an attempt to merge the two, as corporate social performance (e.g. Carroll, 1979; Clarkson, 1995; McGee, 1998; Preston and Post, 1975; Wood, 1991;

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Zenisek, 1979). In the past two decades, this discussion has been influenced by stakeholder theory, with the field of business ethics adding moral duties and value systems (e.g. Amba-Rao, 1993; Ford and Richardson, 1994; Frederick, 1986; Freeman, 1984; Mitchell, Agle and Wood, 1997; Sohn, 1982).

The most elaborated attempts to integrate these different strands can be found in the research on *corporate social performance*, which considers principles, processes and outcomes. Building on Wartick and Cochran (1985), Donna Wood (1991, p. 693) defined corporate social performance as “a business organization’s configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm’s societal relationships”. In this perspective, the concept of social responsibility encompasses three levels of analysis (society, firm and manager) with three accompanying principles (see box 1): at the social/institutional level, the principle of legitimacy; at the organizational level, the principle of public responsibility; and at the individual level, the principle of managerial discretion.

There is still considerable debate on the measurement of corporate social performance. The outcome depends, for example, on whether one takes the social or organizational level of analysis (cf. Hopkins, 1997). In all discussions, however, codes of conduct issued by firms figure prominently as an indicator of socially responsible business. The discussion on the relationship between social and financial performance is much less open to debate. Griffen and Mahon (1997) and Roman, Hayibor and Agle (1999, p. 121), who reviewed 25 years of research in this field, conclude that the vast majority of studies (with a wide variety of measuring methods) supported the idea that, at the very least, good social performance did not lead to poor financial performance. To the contrary, most studies point at a positive correlation. The issue is not yet fully resolved, however. Research on the performance of socially responsible firms has focused on market capitalization of large sets of internationally operating firms. One indicator, the so-called Domini index, scored 400 firms over the 1990-1998 period, with a systematically higher market capitalization than those in the Standard and Poor 500 index (cf. Van Tulder, 1999).

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### **Box 1. Principles of corporate social responsibility**

**Principle of legitimacy:** Society grants legitimacy and power to business. In the long run, those who do not use power in a manner which society considers responsible will tend to lose it.

*Level of application:* institutional, based on a firm's generic obligations as a business organization

*Focus:* obligations and sanctions

*Value:* defines the institutional relationship between business and society and specifies what is expected of any business

**Principle of public responsibility:** Businesses are responsible for outcomes related to their primary and secondary areas of involvement with society (primary involvements are the essential tasks of the firm, secondary involvements the effects of these primary tasks).

*Level of application:* organizational, based on a firm's specific circumstances and relationships to the environment

*Focus:* behavioral parameters for organizations

*Value:* confines a business's responsibility to those problems related to the firm's activities and interests, without specifying a too-narrow domain of possible action

**Principle of managerial discretion:** Managers are moral actors. Within every domain of corporate social responsibility, they are obliged to exercise such discretion as is available to them, toward socially responsible outcomes.

*Level of application:* individual, based on people as actors within organizations

*Focus:* choice, opportunity, personal responsibility

*Value:* defines managers' responsibility to be moral actors and to perceive and exercise choice in the service of social responsibility

*Source:* Wood (1991, p. 696).

Codes of conduct have relevance for all three levels mentioned in figure 1. Nevertheless, individual ethical principles are usually covered by internal codes of conduct, which consist of guidelines for staff on how to behave when confronted with dilemmas such as conflict of interests, gifts, theft, insider trading, pay-offs and bribery. These types of codes are not the subject of current debate because they hardly address the business-society relationship. This article focuses instead on firms' externally oriented codes, and codes issued

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by other actors, which relate to the principles of legitimacy and public responsibility. Key questions to be addressed include the list of countries where TNCs are responsible when acting internationally (home, host country or both), how social control can be exerted and by whom, and how firms can cooperate effectively with different actors.

Moving from the principles of social responsibility to the processes of social responsiveness, the focus shifts to managerial action, to “the capacity of a corporation to respond to social pressures” (Frederick, 1986, pp. 154-155). This encompasses an analysis of the situation including an assessment of stakeholder demands and the development of appropriate plans. The contents of these managerial responses are embodied in environmental management, stakeholder management and issues management, which deal with context, actors and interests. In the analysis of the codes of conduct, these features have been incorporated.

To some extent, this also applies to the third aspect of corporate social performance, i.e. the outcomes. In Wood’s (1991) perspective, outcomes consist of social impacts, programmes and policies. Only the first, the social impact, can reasonably be assessed and used to draw conclusions about actual performance. For programmes and policies this is much more complicated. It is nevertheless possible to examine codes of conduct for their compliance mechanisms: monitoring, sanctions and financial commitment. Together with the specificity of the contents, they determine the likelihood of compliance.

### **Codes of conduct : rationales and types**

The rationale for codes of conduct can be found in the business-society interface. Codes of conduct, therefore, encompass guidelines, recommendations or rules issued by entities within society (adopting body or actor) with the intent to affect the behaviour of (international) business entities (target) within society in order to enhance corporate responsibility. In this definition, the adopting body can be any social actor, whereas firms are always the target. It should be noted that firms might design codes for other purposes than for the sake of their own ethical behaviour and corporate responsibility. It is highly conceivable that codes adopted by firms are in essence meant to

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influence other social actors: regulators, customers, communities, suppliers and contractors, competitors or shareholders. The possibility that codes may serve other purposes than social responsibility as such is relevant when analysing their properties and substance.

Hence, two types of codes do exist. On the one hand, social, non-profit actors may use codes of conduct to guide and/or restrict firms' behaviour, thus trying to improve corporate social responsibility. Adopting bodies are either governments or international organizations (at the macro level) or social interest groups such as consumer, environmental and minority organizations, trade unions and churches, at the meso level. On the other hand, codes can be drawn up by firms (micro level) or business support groups (meso level), such as industry and trade associations, chambers of commerce, think tanks and business leaders forums. In these cases, codes serve to influence other actors and/or to carry out voluntary or anticipatory self-regulation.

With regard to the effect on other actors, one might think of new market opportunities, risk reduction, increased control over business partners or improvement of the corporate image. Except for control over business partners, whereby codes can potentially become strategic instruments, the other aspects are related to public relations. This could be seen with suspicion, as mere rhetoric (cf. environmentalists who accuse TNCs of 'greenwashing'), but also in a more straightforward, almost existential way, in that firms need a social 'license to operate'.

Codes can also play a role in the relationship between the public and private sectors. Firms generally resist excessive government laws and regulations which are seen to restrict their freedom of action. The chances of successfully preventing such 'command and control' increase if firms convincingly show that they can regulate themselves. Self-regulation encompasses voluntary standards adopted by firms or their business support groups in the absence of regulatory requirements, or those which are taken to help compliance or exceed pre-existing regulations (Hemphill, 1992). Thus, codes of conduct are drawn up to anticipate or prevent mandatory regulation.

Given these different rationales, the codes of conduct designed by the four types of actors at the three levels will be analysed in



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more detail. In total, 132 codes have been collected (see annex table 1 for a full list). At the macro level, international organizations include ILO, OECD, UNCTAD and the World Health Organization. Of the 11 codes, six originated in the 1970s and early 1980s, and the remaining five in the second wave in the 1990s.

The micro level encompasses 84 codes drawn up by the largest TNCs in the world. Consequently, more than 60 belong to the 1997 global Fortune 500 ranking. A great number of the non-United States Fortune 500 firms (in particular firms from Japan and the Republic of Korea) did not have a code and were thus not included in the analysis. Approximately 30 per cent of the codes have been adopted by European firms. The remaining codes were selected because the firms that have adopted them have been pioneers in this field (such as the Body Shop or Gap). The analysis is based on the most recent version of firms' codes.

At the meso level, two types of actors' codes have been analysed. First, these of social interest groups such as the Clean Clothes Campaign, the Council on Economic Priorities Accreditation Agency and the Coalition for Environmentally Responsible Economies (all 13 codes were adopted in the 1990s). Secondly, codes adopted by business support groups ranging from *Keidanren* to the insurance industry and the World Travel and Tourism Council have been examined. With the exception of the International Chamber of Commerce's Guidelines for Multinational Investment (1972) and the Chemical Industry's Responsible Care (mid-1980s), all 24 codes are dated in the 1990s.

### **Analysing codes of conduct: framework and results**

Even after cursory reading, one can notice that some codes are more thorough than others. This difference does not necessarily hinge on the number of issues covered or on prohibitory rules. Thoroughness rather depends on compliance likelihood, i.e. the probability that firms will conform in practice to codes either proclaimed by themselves or developed by other actors. Compliance likelihood is determined by the compliance mechanisms included in the codes and the extent to which the claims put forward are measurable. The more specific the codes are, the better can they be

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measured and, subsequently, monitored. Monitoring is expected to enhance codes' comprehensiveness and compliance likelihood.

Hence, to determine the compliance likelihood of codes of conduct, two sets of criteria have been used: their specificity and compliance mechanisms. Figure 1 gives a further specification of these broad categories into nine and five elements, respectively. In the case of specificity, these are grouped in issues, focus and measurability. These different aspects will be explained briefly, also indicating how operationalization has taken place.<sup>3</sup>

### *Specificity*

#### *Social, environmental and generic issues*

Codes of conduct contain statements about social, environmental and more generic aspects, or all of them. Each of these issue areas is divided into five categories (see second column in figure 1); these, in turn, consist of different but related individual components (see below). A code can address several issue categories, ranging from 'zero out of five' to 'five out of five' (see third column in figure 1).

The contents of the social policy of a firm seem to be approximated best by a number of Conventions, Recommendations and the *Tripartite Declaration* adopted by the International Labour Organization (ILO, 1991). Four of the social issue categories in figure 1 are derived from this tripartite declaration:

- employment (consisting of employment promotion; equality of opportunity and treatment; and security of employment);
- training;
- working conditions (wages and benefits; conditions of work and life; safety and health);
- industrial relations (freedom of association and the right to organize; collective bargaining; consultation; examination of grievances; settlement of industrial disputes).

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<sup>3</sup> A very detailed description and justification of all the elements of the framework can be found in Welters and van Tulder (1997).

**Figure 1. A model to analyse and compare codes of conduct**

Criteria	Details	Classification	
I S S U E S p e c i f i c i n g	1.1. Social	Employment; training; working conditions; industrial relations; force	ranging from 0 out of 5 to 5 out of 5
	1.2. Environment	Management policies; input/output; stakeholders; finance; sustainable development	ranging from 0 out of 5 to 5 out of 5
	1.3. Generic	consumer interests; communities; global development; ethics; legal requirements	ranging from 0 out of 5 to 5 out of 5
	2.1. Organizations targeted	organizations; firms; industries; business partners; specific firms	no/general/frail/moderate/moderate-strong/strong
	2.2. Geographic scope	global; nearly global; general region; regulatory system; specific country	ibid.
	2.3. Nature	general prescription/description; predominantly general; general and specific; predominantly specific; specific	ibid.
M e a s u r e	3.1. Quantitive standards	quantification (% of): >90; 51-90; 25-50; 10-25; <10; none	predominant/majority/medium/minority/few/none
	3.2. Time horizon	quantification (% of): >90; 51-90; 25-50; 10-25; <10; none	ibid.; and none/vague/clear
	3.3. Reference		none/home/host/international
C o m p l i a n c e	4.1. Monitoring systems and processes		clear/clear-vague/vague/none
	4.2. Position of monitoring actor		ranging from first to sixth party
	4.3. Sanctions		none/mild/severe
	4.4. Sanctions to third parties		n.a./none/mild/severe
	4.5. Financial commitment		low/moderate/high/very high/none

Source: Compiled by the authors.

A major shortcoming of the declaration is that it contains no provisions on child labour, an issue which has increased in importance in the international debate, and covered by another ILO convention. It is here included in a fifth social issue category designated as aspects of force (child labour; forced or compulsory labour; disciplinary practices).

**Table 1a. Number of social issues in different codes**

*(in per cent of code type)*

	0	1	2	3	4	5
International organizations	36.4	18.2	0	9.1	9.1	27.3
Social groups	7.7	7.7	15.4	0	38.5	30.8
Business groups	58.3	0	4.2	16.7	20.8	0
Firms	4.8	19.0	15.5	25.0	28.6	7.1

*Source:* Authors' calculation.

Table 1a summarizes the results of the codes with regard to social issues, divided into the different categories. Social interest groups, followed by international organizations and TNCs, include the highest number of social issues. The table also shows that a considerable percentage of business support groups and international organization codes do not deal with social issues at all; this applies to only 5 per cent of TNC and 8 per cent of social interest group codes. To give an idea with regard to child labour, this is mentioned in 31 per cent of all the codes; 18 per cent of the international organizations codes; 62 per cent of social interest group codes; and 29 per cent of both business support groups and TNCs' codes.

To illustrate the dynamics of social codes, box 2 presents a short case study of the action-reaction patterns that have taken place in the process of formulation of such codes in the sporting goods industry. Box 2 refers to the major actors of the sector which have also been included in the sample (see annex table 1).

**Box 2. Evolution of codes of conduct: the sporting goods industry**

In 1992, Levi Strauss was the first to adopt a supplier code, but Nike followed very quickly in the same year with its Nike Code of Conduct. In response, Reebok – Nike's main United States competitor – followed suit with its 'human rights production standard' – an almost identical code. The almost parallel adoption of supplier codes by firms in the United States fashion and sporting goods industry indicates the importance of strong consumer action for their inclination to come up /...

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**(Box 2, concluded)**

with codes. In 1993, the American Athletic Footwear Association (AFA) adopted a Statement of Guidelines on Practices for Business Partners, which is more vague than the Nike and/or Reebok codes. Criticism did not stop, however. Social interest groups, such as trade unions and critical consumer groups, continued their actions against the socially dubious circumstances under which the suppliers of United States firms, in particular, worked.

The adoption, in 1997, of a Model Code of Conduct by the World Federation of the Sporting Goods Industry (WFSGI), another business support group, did not spur more specific codes of conduct. It merely offered a watered-down minimum guideline for firms, which were also advised to develop their own codes of conduct. A specific WFSGI committee did monitor child labour in Pakistan's soccer ball industry, and it tried to abolish that practice with some success.

More sophisticated codes were stimulated by a big customer and licensee of the sporting goods industry: FIFA, the international football association. In 1996, FIFA adopted a Code of Labour Practice, in cooperation with two important international trade unions. It is primarily a social code that describes compliance mechanisms in detail. FIFA is the monitoring party, and severe sanctions for non-compliance are included.

An equally important stimulus for specific United States codes was provided by the 1997 WorkPlace Code of Conduct elaborated by the Apparel Industry Partnership (AIP). AIP had been initiated by the Clinton Administration in 1996 and is commonly referred to as the 'President's Taskforce on Sweatshops'. The group included United States apparel producers (such as Nike, Reebok and Liz Claiborne), social interest groups and business support groups. The code is more specific than any of the industry codes, is monitored by participating firms and independent monitoring actors, and sanctions are stipulated for third parties in case of non-compliance.

*Source:* Compiled by the authors.

Moving to environmental issues, these are based on the 50 reporting ingredients used by UNEP and a consultancy firm Sustainability in a series of benchmark surveys (e.g. UNEP/Sustainability, 1996). Although these methods were originally

designed to analyse corporate environmental reports, many elements of this scheme can also serve to analyse codes of conduct. We regrouped and condensed these original 50 items to increase comparability with the other issue categories and to eliminate the ingredients which are non-environmental (Kolk, 1999). Five UNEP/Sustainability categories are still used:

- management policies and systems (consisting of corporate environmental management strategy and vision; integrated environmental management; environmental assessment; research and development);
- input/output inventory (inputs; process management; health and safety; risk assessment; outputs; products);
- finance (financial aspects; environmental liabilities);
- stakeholder relations (employees; legislators and regulators; local communities; distributors; suppliers and contractors; customers and consumers; secondary stakeholders);
- sustainable development (technology cooperation; global environment; global standards).

**Table 1b. Number of environmental issues in different codes**  
(in per cent of code type)

	0	1	2	3	4	5
International organizations	27.3	18.2	9.1	18.2	27.3	0
Social groups	46.2	30.8	7.7	0	0	15.4
Business groups	33.3	12.5	0	20.8	33.3	0
Firms	29.8	7.1	11.9	10.7	14.3	26.2

Source: Authors' calculation.

In table 1b, the number of environmental issues mentioned in the codes is calculated. Of the 132 codes examined, a higher per cent lacks environmental issues (32 per cent) than social issues (17 per cent). Especially social interest groups and TNCs' codes pay much less attention to environmental than to social issues. If they do, however, TNC, but also business support groups and international organizations' codes include more issue categories than social interest groups' codes. Financial aspects of environmental issues are only mentioned by TNCs in 25 per cent of the codes. Reference to

environmental liabilities is made by only 17 per cent of TNC codes, and by 15 per cent of social interest groups, 9 per cent of international organizations and 4 per cent of business support groups' codes. Social interest groups' codes do not include statements on firms' cooperation with suppliers and contractors on environmental issues, while business support groups (46 per cent), TNCs (36 per cent) and international organizations (18 per cent) do so.

The third and final issue includes statements of a more general interest which do not fall under the headings 'social' and 'environmental'. Generic issues are mentioned less frequently in codes of conduct because they are less connected to firms' operations. Five categories are distinguished here as well:

- consumer interests (consumer needs; disclosure of information; consumer concerns; marketing practices);
- community interests (community involvement; disclosure of information; community philanthropy/sponsoring);
- global development (global issues; sociopolitical setting; fair and free trade practices; development and philanthropy/sponsoring in developing countries);
- ethics (fundamental human rights and freedom; fundamental ethical values (see Raiborn and Payne, 1990); bribery and facilitating payments);
- legal requirements (legal compliance of the firm; legal compliance vis-à-vis business partners).

As table 1c shows, social interest groups exhibit the least interest in generic issues, and international organizations and TNCs

**Table 1c. Number of generic issues in different codes**

*(in per cent of code type)*

	0	1	2	3	4	5
International organizations	9.1	27.3	9.1	18.2	27.3	9.1
Social groups	38.5	7.7	30.8	15.4	0	7.7
Business groups	20.8	37.5	25.0	8.3	4.2	4.2
Firms	13.1	15.5	19.0	25.0	13.1	14.3

*Source:* Authors' calculation.

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the most. Specific issue categories are salient. Reference to fundamental human rights and freedoms, as embodied in declarations and conventions, is made by 6 per cent of TNC codes, 8 per cent of those of business support groups, 18 per cent of international organizations and 39 per cent of social interest groups. TNCs especially are notable for their much higher support when general statements on fundamental ethical values are concerned; these are mentioned in 51 per cent of the TNC codes.

### *Focus*

The more elaborated and focused codes are, the better they might be quantified or lead to measurable standards. This does not always apply, however: there are issues which can hardly be measured, although their statements may be very focused in qualitative terms, for example, when clear targets are formulated for participating organizations. Therefore, focus is an indication complementary to measurability when trying to assess the specificity of codes of conduct. The focus can differ with respect to the target, the geographic scope and the nature of codes (see figure 1).

The target of statements of corporate social responsibility is the organizations addressed by the code. These can be all organizations, firms in general, firms within a particular industry, business partners or specific firms. Codes are classified as least focused (general) when they aim at all organizations, which includes governments and firms. A frail focus implies that all firms are targeted, irrespective of the industry or firm-specific attributes. One step further towards (moderate) specificity involves the objective to influence the behaviour of firms within a given industry. When codes address the business partners of firms, i.e., their suppliers, contractors and distributors, their targets can be designated as moderate to strong.<sup>4</sup> Such conditions can serve to regulate other firms' conduct, but also as self-imposed standards to select business partners. Finally, a strong focus means that codes affect the internal operations of specific firms. As can be seen in table 2a, business support groups and especially TNCs are strong or moderate to strong with regard to the target. Aggregating these two categories results in 93 per cent of the TNC codes. Codes adopted by international organizations and, to a lesser

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<sup>4</sup> This particular category covers the network of so-called core firms (Ruigrok and Van Tulder, 1995).



extent, social interest groups usually have a much more general or frail target.

**Table 2a. Target of different types of codes**

*(in per cent of code type)*

	None	General	Frail	Moderate	Mod/strong	Strong
International organizations	0	45.5	36.4	0	18.2	0
Social groups	0	30.8	30.8	23.1	15.4	0
Business groups	0	8.3	25.0	33.3	33.3	0
Firms	0	3.6	2.4	1.2	42.9	50.0

*Source:* Authors' calculation.

A comparable categorization has been made with regard to the geographic scope. The least focused (general) are statements which apply to all locations. Slightly more specific, but still very frail are those which are global except for a particular country or which refer to applicability in developed or developing countries. Moderately focused codes aim at firms in a specific large region (Asia, America, Africa, Europe); in the case of moderate/strong, they refer to groups of countries which share economic and political institutions, such as the European Union, with rules or regulations in place for elements of corporate social responsibility. Finally, a strong focus means that codes apply to (parts of) one country. The overwhelming majority of the 132 codes are merely global in scope (categories none, general and frail) (see table 2b). This applies to almost all actor groups, but least for social interest groups.

**Table 2b. Geographic scope of different types of codes**

*(in per cent of code type)*

	None	General	Frail	Moderate	Mod/strong	Strong
International organizations	9.1	63.6	9.1	18.2	0	0
Social groups	23.1	38.5	7.7	0	15.4	15.4
Business groups	70.8	29.2	0	0	0	0
Firms	17.9	72.6	1.2	4.8	2.4	1.2

*Source:* Authors' calculation.

The third aspect of the focus relates to the treatment of issues included in the code. The way codes address social, environmental and generic issues is expected to have a profound effect on the compliance likelihood. If issues are mentioned in general, leaving much room for interpretation, they will be more difficult to monitor than in case of a restrictive formulation. Furthermore, codes of conduct can either stimulate certain action (prescription) or discourage or even forbid activities (restriction). Both prescription and restriction aim at a general set of guidelines or at specific positive or negative action. On the basis of these four types, the same categories have been distinguished: general (prescription or description); frail (predominantly general); moderate (balanced combination of general and specific); moderate/strong (predominantly specific); and strong (specific restriction and/or prescription). It should be noted that the nature of issues cannot be assessed equally; social issues are covered by more codes and are more easy to specify than environmental and generic issues.

Analysing the different types of codes, the picture with regard to nature is almost the reverse of target (cf. table 2c with table 2a). Social interest group codes, closely followed by international organization codes, are strong, containing specific restrictions and/or prescriptions. TNC and particularly business support group codes are predominantly general or frail. Balancing these different items, codes of social interest groups and international organizations certainly have a stronger focus, although TNC codes have the potential to become more strict as the target has already been clearly defined. Moreover, 11 per cent of the TNC codes is strong, and 14 per cent is moderate to strong.

**Table 2c. Nature of different types of codes**

*(in per cent of code type)*

	None	General	Frail	Moderate	Mod/strong	Strong
International organizations	0	9.1	18.2	9.1	18.2	45.5
Social groups	0	15.4	7.7	0	23.1	53.8
Business groups	0	45.8	33.3	8.3	4.2	8.3
Firms	0	40.5	20.2	14.3	14.3	10.7

*Source:* Authors' calculation.

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## *Measurability*

The use of quantitative standards to define and operationalize concepts increases the measurability of statements. To arrive at a yardstick, the number of social and environmental issues addressed by a code is counted, calculating subsequently the percentage which has been quantified. If this applies to more than 90 per cent of all issues, then the code falls into the category of 'quantified'. In decreasing rates of quantification, it can be labelled as 'majority' (51-90 per cent), 'medium' (25-50 per cent), 'minority' (10-25 per cent), 'few' (less than 10 per cent) or none. In all codes, quantitative standards are not used very frequently; 'predominantly', 'majority' and 'medium' only applies to respectively 2 and 8 per cent of the 132 codes. These percentages originate only from TNC codes.

The inclusion of a time horizon also adds to measurability and credibility (Burns et al., 1996, p. 19). As in any area of business, operationalized goals are accompanied by time planning. Whether this encompasses a short, medium or long term, however, depends on the issues at stake, which complicates a generally valid assessment. In view of the fact that the time horizon is a significant component, three broad categories are distinguished: none defined; vague; and clear. In 14 per cent of all the codes, the time horizon is clear, in 13 per cent vague. Differentiating between the types of actor, international organization codes have the highest percentage of clarity (27 and 0 per cent vague), followed by codes of social interest groups (15 and 23 per cent vague), TNCs codes (13 and 10 per cent vague) and business support groups (8 and 4 per cent vague).

In addition, the percentage of the issues with a time horizon can be calculated and classified, just like quantitative standards. Time horizons with regard to monitoring are not included here, but as part of the monitoring systems examined below. In 9 per cent of the international organization codes, more than 90 per cent of the issues has a time horizon (predominantly); this category does not appear in the other types of codes. A majority of the issues with a time horizon (50-90 per cent) can be found in 8 per cent of the Social Interest Group codes and 2 per cent of the TNC codes; another 2 per cent of the TNC codes can be labelled as 'medium' (25-50 per cent with a time horizon).

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The third component of measurability is reference to standards. This issue is part of a broader debate on universal versus country/culture-specific codes. Box 3 gives some more background information on the nature of the dilemmas faced by TNCs.

### **Box 3. Universality or specificity of principles?**

Most disputed about codes of conduct has been the issue of universal versus country/culture-specific codes. This dilemma is related to cross-cultural management: TNCs have to decide whether to integrate and coordinate the activities of their affiliates, or allow them to carry out loosely organized and relatively autonomous activities. Prahalad and Doz (1986) introduced a so-called 'integration-responsiveness' grid, which maps the dynamics of a business along the scales of pressure for global integration versus local responsiveness. The parallel with codes of conduct is obvious: a universal code corresponds to global integration, a code that is more contingent upon host economy characteristics exemplifies a trend towards local responsiveness.

Research on codes of conduct – either issued by TNCs themselves or by international organizations – does not offer conclusive evidence as to a particular trend in this respect. Whereas most codes adhere to host-country standards (table 3), it is remarkable that TNCs are more prone to support general statements on fundamental ethical values, such as human rights. Few firms, however, explicitly support international standards issued by organizations such as the United Nations or the ILO.

Royal Dutch/Shell, for example, has been among the first ones to adopt a corporate code of conduct. Its code originated in 1976, and it has been adjusted eight times. The most drastic update of Shell's code took place in 1997, after public debate on the Brent Spar and the exploitation of Nigerian oil fields. It prompted Shell to be the first TNC in the world to embrace the 1948 United Nations Universal Declaration of Human Rights. Shell was also the first large TNC that issued a 'social-ethical' annual report in 1998. Before, only smaller and more overtly idealistic companies such as Body Shop, Ben & Jerry's, Danish SBN Bank and United Kingdom fair-trade organization Tradecraft had issued such a report (VNO-NCW, 1999, p. 37). Shell explicitly supports the aims of the 1998 ILO 'Declaration on Fundamental Principles and Rights at Work' (Shell, 1999, p. 28). Shell presents its commitment to human rights as a "deep felt commitment and at the very heart of our core values of honesty, integrity and respect for people" (p. 28). At the same time,

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**(Box 3, concluded)**

however, Shell also notes that, despite good progress, it faces continued challenges and dilemmas. Shell cooperates with human rights' organizations in guiding its actions. It has looked for social debate and approval (cf. Shell, 1999) for its codes of conduct. It wants to demonstrate how seriously it takes its own code. In 1997, for example, 23 employees were fired for not complying with the firm's codes on corruption. Because of its global presence, Shell seems to search more for global alliance partners, such as the Worldwatch Institute.

In the integration-responsiveness grid, Shell can be positioned as a 'global business' with an integrated product and a need for worldwide management – even though the firm consists of *de jure* autonomous subsidiaries. The inclination towards universal norms, therefore, is understandable.

Another TNC of comparable binational (United Kingdom-Netherlands) background is Unilever. Unilever's code stems from 1980 and, like Shell, has been adjusted several times. Compared to Shell, Unilever produces a wide variety of products which are adapted to local consumer needs. Therefore, it has to be much more locally responsive. Unilever's management does not agree with Shell's statement on universal (human) rights and its support of other international standards. Unilever contends in its code that there still is a considerable divergence in the interrelation of (human) rights, and that the Universal Declaration of Human Rights is open for debate on its exact applications in different countries. Unilever adapts more to local circumstances, rather than enforcing its own universal norms. Unilever's strategy aims at regional coalitions with interest groups.

United States firms, such as IBM - one of the firms that adopted a corporate code already in the 1960s – tend to stress 'universal' principles in their codes of conduct. Japanese firms, such as Mizuno or Toshiba, stress adaptation to local customs and norms as exemplified by statements by many Japanese firms on being good 'corporate citizens'.

*Source:* Compiled by the authors.

It can be observed that some codes follow international standards closely whereas others only include a few references or none. Most codes use either host-country laws or local industry practices as the basis for one or two issues, such as wages and benefits.

Therefore, it is difficult to draw an overall conclusion about standards for the entire code. General provisions on compliance, such as endeavours to comply with all applicable laws and standards, have been incorporated in 'generic issues'. Here, a distinction is made between international, home-country and host-country standards, and none defined (either no reference at all, or corporate or industrial standards). International standards include all conventions, treaties and (voluntary) agreements adopted by at least two countries (bilateral, regional, international). Codes sometimes allude to more than one standard, if they do it at all. Especially a considerable number of business support groups' and TNCs' codes does not mention any standard (respectively 54 and 25 per cent). The standards most often referred to in these private-sector codes are those of the host country (in respectively 21 and 36 per cent of the business support groups and TNC codes). Home-country standards, either alone or in combination with international or host-country standards, are mentioned in 19 per cent of the TNC, 17 per cent of the business support group and 15 per cent of the social interest group codes. International standards only rank highest in the international organization codes (54 per cent), followed by codes of social interest groups (23 per cent), TNCs (18 per cent) and business support groups (8 per cent).

**Table 3. Measurability scores of codes on four criteria**  
(strictest classes; in per cent of particular type of code)

	Quantification	Time horizon (issues)	Time horizon (term)	Standards
International organizations	0	9.1	27.3	72.7
Social groups	0	7.7	15.4	69.3
Business groups	0	0	8.3	25.0
Firms	3.6	2.4	13.1	39.4

Source: Authors' calculation.

Table 3 summarizes the four elements of measurability examined in this section, singling out the strictest classes for each of them. In each case, the percentage of codes of international organizations, social interest groups, business support groups and TNCs which contains a criterion is given. Overall, strictness is limited,

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except for standards where a relatively broad definition has been followed, aggregating home-country and/or international standards. Compared to the preceding analysis concerning focus, international organization codes score higher on measurability than those of social interest groups, again followed by codes of TNCs and business support groups.

### *Compliance*

The current debate on codes of conduct focuses on compliance mechanisms, a broad term for implementation, monitoring, reporting, auditing, verification and enforceability. These all serve to increase the likelihood of compliance. In our framework, five categories have been included: monitoring systems and processes; the position of the monitoring actor; sanctions to the firm; sanctions to third parties; and financial commitment (see figure 1).

Monitoring relates to the collection of information and its verification, i.e., to checking whether it is accurate, complete, relevant and reliable. To characterize the quality of monitoring provisions, four categories are used: clear; vague/clear; vague; and none defined. When a good insight into the monitoring process and system can be obtained, including criteria for assessment, and its existence is well known, a code is labelled as clear. Vague/clear means that some monitoring process is envisaged but that criteria for assessment or specific time-frames are lacking. If a code gives no further details other than that monitoring will take place, it is qualified as vague.

As can be seen in table 4a, a very high percentage of business support group codes does not include any statement on monitoring systems and processes. TNCs score lowest in this respect, but this percentage does not differ much from codes of international organizations and social interest groups. TNCs appear to recognize the importance of monitoring in general, as 65 out of 84 codes refer to it (only vaguely in 23 codes, vaguely/clearly in 22 and clearly in 20 codes). In decreasing order, the highest percentage of clear monitoring systems can be found in codes of social interest groups (46 per cent), followed by international organizations (27 per cent), TNCs (24 per cent) and business support groups (8 per cent).

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**Table 4a. Clarity of monitoring systems and processes**

*(in per cent of code type)*

	None	Vague	Vague/clear	Clear
International organizations	27.3	36.4	9.1	27.3
Social groups	30.8	15.4	7.7	46.2
Business groups	62.5	12.5	16.7	8.3
Firms	22.6	27.4	26.2	23.8

*Source:* Authors' calculation.

Directly related to the credibility and effectiveness is the person who monitors, particularly his/her independence. Although an independent monitoring party increases compliance likelihood, the strictness of the code also plays a role. If criteria are very strict, even a relatively dependent actor might suffice, whereas independence will be crucial when vagueness prevails. Six types of monitoring actors can be discerned:

- first party: the firms themselves;
- second party: business support groups such as trade and industry associations;
- third party: external professionals paid by the firm monitored;
- fourth party: combinations of different actors (for example, business support groups and social interest groups);
- fifth party: social interest groups only, without involvement of the firm;
- sixth party: legal authorities.

Most codes do not specify the monitoring party (41 per cent of all codes), or use first-party monitoring (44 per cent). Of the remainder, reference to the fourth party is most frequent (8 per cent), while the fifth party is not mentioned at all. Even social interest groups limit themselves to fourth-party monitoring (in 31 per cent of their codes); international organizations and TNC codes also allude to this (in 9 and 7 per cent of their respective codes). Second-party monitoring is only mentioned by international organizations (9 per cent) and business support groups (4 per cent); sixth-party monitoring only by international organizations themselves (36 per cent). The



majority of TNC codes leaves monitoring to the firms themselves (58 per cent); 32 per cent refers to none.

This result corroborates with the findings of the Council on Economic Priorities (CEP, 1998), which found that of the firms with sourcing guidelines for labour rights, only 44 per cent actually monitors their implementation. The majority of these ‘monitoring firms’ does this internally, whereas only a very tiny proportion uses external auditors, consultants or non-governmental organizations. Interestingly enough, most firms that had established effective monitoring belonged to the Apparel Industry Partnership (AIP) referred to in box 2. Table 4b presents the percentages for the different categories of codes and monitoring parties.

**Table 4b. Monitoring party mentioned in different codes**

*(in per cent of code type)*

	None	First	Second	Third	Fourth	Sixth
International organizations	36.4	9.1	9.1	0	9.1	36.4
Social groups	38.5	23.1	0	7.7	30.8	0
Business groups	75.0	20.8	4.2	0	0	0
Firms	32.1	58.3	0	2.4	7.1	0

*Source:* Authors’ calculation.

Enforcement or sanctions relate to the consequences of non-compliance. The inclusion of sanctions in codes may deter firms from breaking their commitment, and increase the compliance likelihood. Coercive measures can vary greatly in gravity and impact. At one extreme, they may be characterized as severe when business activities threaten to be terminated in case of non-compliance. At the other extreme, they may be as mild when having no major implications for firms (e.g., warnings and exclusion from certain memberships). Severe sanctions are mentioned by 16 per cent of the TNC codes, none of the business support group codes, 15 per cent of the social interest group codes and 9 per cent of the international organization codes.

Sanctions to third parties are used in particular by those firms with substantial outsourcing, that want to encourage subcontractors

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or distributors to comply with the code as well. A variety of codes has been especially designed for these contracting firms, envisaging different types of enforcement measures.<sup>5</sup> Here, these are labelled as mild (for example, fines or demand for corrective action) or severe (severance of the relationship, cancellation of a contract). Sanctions are classified as 'not applicable' if third parties are not mentioned, and as 'none defined' if codes refer to third parties but without sanctions. Considering only business support groups and TNC codes (the most relevant in this respect), 12 TNC codes contain severe sanctions to third parties (and three mild); this is true to eight business support group codes (and one mild).

Finally, a higher financial commitment to the code is likely to positively influence compliance. If the codifying agency requires a high membership fee, the number of adopting firms will be smaller and social control higher. In addition to fees, an indication might be given in a code of the financial investments required (as a percentage of sales, or of total investments). For this purpose, financial commitment is categorized as 'very high' (if larger than \$500,000 or 5 per cent investment), 'high' (between \$100,000 and \$500,000 or 1 to 5 per cent investment), 'moderate' (approximately \$50,000 or moderate investment) or 'low' (below \$10,000). As might be expected, codes requiring financial commitments are not very common. It does not at all occur in the case of international organization codes, and in only 1 of the business support group codes (out of 24) is a low financial commitment involved. In social interest group codes, only two out of 11 codes refer to it (one low and one moderate). With regard to TNCs, the numbers are higher: of the 84 codes, two require very high commitments, six high, one moderate and two low.

## **Conclusions and policy implications**

Can the wave of interest in corporate social responsiveness, in general, and corporate codes of conduct, in particular, adequately address instability in international economic relations? This article considered these policy questions by first analysing the contents of a

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<sup>5</sup> See, for example, the sanctions mentioned by the United States Department of Labor (1996, p. 66) in case contractors or suppliers violate the United States assemblers' codes of conduct.

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large number of codes that have been drafted by four groups of actors. Largely, two clusters of codes could be distinguished: codes adopted by international organizations and social interest groups, and codes drawn up by business support groups and TNCs. International organizations and social interest groups designed codes primarily to guide and/or restrict firms' behaviour, while business support groups and TNCs draw up codes to influence other actors and/or to anticipate or prevent mandatory regulation.

Firms' renewed attention to codes cannot only be interpreted as a defensive response to social pressure. It should increasingly be understood as an effort to engage in a constructive dialogue with external stakeholders on the role of business in society. Codes – now more than ever before – have the function of deciphering the limits of regulation and the roles of governments, firms and representatives of civil society. Codes are an 'entry to talk'. The agenda-setting potential of codes, therefore, should not be underestimated.

The potential for addressing current socioeconomic problems is lowest for business support groups. Comparing the four actors initiating codes of conduct with regard to focus, measurability and compliance mechanisms, the codes issued by business support groups proved weakest on all scores. This reflects their 'lowest common denominator' principle: many of the meso codes succeed in attracting considerable numbers of subscribing firms because the statements are very vague. At the same time, this renders monitoring and sanctions useless, if they exist at all. One might see these codes as awareness-raising tools. However, once this function has been fulfilled, which currently seems to be the case, they become public relations and alibis against more drastic steps, rather than active means to increase corporate social responsibility.

On average, TNC codes score better, especially concerning the organizations targeted, their reference to standards, monitoring systems and position of the monitoring actor. But half of the TNC codes focuses on internal operations and, with only a few exceptions, the rest on business partners (suppliers, contractors, distributors). Of the business support group codes, only one third applies to business partners, one third to a specific industry, whereas the remainder has a general orientation. Three fourths of the business support group

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codes makes no reference at all to standards or only to those of the host country; this is 60 per cent in the case of TNCs. Finally, only one quarter of TNC codes clearly identifies monitoring systems and processes.

TNC codes continue to share certain national characteristics. The majority of codes is still initiated by United States companies, United States business groups and United States NGOs. Up to now, European firms have lagged behind United States firms. Japanese firms generally do not show much interest in adopting codes –and even less in enforcing them. In the early 1990s, this pattern was already noted with regard to interest in codifying business ethics. At that time, European firms were expected to catch up with their United States counterparts by 1996 (Langlois and Schlegelmilch, 1990, p. 524); which turned out not to be the case.

An important factor in this respect is the difference in the way in which an international division of labour is incorporated into firms' strategies. United States firms have been most advanced in internationalizing their supply structures. Japanese firms have trailed relatively far behind, whereas European firms are somewhere in between (Van Tulder, 1999). With a more limited international division of labour in firms' own production network, the need to adopt international codes of conduct is lower. Therefore, the universal nature of voluntary TNC codes is bound to remain restricted. In the formulation of their codes, firms have to deal with the same tension between global integration and local responsiveness as they face in overall international strategic management (cf. Prahalad and Doz, 1986; see box 3). Coalitions with particular stakeholders might tip the balance to either side.

Most of the social interest group codes are relatively new and were drawn up after 1992. Social interest groups are gaining experience with requirements which are feasible for a sufficient number of firms and simultaneously substantial enough to really enhance corporate social responsibility. Social interest groups obviously want to avoid falling into the international organization 'trap' of having to lower standards as a prerequisite for becoming accepted, and, in the process, losing much of the codes' original

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strength and meaning. From the exploratory analysis and comparison of codes in this article, it can be concluded that the compliance likelihood of social interest group codes is not very high, although higher than in the other types of codes. Measurability – with regard to quantitative standards and time horizons – is not high in social interest group codes, and even lower than in some of the TNC codes. This also applies to sanctions and financial commitment, which are part of the compliance mechanisms.

However, three fourths of the social interest group codes do refer to home country and/or international standards, which is considerably stricter than in the other types. A similar, stricter pattern can also be observed with regard to monitoring systems and the monitoring actor. Still, it is to be noted that a substantial percentage of social interest group codes does not refer to standards at all, and does not specify or include monitoring systems and actors. The framework which has been used to analyse codes of conduct might perhaps also serve to identify their strengths and weaknesses, and future improvements. It should be noted that international NGOs, such as Greenpeace, do not develop codes themselves, but rather put pressure on firms to adopt and implement stricter codes.

The impact of codes issued by international organizations has remained modest. There is currently a very limited number of references to existing international standards in TNC and business support group codes. This may be due to the fact that universally applicable norms are not acceptable for TNCs. At the same time, it might indicate that there is a strong need for more up-to-date international codes. The codes of conduct initiated in the framework of the United Nations, in particular, have remained rather broad and rarely have they been taken seriously by member countries as sufficiently adequate or binding. Since the mid-1990s, and as a response to this situation, the governments of developed countries have taken initiatives to adopt more binding codes. Suggestions by the European Parliament for a European code of conduct for firms, the Apparel Industry Partnership (see box 2) and the revision of the OECD Guidelines for Multinational Enterprises can be cited as prime examples. More functional international organizations have also started to fill the void. To cite an example, in collaboration with

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international trade unions, the Fédération Internationale de Football Association (FIFA) has issued codes with a high compliance likelihood.

These developments point at an important new phenomenon in the formulation and implementation of codes of conduct: the establishment of coalitions between firms, international organizations and other actors. It seems that cooperation among the different actors results in more profound codes. Such coalitions can take a large number of forms and be initiated by different actors. In some cases, for example, TNC codes have had an impact on those developed by social interest groups and international organizations. As they sometimes go a step further than a few of the social interest groups and especially the international organization codes, this helps to increase the acceptability of stricter requirements.

Although stricter than TNC codes on aspects such as their nature and the position of the monitoring actor, the compliance likelihood of international organization codes is generally not very high. This reflects partly conflict of interests and/or lack of support. Other codes were never intended to be put into practice, serving mainly as 'model codes' (ILO, 1998). Research on the contents of international codes initiated by governments also shows that policy competition between national governments often hampers stricter formulations. Firms might be better capable of developing cohesive codes that can also be implemented.

At the same time, international codes can trigger other coalitions. Following the United Nations Food and Agriculture Organization's 1995 initiative to formulate a code of conduct for responsible fisheries, firms such as Unilever, together with environmental organizations, founded a 'coalition for sustainable fisheries' in the North Sea area. The beginning of an era of multilateral diplomacy can be witnessed in which TNCs, governments and NGOs bargain over the formulation and implementation of codes of conduct. This is likely to be a never-ending 'process' as codes will continuously be drawn and redrawn on the basis of social bargaining, with new alliances of business support groups and social interest groups being developed (cf. Van Tulder, 1999). Therefore, from a policy

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perspective, the *interaction* among the various actors initiating codes appears to be the most interesting development for the coming years.

Finally, monitoring and sanctions remain the most important test for the seriousness of the codes' implementation. A noticeable development is that new monitoring agencies measure the compliance likelihood of codes as well as their impact on social performance. The Council on Economic Priorities, trade union organizations, and investment banks are becoming better able and more willing to judge codes' seriousness. The Social Accountability 8000 Standard, initiated by the CEP for regulating labour practices abroad, seems promising. The CEP initiative follows other initiatives with regard to international standards in areas such as quality management (ISO 9000) and environmental management (ISO 14000) (Kolk, 2000). The world's largest certification bodies are engaged in Social Accountability 8000's third-party (independent) monitoring system, for which accreditation began in 1998. Extensive evaluation of such instruments is required, as viable monitoring procedures and credible coalitions of partners issuing codes will increase the significance of codes of conduct beyond the maxim 'words, words, words'. ■

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## Annex table 1. List of codes of conduct

### International organisations (n=11)

EC	Commission of the European Communities
FAO	Food and Agriculture Organization
FIFA	Fédération Internationale de Football Association
ILO	International Labour Organization
ITTO	International Tropical Timber Organization
OECD	Organisation for Economic Co-operation and Development
UN	United Nations
UNCED	United Nations Conference on Environment and Development
UNCTAD	United Nations Conference on Trade and Development
WFSGI	World Federation of the Sporting Goods Industry
WHO	World Health Organization

### Societal groups (n=13)

AHRC	Asian Human Rights Commission
CCC – Code of Labour	Clean Clothes Campaign
CCC – Fair Trade	Clean Clothes Campaign
CEPAA	Council on Economic Priorities Accreditation Agency
CERES	Coalition for Environmentally Responsible Economies
CHRA	Chinese Human Rights Alliance
Christian Aid	
CIIR	Catholic Institute for International Relations
Coalition for Justice	
ECCR	Ecumenical Committee for Corporate Responsibility
LO	Danish Confederation of Labour
REEP	Race Quality in Employment Project
South African Council of Churches	

### Business groups (n=24)

AAMA	American Apparel Manufacturers' Association
AFA	Athletic Footwear Association
AIP	Apparel Industry Partnership
AMC	Association Merchandising Corporation
BAUM	German Environmental Management Association
BTHA	British Toy and Hobby Association
CAUX	Caux Round Table
CCPA	Canadian Chemical Producers' Association
CEFIC	European Chemical Producers' Association
CMA	Chemical Manufacturers Association
EUROPIA	European Petroleum Industry Association
FDKI	Association of Danish Chemical Industries
ICC (1972)	International Chamber of Commerce (Guidelines for Multinational Investment)
ICC (1991)	International Chamber of Commerce (Business Charter for Sustainable Development)
ICME	International Council on Metals and the Environment
ICTI	International Council of Toy Industries
IEF	Industrial Environmental Forum of Southern Africa
Keidanren	
MCCR	Minnesota Center for Corporate Responsibility
NRF	National Retail Federation
TIE	Toy Industries of Europe
UNEP – Banks	United Nations Environment Programme
UNEP – Insurance	United Nations Environment Programme

**(Annex table 1, concluded)****Firms (n=84)**

ACCOR	Koninklijke Ahold
AT & T	Lands' End
BASF	Levi Strauss
Bayer	Limited
Body Shop	Liz Claiborne
Boeing	Lockheed Martin
BP	Lyonnaise des Eaux
Bristol-Myers Squibb	Matsushita
Burton Group	McDonnell Douglas
C&A	Mercantile Stores
Cable & Wireless	3M
Caterpillar	Mizuno
Chevron	Mobil
Colgate-Palmolive	Motorola
Converse	Nestlé
Dayton Hudson	News Corporation
Digital Equipment	Nike
Dow Chemical	Nissan
Dress Barn	Northern Telecom
EDF	Novartis
Electrolux	PepsiCo
Exxon	Petrofina
Federated Department	Pfizer
Ford Motor	Philips
Gap-Code of Vendor	Prudential Insurance
Gap-Environment	Puma
General Motors	Reebok
Glaxo Wellcome	Rhone-Poulenc
GTE	Roche
Halliburton	Samsung
Hewlett Packard	Shell
Home Depot	SHV
HSBC Holdings	Siemens
IBM	Talbots
ICI	Toshiba
JCPenney	Total
Johnson & Johnson	Unilever
Jones Apparel Group	VF Corporation
JPMorgan	Volkswagen
Kellwood	Walt Disney
Kmart	Weyerhaeuser
	Xerox

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## BOOK REVIEWS

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### *Globalizing Philippine Mining*

Antonio A. Tujan Jr. and Roz-B. Guzman

(Manila, IBON Books, 1998), 234 pages

On 24 March 1996, the rock cracked around a concrete plug in an unused tunnel connected to a tailings dam<sup>1</sup> at the Marcopper mine in the Philippines, releasing 1.6 million cubic metres of mine tailings into the Makulapnit River. The spillage, which entered the larger Boac River and eventually the sea, resulted in silting of the coastal area and affected the livelihoods of around 20,000 people in 42 villages. The mine was partly owned by Placer Dome, a Canadian mining company.<sup>2</sup> The accident attracted considerable international attention, both in the Philippines and internationally. Since it also coincided closely in time with the introduction of a new mining law in the Philippines, the IBON Foundation, a Philippine non-governmental organization (NGO), was stimulated to undertake "more comprehensive research and discussion of the issue of mining and globalization which is behind the Mining Act of 1995". The book reviewed is the result of this research and discussion.

NGO publications on TNCs and the environment usually follow a common pattern. They begin with a marshalling of the facts, usually detailed and accurate, reflecting the energy and dedication of NGO researchers. They then present an analysis of the facts and a synthesis which allow general conclusions to be drawn. The analysis is often

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<sup>1</sup> Tailings are waste material resulting from the extraction of value minerals from mined ore. They are a mixture of finely ground waste rock and water, containing residual quantities of metallic minerals which may be harmful to the environment. They are usually stored in walled-in ponds called tailings dams. A survey of incidents similar to the one at Marcopper is found in UNEP (1996).

<sup>2</sup> Placer Dome has later relinquished its interest in the mine to its Philippine partner, but has pledged to pay compensation.

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rather shallow and may appear one-sided. However, it has to be recognized that NGOs are advocacy bodies, not academic institutions or government authorities. Their task is not to provide a balanced assessment or propose evenhanded solutions, but to draw attention to perceived wrongs and mobilize opinion for reforms. Finally, proposals and recommendations are presented. While these are seldom of a nature that can be immediately accepted by all other stakeholders, including TNCs, they often contain constructive ideas that can and do serve as a starting point for policy formulation and dialogue. The IBON publication follows the general pattern. Unfortunately for the debate in the Philippines, however, the IBON publication is not representative of NGO efforts when it comes to the content.

The authors have clearly made a great effort to collect data and information. However, their research has been peculiarly shallow in some areas, particularly on subjects concerning the international mining economy. Their use of the data is highly selective, leading them to conclusions which are often in contradiction with facts. For instance, when discussing the pricing of mineral commodities (p. 84), the authors claim that “The reference price is pegged at the commodity exchanges while the producers’ price is determined by the producers. Producers from industrialized countries sell at the producers’ price while underdeveloped countries such as the Philippines sell at the reference price. At any rate, the reference price is dictated by big industrial buyers, mainly multinational corporations and their brokers and speculators.” This description will surprise all those who thought that the coexistence of quotation based reference prices and producers’ prices disappeared in the 1980s. Moreover, mining TNCs might wish that the statement in the last sentence quoted were true with its implication that prices can be freely manipulated in the face of market forces. However, concerns about corporate survival will prevent them from testing the theory. Other factual errors and misunderstandings, of which there are many more than can be mentioned here, appear to result more from lack of familiarity with the subject matter. One example is the mention made of the Bingham Canyon mine in Utah (located in San Francisco according to the authors), where the current owner, Rio Tinto, is held responsible for past environmental damage (p. 142A). The authors appear to have missed the fact that this is a very old mine which was acquired by Rio Tinto in 1989 and where

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the company carried out an extensive environmental rehabilitation programme (Crowson, 1992). Although the authors have collected an impressive amount of data, particularly on the Philippine mining industry, this does not make up for the errors, omissions and misinterpretations that fill the volume.

The analysis follows the same pattern as the presentation of data. The following quotation from the introduction of the volume (p. x) sums up the authors' view of the driving forces behind mining investment:

“The resulting decline in mining since the 1980s [in the Philippines] was the result of lower demand due to the global crisis in overproduction and the emergence of new technologies. These meant less demand for metallic ores. But in the effort of monopoly capital to expand areas for trade and investment, mining has not escaped the juggernaut of liberalization, deregulation and privatization which are the hallmarks of neoliberal “globalization”.

The thesis of global overproduction and lower demand appears to arise from a confusion of cyclical and structural events. It is supported in the text with data which purportedly show a buildup of mineral and metal stocks (pp. 191-192, 198). The analysis disregards the cyclical variations in stocks and interprets the rise of stocks in any year as an indication of structural overcapacity, ignoring stock reductions in subsequent years. The authors' assertion that demand for minerals is declining is supported by figures which, with only one exception, relate to individual countries and years, and which do not allow any conclusions about trends. That the assertion is wrong can be easily verified from widely available statistics. The exception to the quoting of data for individual countries is a statement that worldwide iron ore production fell by 6.1 per cent in 1992. According to UNCTAD (1995), the fall was 3.2 per cent. While the discrepancy may be minor, it would have been better if the authors had also mentioned that production in 1993 rose by 4.5 per cent. It is difficult to avoid the conclusion that the authors are quoting only figures that fit into their argumentation. Moreover, the authors do not explain why, if the international mining industry is facing a structural crisis

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characterized by falling demand and overcapacity, mining companies are so anxious to invest in exploration and development of new mines.

Unfortunately, the rest of the analysis follows the same pattern. The authors provide several arguments that purport to demonstrate that mining does not provide any benefits to the Philippines, as mining lacks forward and backward linkages and the industry pays low wages (although no comparison is made with wages in other sectors of the Philippine economy). They make no attempt to weigh these factors against the positive contribution of mining to export revenue and the government budget (which are mentioned in passing) but conclude without further analysis that the overall balance is negative. Similarly, they are critical to foreign investment in the mining industry, but do not even attempt to discuss the possible link between the previous very restrictive legislation on this subject and the decline of the Philippine mining industry.

With regard to environmental management, the authors express a deep distrust of the mining industry in general and of TNCs in particular. The following quotation (p. 143) illustrates their position:

“The liberalization of the Philippine mining industry as a prerequisite to imperialist globalization has to make its contribution to the solution of the crisis. By then, it will be made clear that the solution will have to be carried out at the expense of the environment.”

The authors appear to assume that foreign mining companies are inevitable worse environmental sinners than domestic ones and that progress in the area of environmental management is impossible. The volume includes extensive documentation of negative environmental impacts resulting from mining in the Philippines, mainly by companies with foreign shareholder participation. While the issue of the environmental performance of TNCs as compared to domestic companies is a serious one that deserves in-depth analysis, no such analysis is carried out. The assertion that foreign investment leads to lower environmental standards in any case rests on rather shaky ground in the case of the Philippines since majority foreign ownership of mining companies and, consequently, full managerial control, has until recently been impossible under Philippine law.



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Indeed, the authors have included detailed descriptions of the tailings spill at Marcopper and of similar incidents at another, partly foreign owned mining company. They do not mention, however, the only similar recent incident that has led to loss of human lives. This incident, which took place in September 1995, led to the death of 12 people (UNEP, 1996, p. A73-A74). The company involved had no foreign investors.

Where the authors really disappoint the readers is, however, the concluding part of their book where you expect them to put forward their recipe for improving the situation. Their recommendation deserves to be reproduced in its entirety:

“Globalization of mining has legitimized imperialist plunder and seized the sovereignty of the peoples of the world. It has dislocated workers, ravaged the environment, dispossessed indigenous peoples, displaced small-scale miners, and shattered dreams of national industrialization on a global scale.

The fact that the Philippines case is not isolated raises the strongest possibility of forging unity among the exploited and oppressed peoples of the world to launch a globally coordinated struggle against the globalization of mining and monopoly capital’s exploitation of mineral reserves. This struggle must eventually take back people’s sovereignty and their control over mineral resources.”

It is important to recognize that the NGO responsible for the book reviewed is an exception. Most NGOs that scrutinize the mining industry are not satisfied to wait for the revolution, but are careful to put forward constructive proposals that serve to push companies and governments in the direction of paying more attention to the natural environment and the rights of people affected by mining development. A recent example is provided by a draft publication by the WWF (1999). That publication covers the same thematic and geographical area as the one by Tujan and Guzman. The analysis in that publication, while not completely even-handed, is consistent, and the recommendations stand a reasonable chance of being accepted

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both by governments and mining companies. They include, for instance, that “all mining projects should be subject to the same domestic legislation that applies to all other development projects within a country”, and that “in the case of foreign companies, projects should be bound by the jurisdiction of the territory in which the company has their headquarters...However, where local or international standards are higher than in those of the company’s home country, then these should be the ones that are adhered to”. The WWF also recommends that mechanisms be identified for independent monitoring and regulation of mines; to ensure that a portion of government revenues is available for monitoring, inspection and regulation; and for governments to assess the net value of mining operations to the country in a transparent manner. Recommendations along such lines would have done more to advance the debate in the Philippines and improve the practices of mining TNCs than the argumentation presented by Tujan and Guzman.

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*The Competitiveness of the Singapore Economy:  
A Strategic Perspective*

Toh Mun Heng And Tan Kong Yam (eds.)

(Singapore, Singapore University Press and  
World Scientific, 1998), 354 pages

In addition to numerous books and works available on the subject since the 1980s, world-class consultancy reports have been annually ranking Singapore among the top first economies in terms of efficiency, good governance and business attractiveness for foreign investors. Only some well-known scholars, such as Walden Bello or Paul Krugman, have criticized the modalities of economic growth and productivity gains in Singapore and the other Asian newly industrializing economies (NIEs) during the last few decades. The sudden East Asian financial crisis in 1997-1998, and its intensity in some NIEs such as the Republic of Korea, Indonesia, Malaysia, Hong Kong (China) and Thailand, may prove that they were at least partly right.

In reference to the so-called “Asian economic miracle” (World Bank, 1993), and in the name of the continued struggle for survival of the city-state, some Singaporean scholars do feel a regular need of publishing self-praising works regarding the economic performance of their island. This 1998 book is no exception, but it sounds a little detached from domestic and regional realities, when all neighbour economies and other East Asian nations are going through financial and economic turmoil (with obvious direct and indirect implications for Singapore). It could have also been intellectually and internationally more appealing, if all chapter contributors had not been selected from the National University of Singapore (NUS) itself.

The book is the result of a workshop held at NUS early 1998. Its publication later in the same year could have taken into account some of the developments related to the East Asian crisis, including the recession also affecting Singapore since mid-1998, as officially announced by Prime Minister Goh himself in August. Of course,

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editors can never be blamed for good or less appropriate publication timing, which is largely beyond their own control. Taking into account the crisis, it is rather odd to read in the introduction of the book some statements such as “this book is a timely exercise in view of the fact that the international trading and investment climate has liberalized considerably, and the regional economies are achieving *remarkable economic growth and development* which begin to challenge Singapore’s economic edge”.

Fortunately, and despite the various domestic, regional and global dimensions of the East Asian crisis, the content of part one of the book dealing with macroeconomic strategies remains worth reading. Both chapters 1 and 2 underline some competitiveness framework conditions, which should enable Singapore to catch up during and especially beyond the current recession. The needed development status of Singapore as a global city is interestingly linked to a central consideration: a decreasing number of cities and regions in the world are able to concentrate the command and control functions of highly specialized productions in manufacturing and services. The strategic importance of information content and high technology is therefore stressed, and justifies the third-industrial generation priorities of Singapore during the 1990s and beyond.

In part two of the book, a sectoral analysis is proposed dealing with the future of Singapore’s air and shipping infrastructure, high tech manufacturing, construction, tourism and finance. Chapter 4 suggests what Singapore should learn from the three other Asian NIEs’ high- tech strategies, but it can be questioned how far the experiences of the Republic of Korea and Taiwan Province of China are fully relevant for the small island state. In this regard, Hong Kong (China) has been lagging behind the Republic of Korea, Taiwan Province of China, and even Singapore since the late 1980s! Chapter 7 puts forward several proposals for restructuring the financial sector, a move which has started to be implemented since the beginning of the recession in the city-state.

Part three of the book is the only part being fairly inventive and original, as it deals with the social and cultural perspectives of Singapore’s competitiveness. For a few years, the local authorities

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do recognize that any sustainable economic transformation of Singapore is also dependent on cultural and societal capacity for change, among other factors. Chapters 9 and 10 address the difficult issues of the social dimensions of globalization and competition in Singapore, and how far it challenges the skills and adaptability of the limited human resources available in the island. Chapter 8 has been drafted on local small and medium-sized enterprises (SMEs) by a Swedish Senior Teaching Fellow at NUS. This article is welcomed as one of the few publications written on the subject in the 1990s. With the exception of the first recession experienced in 1982-1985, local entrepreneurship and SMEs have hardly drawn any real interest and commitment in Singapore. Contrary to Taiwan Province of China and Hong Kong (China), SMEs have played a very marginal role in Singapore, which continues to be dominated by foreign transnational corporations and large local public enterprises. ■

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***Globalization, Foreign Direct Investment and  
Technology Transfers: Impacts on and  
Prospects for Developing Countries***

Nagesh Kumar in collaboration with  
John H. Dunning, Robert E. Lipsey, Jamuna P. Agarwal  
and Shujiro Urata

(London and New York: Routledge in association with the  
United Nations University Press, 1998)

This book is the seventh in a series whose collective aim is to support the research initiatives of the United Nations University Institute for New Technologies in the area of technology policies as an instrument of development in developing countries. Its primary objective is to examine the position of developing countries as recipients of foreign direct investment (FDI); and to a lesser extent, as recipients of international technology transfer and as creators and generators of technology. The time-frame of analysis was 1975 to 1995.

The book is divided into four parts. Part I sets the background for analysis in its examination of the geography of FDI and technology creation and transfer. The aim of Parts II and III is to examine the role of developing countries in the outward FDI and technology exports of some conventional and emerging source countries and, in particular, the United States, Germany, Japan and the developing countries. Finally, Part IV lays out the implications of the research findings for policy formulation at the national, regional and global levels.

The facts surrounding the developments in FDI and technological creation and transfer in the period 1975-1995 do not provide cause for much optimism for developing countries. In the area of FDI, the share of developing countries in FDI inflows worldwide increased only slightly from 23 per cent in 1975-1980 to 25 per cent in 1981-1985, and 25 per cent in 1986-1995. A majority of that increase is accounted for by one country - China - whose

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massive growth of inflows in recent years has served to perpetuate the high geographical concentration of inward FDI within developing countries.<sup>1</sup> Apart from the marginalization of developing countries in inward FDI and the geographical concentration in a narrow set of countries, the quality of transnational corporation (TNC) activity in developing countries leaves much to be desired. The motives for international production in developing countries stem largely from the desire of TNCs to gain access to abundant labour at lower cost and to exploit markets. In the higher value-added TNC activities, such as research and development (R and D) activity which have potentially greater positive spillover effects on the development of indigenous firms and industries of host countries, developing countries as a whole account for such a small share - only about 5 per cent of all overseas R and D activity of American and Japanese TNCs (Kumar, 1996). These tend to be concentrated within an even more narrow set of developing countries that have relatively superior technological infrastructure and resources.<sup>2</sup>

The small share, and declining significance, of developing countries for American and German TNCs in the period 1975 to 1995 is reflected in the chapters by Lipsey and Agarwal. The share of developing countries in the outward FDI stock of the United States decreased by half from 32 per cent in 1977 to 16 per cent in 1991; such a share recovered only slightly to 20 per cent in 1995. Their share in the outward FDI stock of Germany in the 1990s is even much less, at 10 per cent; and such a small share may even be threatened by the motives of German TNCs to penetrate further the relatively newer markets of Central and Eastern Europe. This factor, combined with the geographical proximity of the region and its cultural affinity, would accentuate its attractiveness to German FDI in the future. Hence, although Agarwal may be dismissive of an investment diversion of German FDI from developing countries to Central and

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<sup>1</sup> The 10 largest developing host economies accounted for some two thirds of inward FDI stock in developing countries in the 1980s and 1990s. The 10 countries in the 1990s are China, Singapore, Indonesia, Mexico, Brazil, Malaysia, Saudi Arabia, Argentina, Hong Kong and Thailand (UNCTAD, 1996).

<sup>2</sup> Besides, the aim of such overseas R and D activity in developing countries is to exploit home country based R and D of TNCs through adaptation, and not to augment home country-based R and D. The latter is a more advanced innovative activity conducted in the developed countries (Kumar, 1996). The distinction between the two kinds of R&D by TNCs is analyzed further in Kuemmerle (1996).



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Eastern Europe on the basis of parallel growth of German FDI in both regions in recent years, it would not have been unreasonable to assume that German FDI in developing countries could have grown faster had the locational advantages of Central and Eastern Europe not improved in recent years.

Japan is perhaps the only major source of FDI that directs a more substantial proportion of its FDI to developing countries. As shown by Urata's contribution developing countries accounted for an average share of about 53 per cent of Japanese outflows in 1980-1984 and, although such average share declined to one third in the period 1985 to 1990 owing to the rapid expansion of Japanese FDI in Europe prior to the formation of the Single Market, it has been on an upward trend since. It is, however, the developing countries in Asia that are gaining from the activities of Japanese TNCs owing to its geographical proximity, high economic growth, abundance of low-wage workers and trade and FDI liberalization. Technology exports to Asia from Japan have also been of considerable importance, accounting for some 52 per cent of the value of these exports worldwide in the period 1985-1995.

In addition to Japan, another promising source for FDI and technologies in developing countries (particularly the least developed ones) is other developing countries. The possibility of this emerging source of FDI is explored by Kumar. However, despite the growth of outward FDI from developing countries in recent years, their share in the global stock of outward FDI remains small at 9 per cent in 1995. Developing countries are also likely to remain a relatively insignificant source of technologies, except perhaps for the South and South-East Asian countries that are important recipients of both technology exports and outward FDI flows from the Republic of Korea and Taiwan Province of China - the two most rapidly innovating developing countries.

In his contribution, Dunning describes the developments in the geography of inward FDI flows in the period 1975 - 1995 as evidence of an emerging or changing trend. The depth and breadth of his analysis of the recent trends - which span the dynamics of rapidly changing configurations of ownership, internalization and location advantages of firms and countries, as well as the structure of source countries, the industrial composition of FDI and the structure and

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strategies of the leading TNCs - is worthy of much admiration.<sup>3</sup> However, when one takes a longer-term perspective of broader trends in inward FDI, the geographical distribution of the global *stock* of inward FDI between developed countries and developing countries (at 75 per cent and 25 per cent, respectively) has remained stable since 1975, despite the profound changes in the geography of inward FDI flows over the last 25 years. The recent developments in the geography of inward FDI are merely a continuation of a trend set in motion at the end of the Second World War. That period marked a structural change in the geographical distribution of inward FDI away from the previously dominant group of host countries - the developing countries - towards the developed countries. Such structural change is *long term* and *permanent* because not only have developed countries continued to be the dominant recipients of FDI since 1945, but such a pattern is expected to remain, and perhaps be reinforced, for a considerable time into the future. The most significant explanation for this has been provided by Dunning in this book. Unlike other types of international production activity, the imperatives of innovation-driven international production - spurred by the need to both exploit and augment technological expertise - tend to foster an even more concentrated geographical pattern of FDI, not only in developed countries, but also within industrial districts in these countries.

The examination of the technological capabilities of developing countries is the other focus of the book. These capabilities remain low, and the prospects for their further expansion seem rather bleak, as seen in the declining share of developing countries in arms-length cross-border technology transfer payments, license fees and royalty payments from 27 per cent in 1976-1980 to 25 per cent in 1981-1985,

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<sup>3</sup> Dunning's methodological effort in showing the distinctive nature of the ownership of FDI (its foreign ownership) as an explanation of the changing geography of FDI in the period 1975-1995 is commendable. In doing so, he deflated FDI in the period 1990-1994 by total investment (gross domestic fixed capital) in order to remove that part of FDI which may be due to factors other than the foreign ownership of the investment. However, he could have also adjusted total investment accordingly, in order to remove that part of total investment which may be due to foreign ownership. He was aware of this as he mentions it as a caveat, but did not make the calculations. It would have been of interest to determine the ratios between *adjusted* FDI and *adjusted* total investment for 1990-1994, and to compare these with the corresponding unadjusted data for the same period, and for 1975-1980.

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and 20 per cent in 1986-1995.<sup>4</sup> As with inward FDI, the technology transfer payments tended to be made by a small cluster of developing countries.

A point worthy of clarification in this context arises from the consideration of FDI and arm's-length licensing as *alternative* channels of the international transfer of technology or knowledge. This stems from an attempt to extend the idea behind the theories of internalization in its treatment of licensing and FDI as alternative modes for exploiting foreign markets by firms to explain alternative modes in which recipient countries gain access to international technologies. From the perspective of recipient countries, the extended idea does not hold, considering that the international transfer of disembodied (know-how) and embodied (know-why) technologies take place under arm's-length contracts (or licensing arrangements) and FDI, respectively.<sup>5</sup> Given that different kinds of technologies are transferred through the two modes, licensing and FDI are to be considered as *complementary* channels for the international transfer of technology.

Related to this is the book's point that FDI has regained some of its lost importance as a mode of technology transfer since the mid-1980s. The key point is that neither the amount of technology transfer payments, license fees and royalty payments nor its growth rate ever surpasses the amount of FDI inflows or its growth rate even in the period mid-1960s to 1980s when licensing had been a more significant mode of technology transfer.<sup>6</sup> This means that FDI has always been

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<sup>4</sup> When one considers that such a share includes those technology transfer payments made by foreign affiliates in developing countries which has increased considerably in recent years, the share of technology transfer payments actually made by non-affiliated firms or indigenous firms in developing countries is not only small, but is also expected to become even smaller.

<sup>5</sup> For a more comprehensive explanation of the determinants of licensing and FDI as modes of technology transfer, see chapter VI of Tolentino (1993).

<sup>6</sup> The data in table 2.7 of the book show that technology transfer payments, licence fees and royalty payments accounted for some 21 per cent of FDI inflows in the period 1975 - 1995, and even in the period 1975 - 1985 when licensing is argued to have been more significant as a mode of technology transfer, its share of FDI inflows was only 24 per cent. The growth rates recorded by FDI inflows have always been faster than those of technology transfer payments over the whole period 1975-1995 or any of the sub-periods.

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the more significant mode of international technology transfer, and particularly since the mid-1980s.

It would have been useful if more emphasis had been given to the analysis of the relative importance of the two modes of technology transfer and, in doing so, explain why FDI has always been the far more significant mode for technology transfer compared to arm's-length sources of technology, and why it has also grown faster particularly since 1985. It would have also been interesting to compare the growth of intra-firm technology transfer payments in recent years with the growth of FDI inflows. In any event, Kumar attributed the renewed importance of FDI since the mid-1980s to the liberalization of foreign investment policy regimes; and to the emergence and commercial application of new technological paradigms in different industries which prompted techno-nationalism and technological protectionism in the industrialized world. The theories of internalization are of direct relevance in this context as a framework of analysis, with perhaps some insights drawn from the theory of technological accumulation and competence or the more general eclectic paradigm of international production. These frameworks would have provided a broad spectrum of views to explain the recent imperatives for the internalization of technological advantages by firms.

Developing countries have also not made any large dent in technology creation and generation worldwide as displayed in their very small share of the total number of United States patents granted in the period 1977-1996 (1.6 per cent), and in their share of global R and D expenditures which declined from nearly 6 per cent in 1980 to some 4 per cent in the early 1990s.<sup>7</sup> Kumar gathered all the available evidence to argue that technology creation and generation is concentrated not only in the developed countries, but in large firms

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<sup>7</sup> A factor contributing to the lower R and D expenditures in developing countries - apart from the low levels of local technological capabilities - is the inability of these countries to attract the R and D activities of TNC affiliates, as mentioned earlier. The R and D activities of TNC affiliates are accounting for a considerable proportion of national R and D expenditures in a number of host countries. It accounted for over 15 per cent in Australia, Belgium, Canada, the United Kingdom, the United States, Germany, the Republic of Korea and Singapore in the 1980s (Dunning, 1994).

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with a high degree of multinationality.<sup>8</sup> Thus, in addition to the technological dependency of developing countries on developed countries, similar themes of marginalization and geographical concentration recur for developing countries in the area of technology creation and transfer as in the area of inward FDI.

The way forward for developing countries is examined by Kumar in the last chapter of the book. His policy recommendations are to build local technological capabilities, to promote import-substituting FDI through protectionist trade policies, and to promote regional economic cooperation and integration among developing countries to attract efficiency-seeking FDI. The implementation of these policies require the strategic intervention by their governments in several areas, viz.:

- The nurturing of clusters of strong indigenous firms whose value-added activities attract foreign-owned TNCs in the internationally oriented sectors;
- The consideration of licensing as part of a more autonomous path to technological development (à la Japan and the Republic of Korea);
- The implementation of effective competition policies to regulate rent seeking by foreign and local monopolies; and
- The promotion of policies for the effective diffusion of technology by foreign-owned enterprises.

These are commendable policy suggestions with a few caveats. First, the success with which the adoption of protectionist trade policies leads to the growth of local market-seeking international production can only occur when the economy is of sufficiently large size, and

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<sup>8</sup> Kumar noted a strong interaction between large firm size, large expenditures on R and D, high number of United States patent ownership and a high degree of multinationality through the accumulation of data on the sales (1994), R and D expenditure (1994), United States patents granted (1977-1996) and multinationality index (1994) of the top 50 corporations owning US patents. With the data that had been gathered, a much stronger proof of the concentration of innovative activity in large, multinational firms could have been provided through regression analysis, with the specification of either R and D expenditure (1994) or United States patents granted (1977-1996) as the dependent variable and the size of the firm (as indicated by sales) and the multinationality index as the independent variables.

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has high and/or rapidly growing per capita income. Secondly, efforts to nurture or support a strong nucleus of flagship indigenous firms or national champions in developing countries need to be viewed in the context of developing or shaping comparative advantages in rapidly growing international industries or the traditional infant-industry argument, and not in the context of a strategic trade policy. This is because developing countries are simply trying to catch up rapidly by racing down the ‘learning curve’ (Krugman, 1984) in growth industries in a world in which for the most part foreign firms have already finished learning. Thus, unlike in strategic trade policy, there are no rents to be shifted between countries, and no responses are expected from foreign firms or governments. Finally, it needs to be added that, in line with the requirements for new locational advantages of countries, developing countries need to invest to continually upgrade the quality of their human and physical capital in the interest of their own development, and to attract more, growth-promoting foreign TNCs. ■

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# JUST PUBLISHED

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## UNCTAD series on issues in international investment agreements

### Fair and Equitable Treatment

(Sales No. E.99.II.D.15)(\$12)

In recent years, the concept of fair and equitable treatment has assumed prominence in the investment relations between States. While the earliest proposals that made reference to this standard of treatment for investment are contained in various multilateral efforts in the period immediately following the Second World War, the bulk of the State practice incorporating the standard is to be found in bilateral investment treaties (BITs) which have become a central feature in international investment relations.

In essence, the fair and equitable standard provides a yardstick by which relations between foreign direct investors and Governments of capital-importing countries may be assessed. It also acts as a signal from capital-importing countries, for it indicates, at the very least, a State's willingness to accommodate foreign capital on terms that take into account the interests of the investor in fairness and equity. Furthermore, as most capital-importing countries have now entered into agreements that incorporate the standard, reluctance to accept this standard could prompt questions about the general attitude of a State to foreign investment.

Although the concept of fair and equitable treatment now features prominently in international investment agreements, different formulations are used in connection with the standard. An examination of the relevant treaties suggests at least four approaches in practice, namely:

- An approach that omits reference to fair and equitable treatment.
- An approach in which it is recommended that States should offer investment fair and equitable treatment, but such treatment is not required as a matter of law (the hortatory approach).

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- A legal requirement for States to accord investment “fair and equitable” treatment, “just and equitable” treatment, or “equitable” treatment.
  - A legal requirement for States to accord investment fair and equitable treatment, together with other standards of treatment, such as most-favoured-nation and national treatment.

These different approaches can serve as models for future practice, though it should be noted that the approach that combines fair and equitable treatment with related standards of treatment has received most support in recent practice.

Because an assurance of fair and equitable treatment in an investment agreement is meant to provide foreign investors with some degree of security for their investment, the standard is one of a number of measures designed to facilitate the flow of investment capital across borders. For capital-importing States, therefore, the standard is perceived as one way of assisting in the process of economic development. However, as the investment climate in a given capital-importing country usually turns on several variables, including the standard of treatment provided as a matter of law, it is difficult to indicate, *a priori*, the extent to which an assurance of fair and equitable treatment may assist particular States in the process of economic development.

### **National Treatment**

(Sales No. E.99.II.D.16)(\$12)

The national treatment standard is perhaps the single most important standard of treatment enshrined in international investment agreements (IIAs). At the same time, it is perhaps the most difficult standard to achieve, as it touches upon economically (and politically) sensitive issues. In fact, no single country has so far seen itself in a position to grant national treatment without qualifications, especially when it comes to the establishment of an investment.

National treatment can be defined as a principle whereby a

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host country extends to foreign investors treatment that is at least as favourable as the treatment that it accords to national investors in like circumstances. In this way the national treatment standard seeks to ensure a degree of competitive equality between national and foreign investors. This raises difficult questions concerning the factual situations in which national treatment applies and the precise standard of comparison by which the treatment of national and foreign investors is to be compared.

National treatment typically extends to the post-entry treatment of foreign investors. However, some bilateral investment treaties (BITs) and other IIAs also extend the standard to pre-entry situations. This has raised the question of the proper limits of national treatment, in that such an extension is normally accompanied by a “negative list” of excepted areas of investment activity to which national treatment does not apply, or a “positive list” of areas of investment activity to which national treatment is granted. In addition, several types of general exceptions to national treatment exist concerning public health, safety and morals, and national security, although these may not be present in all agreements, particularly not in BITs.

National treatment interacts with several other investment issues and concepts. Most notably there are strong interactions with the issues of admission and establishment, the most-favoured-nation (MFN) standard, host country operational measures and investor-State dispute settlement.

National treatment raises some of the most significant development issues in the field of foreign direct investment (FDI). This standard stipulates formal equality between foreign and national investors. However, in practice national investors, especially those that could be identified as “infant industries” or “infant entrepreneurs”, may be in an economically disadvantageous position by comparison with foreign investors, who may be economically powerful transnational corporations (TNCs). Such “economic asymmetry” may require a degree of flexibility in the treatment of national investors, especially in developing countries, for instance through the granting of exceptions to national treatment.

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## Books received on foreign direct investment and transnational corporations since December 1998

- Barreto Filho, Fernando Paulo de Mello, *O Tratamento Nacional de Investimentos Estrangeiros* (Brasília: Instituto Rio Branco, Fundação Alexandre Gusmão, Centro de Estudos Estratégicos, 1999), 163 pages.
- Croatian Investment Promotion Agency, *Croatia - Economic Outlook 1999* (Zagreb: Croatian Investment Promotion Agency, 1999), 103 pages.
- Croatian Investment Promotion Agency, *Legal Framework for Doing Business in Croatia, 1999* (Zagreb: Croatian Investment Promotion Agency, 1999), 189 pages.
- Li, Feng and Jing Li, *Foreign Investment in China* (Houndmills: Macmillan, 1999), 265 pages.
- Nachum, Lilach, *The Origins of the International Competitiveness of Firms: The Impact of Location and Ownership in the Professional Service Industries* (Cheltenham: Edward Elgar, 1999), 256 pages.
- Netherlands, Ministry of Foreign Affairs, *Diamonds and Coals: Evaluation of the Matra Programme of Assistance to Central and Eastern Europe, 1994-1997* (The Hague: Ministry of Foreign Affairs, n.d.), 248 pages.
- Pajarinen, Mika, Petri Ruovinen and Pekka Ylä-Anttila, *Small Country Strategies in Global Competition: Benchmarking the Finnish Case* (Helsinki: Taloustieto Oy, The Research Institute of the Finnish Economy and The Finnish National Fund for Research and Development, 1998), 162 pages.
- Tujan, Antonio A. Jr. and Ros-B Guzman, *Globalizing Philippine Mining* (Manila: IBON Books, 1998), 234 pages.

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## Report of the editors of *Transnational Corporations*

In 1998 the seventh year of its publication the *Transnational Corporations* continued its drive to become one of the most respected journals in the field. Difficulties in the publication process have resulted in continued delays in the publication of volume 7. However, with changes in the editorial process and staff involved in the journal it is hoped that the journal will be published on time by the end of 1999.

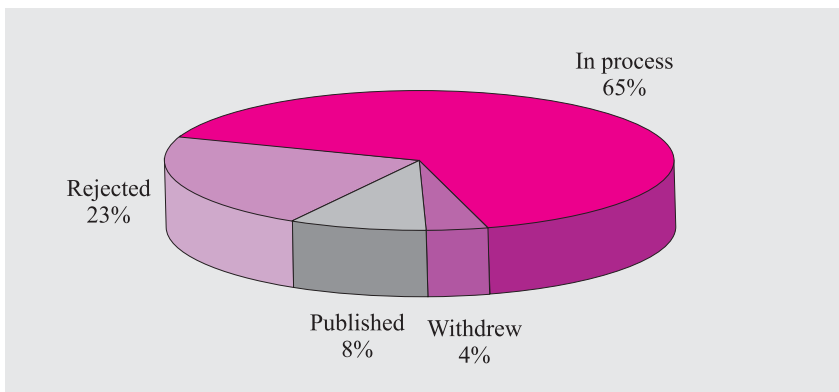
### The editorial process

In 1998, the journal continued to benefit from the guidance provided by the members of the Board of Advisers (and especially its chairperson)) and reviewers (the reviewers are listed on page iv). The journal relies heavily on its reviewers to provide prompt and professional reviews of submitted manuscript.

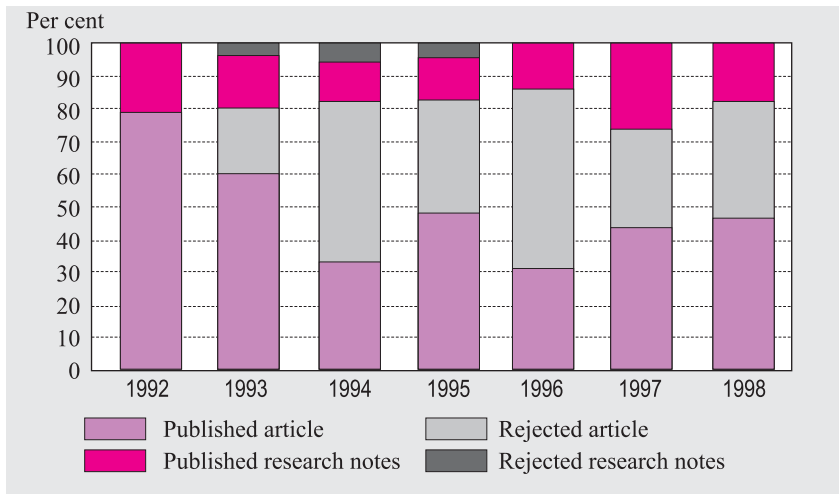
The journal continues to have a low publication rate in a drive to improve the quality of the manuscripts. In 1998 only 8 per cent of the manuscripts were published (figures 1 and 2). There still, however remains a high proportion of manuscripts being processed. The staff is working to clear this backlog and also to reduce significantly the time taken from submission to decision of a manuscript.

The circulation of the journal is still approximately 4,500 copies including subscribers and persons and institutions receiving the journal through UNCTAD's mailing list.

**Figure 1. *Transnational Corporations*: breakdown of manuscripts as of 31 December 1998**



**Figure 2. Transnational Corporations: breakdown of manuscripts since inception**



In 1998, 15 book reviews were published - one less than a year before. In turn, the number of non-English-language books reviewed increased from 2 to 3 (2 French- and 1 Chinese-language book).

## Editors and the Board of Advisers

Karl Sauvant continued as Editor of the journal. During the year he was joined by Bijit Bora as Associate Editor. The Associate Editors were Kalman Kalotay, James X.Zhan, Fiorina Mugione and Michael Bonello. Arghyrios Fatouros was the Guest Editor for international framework issues, kalman Kalotay was the Book Review Editor and Teresita Sabico the Managing Editor.

There was no change in the composition of the Board of Advisors. The editors are indebted to the Board for the professional advice they recieved in the course of 1997.

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## GUIDELINES FOR CONTRIBUTORS

### I. Manuscript preparation

Authors are requested to submit three (3) copies of their manuscript in English (British spelling), with a declaration that the text (or parts thereof) has not been published or submitted for publication elsewhere, to:

The Editor, *Transnational Corporations*  
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and Enterprise Development  
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Tel: (41) 22 907 5707  
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Articles should, normally, not exceed 30 double-spaced pages (12,000 words). All articles should have an abstract not exceeding 150 words. Research notes should be between 10 and 15 double-spaced pages. Book reviews should be around 1,500 words, unless they are review essays, in which case they may be the length of an article. Footnotes should be placed at the bottom of the page they refer to. An alphabetical list of references should appear at the end of the manuscript. Appendices, tables and figures should be on separate sheets of paper and placed at the end of the manuscript.

Manuscripts should be word-processed (or typewritten) and double-spaced (including references) with wide margins. Pages should be numbered consecutively. The first page of the manuscript should contain: (i) title; (ii) name(s) and institutional affiliation(s) of the author(s); (iii) address, telephone and facsimile numbers of the author (or primary author, if more than one).

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Authors should provide the diskette of manuscripts only when accepted for publication. The diskette should be labelled with the title of the article, the name(s) of the author(s) and the software used (e.g. WordPerfect, Microsoft Word, etc.). WordPerfect is the preferred software.

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## II. Style guide

A. **Quotations** should be double-spaced. Long quotations should also be indented. A copy of the page(s) of the original source of the quotation, as well as a copy of the cover page of that source, should be provided.

B. **Footnotes** should be numbered consecutively throughout the text with arabic-numeral superscripts. Footnotes should not be used for citing references; these should be placed in the text. Important substantive comments should be integrated in the text itself rather than placed in footnotes.

C. **Figures** (charts, graphs, illustrations, etc.) should have headers, subheaders, labels and full sources. Footnotes to figures should be preceded by lowercase letters and should appear after the sources. Figures should be numbered consecutively. The position of figures in the text should be indicated as follows:

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Put figure 1 here

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D. **Tables** should have headers, subheaders, column headers and full sources. Table headers should indicate the year(s) of the data, if applicable. The unavailability of data should be indicated by two dots (..). If data are zero or negligible, this should be indicated



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by a dash (-). Footnotes to tables should be preceded by lowercase letters and should appear after the sources. Tables should be numbered consecutively. The position of tables in the text should be indicated as follows:

Put table 1 here

E. **Abbreviations** should be avoided whenever possible, except for FDI (foreign direct investment) and TNCs (transnational corporations).

F. **Bibliographical references** in the text should appear as: “John Dunning (1979) reported that ...”, or “This finding has been widely supported in the literature (Cantwell, 1991, p. 19)”. The author(s) should ensure that there is a strict correspondence between names and years appearing in the text and those appearing in the list of references.

All citations in the list of references should be complete. Names of journals should not be abbreviated. The following are examples for most citations:

Bhagwati, Jagdish (1988). *Protectionism* (Cambridge, Massachusetts: MIT Press).

Cantwell, John (1991). “A survey of theories of international production”, in Christos N. Pitelis and Roger Sugden, eds., *The Nature of the Transnational Firm* (London: Routledge), pp. 16–63.

Dunning, John H. (1979). “Explaining changing patterns of international production: in defence of the eclectic theory”, *Oxford Bulletin of Economics and Statistics*, 41 (November), pp. 269–295.

United Nations Centre on Transnational Corporations (1991). *World Investment Report 1991: The Triad in Foreign Direct Investment*. Sales No. E.91.II.A.12.

All manuscripts accepted for publication will be edited to ensure conformity with United Nations practice.



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## READERSHIP SURVEY

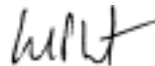
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