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Editorial statement

Transnational Corporations (formerly *The CTC Reporter*) is a refereed journal published three times a year by UNCTAD. In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975-1992) and by the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992-1993). The basic objective of this journal is to publish articles and research notes that provide insights into the economic, legal, social and cultural impacts of transnational corporations in an increasingly global economy and the policy implications that arise therefrom. It focuses especially on political and economic issues related to transnational corporations. In addition, *Transnational Corporations* features book reviews. The journal welcomes contributions from the academic community, policy makers and staff members of research institutions and international organizations. Guidelines for contributors are given at the end of this issue.

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Forty years of UNCTAD research on FDI

Torbjörn Fredriksson *

UNCTAD has established itself as the most authoritative source of data and analysis related to foreign direct investment, development and related policies. This article considers the main contributions UNCTAD has made in this area over the past 40 years, since its inception. Contributions are classified in terms of collection and development of data; conceptual development and economic analysis; and policy development and normative work. The emphasis of the review is on the period 1991 to 2003, thus capturing more than a decade of *World Investment Reports*, the main outlet for the organization's research and policy analysis.

Key words: foreign direct investment, transnational corporations, development, government policies

UNCTAD's evolving treatment of FDI

The international expansion of activities by transnational corporations (TNCs) through foreign direct investment (FDI) has evoked mixed reactions over the years. There has been heated debate regarding the relative significance of the potential benefits that inflows of FDI can bring (in terms of capital, technology, access to markets, competition, etc.) and the possible negative consequences an increased level of foreign ownership can imply. Understanding the full implications of FDI is complex since it interacts with many other issue areas relating to, e.g. finance, trade, employment, environment,

* Transnational Corporations Affairs Officer, United Nations Conference on Trade and Development, Geneva, Switzerland. The author has benefited greatly from useful comments received from many people, especially John H. Dunning, Persephone Economou, Fulvia Farinelli, Masataka Fujita, Charles Gore, Shigehasa Kasahara, Padma Mallampally, Lorraine Ruffing, Karl P. Sauvart, Satwinder Singh, Anh-Nga Tran-Ngyuen and Jörg Weber. A revised version of this article will appear in a volume which covers key contributions of UNCTAD over the past 40 years in the areas of international trade; money, finance and debt; FDI, shipping, competition and technology. It is being prepared for the UNCTAD XI Conference in Sao Paulo, Brazil in June 2004.

technology and, more broadly, development. Meanwhile, the issue of FDI has grown more important during the past 40 years as TNCs have become key agents of change in the globalizing world economy.

In the broad context of UNCTAD's development-oriented thinking, the perception of the role FDI plays in the development process has evolved over time. At the first UNCTAD Conference in 1964, member States generally acknowledged the role that FDI can play in economic development and underlined the need to remove obstacles to the flow of FDI from industrialized to developing countries.¹ Parts of its recommendations dealt explicitly with the issue and called upon member States to "adopt measures which will stimulate the flow of private investment capital for the economic development of the developing countries, on terms that are satisfactory both to the capital-exporting countries and the capital-importing countries", noting the responsibilities of home countries, host countries, investors and the international community (box 1).

Box 1. Recommendations at UNCTAD I with regard to the promotion of foreign investment to developing countries

UNCTAD I adopted a recommendation concerning actions by capital-exporting and capital-importing countries, investors and relevant institutions in order to encourage the flow of private capital towards developing countries.

It recommended among other things that the Governments of capital-exporting developed countries avoid measures "preventing or limiting the flow of capital from such countries to developing countries, and ... take all appropriate steps to encourage the flow of private investments to developing countries, such as tax exemption or reductions, giving investment guarantees to private investors, and by facilitating the training of managerial and technical staff".

/...

¹ Even before UNCTAD, the United Nations had addressed the role of FDI. In the Havana Charter, the investment provisions were among the most controversial, contributing to the downfall of the International Trade Organisation in the late 1940s (see United Nations Conference on Trade and Employment, 1948).

Box 1 (concluded)

With regard to private-capital-importing countries, the Conference recommended them to take “all appropriate steps to provide favourable conditions for direct private investment”. It further recommended that developing countries “set up investment bureaux and investment advisory services and ... establish and strengthen credit institutions and development banks and ... determine and publicize the areas of investment, manner of investment and investment policy.” The Conference also recommended developing countries “to establish information centres in capital markets and adopt other suitable means to supply all the necessary information about the information about investment conditions, regulations and opportunities in the developing countries”. Moreover, United Nations bodies and developed country Governments were encouraged to assist developing countries in these endeavours.

Another part of the recommendation focused on the role of investors. It said that “foreign private investment, based upon respect for the sovereignty of the host country, should co-operate with local initiative and capital, rely as far as possible on existing resources in developing countries, and should work within the framework and objectives of the development plans with a view to supplying domestic markets and, in particular, expanding exports”. The Conference expressed its expectation that foreign private investment would “recognize the desirability of re-investment of profits in the developing countries concerned, ...availability of “know-how” ... employment opportunities ... and other corresponding measures”.

Finally, the World Bank was requested to “expedite its studies on investment insurance, in consultation with Governments in both developing and developed countries, and submit [...] the results [...] to the United Nations”. The Conference also requested the Secretary-General of the United Nations to arrange further studies to cover all aspects of foreign private investment.

Source: UNCTAD, 1964, pp. 49-50.

The views expressed in 1964 emphasizing the benefits of FDI contrast with what followed. By the early 1970s, TNCs were in many quarters mainly perceived to be huge economic powers, being beneficial in some cases but necessary evils at best. Their actions in developing countries were often interpreted as a threat to the sovereignty of recipient economies and, if not controlled, could be detrimental to their welfare, with economic colonialism and/or environmental and social degradation as possible results. Against this background, the policy response was to seek ways for national and international bodies to monitor, restrict and regulate the activities of TNCs.

Resolution 56(III) adopted at UNCTAD III in Santiago, Chile, in 1972, dealt with FDI, placing the emphasis on the right of developing countries to regulate it in line with national development needs and to avoid its possible adverse effects, highlighting the negative impact outflows of private foreign capital had had on the balance of payments. The Conference affirmed:

“the sovereign right of developing countries to take the necessary measures to ensure that foreign capital operates in accordance with the national development needs of the countries concerned [...].”

It also expressed “its concern [about certain aspects of FDI] that disrupt competition in the domestic markets, and their possible effects on the economic development of the developing countries.”

Furthermore, the Conference recognized “that private foreign investment, subject to national decisions and priorities, must facilitate the mobilization of internal resources, generate inflows and avoid outflows of foreign exchange reserves, incorporate adequate technology, and enhance savings and national investment”.

Finally, it urged “developed countries to take the necessary steps to reverse the tendency for an outflow of capital from developing countries” (United Nations, 1973a, p. 89).

Consideration of issues related to FDI at UNCTAD temporarily subsided in the early 1970s when the venue for the focus within the United Nations system on the issues was moved to New York. This

decision was sparked by a speech of Chilean President Allende at the General Assembly in November 1972, in which he accused ITT of intervening in Chile's domestic affairs. In consequence, the United Nations Secretariat was asked to prepare a study on *Multinational Corporations in World Development* (United Nations, 1973b), which would serve as a basis for the deliberations of a Group of Eminent Persons of that subject matter. The recommendations of that Group led to the creation of the United Nations Commission on Transnational Corporations, serviced by the United Nations Centre on Transnational Corporations (UNCTC), which began functioning in 1975. The initiative was part of the broader drive towards a New International Economic Order (NIEO).² The UNCTC had three tasks:

- to collect and interpret data on FDI and TNC activities, undertake research on various economic and social aspects of TNCs and on policy issues, particularly in developing countries, with a view to furthering the understanding of TNCs and their effects;
- to service the negotiations on a United Nations Code of Conduct on TNCs that began in 1977 under the aegis of the United Nations Commission on TNCs; and
- to advise governments of developing countries on how best to negotiate with TNCs, and pursue appropriate policies to maximize the benefits from inward FDI.

²The Programme of Action of the Establishment of a New International Economic Order (Assembly resolution 3202 (S-VI), section V) stated that: "All efforts should be made to formulate, adopt and implement an international code of conduct for transnational corporations:

(a) To prevent interference in the internal affairs of the countries where they operate and their collaboration with racists regimes and colonial administrations;

(b) To regulate their activities in host countries, to eliminate restrictive business practices and to conform to the national development plans, and in this context facilitate, as necessary, the review and revision of previously concluded agreements;

(c) To bring about assistance, transfer of technology and management skills to developing countries on equitable and favourable terms;

(d) To regulate the repatriation of the profits accruing from their operations, taking into account the legitimate interests of all parties concurred;

(e) To promote reinvestment of their profits in developing countries".

The setting up of the UNCTC did not mean, however, that TNC-related issues were not discussed in the inter-governmental machinery of UNCTAD in the interim period until 1992. In the sixth session of the Conference and the Committee on Invisibles and Financing related to Trade (CIFT), for example, a report concluded that it was impossible to draw general conclusions on the effect of private foreign investment on the economies of developing countries and that the outcome would vary from case to case.³ Furthermore, in the spirit of the NIEO, UNCTAD IV in 1976 adopted Resolution 97(IV) on TNCs, recommending action at the national, regional and international levels to achieve a reorientation in the activities of TNCs and thus to safeguard the interests of developing countries. The Resolution also recommended that measures be designed and implemented to strengthen the participation of developing countries' national enterprises in TNC activities. The content of this resolution reflected the overall critical sentiment of many developing countries pushing for the formulation of an international code of conduct for TNCs.

During the second half of the 1970s, UNCTAD was active in formulating a set of Multilaterally Agreed Equitable Principles and Rules on Restrictive Business Practices, which was eventually adopted by the General Assembly in 1980 (see also the section on policy analysis below).

In the 1980s, the pendulum started to swing back. After the onset of the commercial bank debt crisis, member countries became more interested in non-debt creating sources of external private finance, of which FDI was naturally an important component. The lingering debt crisis in many developing countries, however, continued to stifle FDI by feeding the general perception of high risk, diminished profitability and poor growth prospects. In fact, the volume of net FDI inflows in real terms to developing countries in total FDI fell from more than one quarter in the early 1980s to less than one fifth in the late 1980s.

³ The report was entitled "Main findings of a study of private foreign investment in selected developing countries" (TD/B/C.3/111).

UNCTAD re-entered the picture after UNCTAD VIII, which established, in 1993 and 1994, within UNCTAD *ad hoc* working groups on non-debt creating flows, focusing on FDI and equity portfolio flows. In parallel, the UNCTC was closed down in 1992 by the new Secretary General of the United Nations, Boutros Boutros-Ghali, as part of the organizational restructuring of its economic sector. In this process, UNCTC's work programme became part of UNCTAD one year later. This meant that UNCTAD was assigned the responsibility for research, policy analysis, technical assistance and consensus building on matters related to the impact of TNCs on economic development, albeit with fewer resources than the UNCTC had at its disposal.⁴ By that time, work on a Code of Conduct on TNCs had ceased due to a combination of reduced interests by virtually all countries in the negotiations on such a Code, resulting among other things from insurmountable differences among the negotiating parties. Instead, attention shifted to strengthening national policies, expanding the network of bilateral investment treaties (BITs) and understanding more fully the impact of international investment agreements of all kinds. The return of investment issues to Geneva also meant that the division of investment and technology was ended.

Thus, since the late 1980s, more attention is being paid to the possible role of FDI in economic development. This shift mirrors several factors. One is that, at the aggregate level, external financing for development has shifted from official to private sources, because of aid fatigue, the unwillingness of many industrialized countries to meet the targets for official development assistance (ODA); and sometimes inefficient use of ODA. The more positive attitude also reflected in part the successful role played by inward FDI – or, more broadly, TNC activities – in some economies, particularly in East Asia, notably Malaysia, Singapore and Thailand. Moreover, governments had improved their administrative capabilities and had become more comfortable in dealing with TNCs. While many

⁴ The “Division on Transnational Corporations and Investment” – the initial name of the relevant division within the UNCTAD Secretariat – has been changed to the “Division on Investment, Technology and Enterprise Development”.

questions related to the impact of TNCs on development have remained controversial, the focus now is more on how to maximize the positive effects of FDI. In fact, all countries today welcome (or even actively compete for) inward FDI, and the vast majority of the world's countries have established specialized agencies to attract and facilitate inflows of FDI, as was once proposed at UNCTAD I. At the same time, it is generally recognized that FDI is only a complement to domestic investment and that sustainable development benefits to host countries depend, to a high degree, on the absorptive capacity among the local enterprise sector.

During the past 40 years, the international reach of TNCs has expanded rapidly. Changes in the global environment, in terms of technological progress as well as investment and trade liberalization, have facilitated the global spread of TNC operations across national frontiers. A snapshot of the universe of TNC activities indicates the high pace at which they have expanded. According to UNCTAD's own estimates, the number of TNCs of 14 Organisation for Economic Co-operation and Development (OECD) countries increased from some 7,000 in the late 1960s to 24,000 as of 1990 and 64,000 at the turn of the century. These firms control some 870,000 foreign affiliates, account for some two thirds of world trade, an even greater share of industrial research and development (R&D) and employ directly more than 53 million workers in their foreign affiliates around the world (*WIR03*). In 2002, moreover, total sales of foreign affiliates amounted to \$18 billion – more than twice the value of world exports of goods and non-factor services (table 1). Some of the largest TNCs (such as ExxonMobil and General Motors) are today comparable to economies such as Chile or Pakistan in terms of value added (*WIR02*).

The growing role of TNCs in the world economy has important implications for the effectiveness of policies, at national as well as international levels. Consequently, although FDI should be seen primarily as a complement to investment by domestic enterprises, and may cause unwanted effects, it is increasingly difficult to discuss policy options in various areas without taking the activities of TNCs into account.

Table 1. Selected indicators of FDI and international production, 1982-2002
(Billions of dollars and percentage)

| Item | Value at current prices (Billion dollars) | | | | Annual growth rate (Per cent) | | | | | | |
|---|--|--------|---------------------|--|----------------------------------|-----------|-----------|------|------|-------------------|------------------|
| | 1982 | 1990 | 2002 | | 1986-1990 | 1991-1995 | 1996-2000 | 1999 | 2000 | 2001 | 2002 |
| FDI inflows | 59 | 209 | 651 | | 23.1 | 21.1 | 40.2 | 57.3 | 29.1 | -40.9 | -21.0 |
| FDI outflows | 28 | 242 | 647 | | 25.7 | 16.5 | 35.7 | 60.5 | 9.5 | -40.8 | -9.0 |
| FDI inward stock | 802 | 1 954 | 7 123 | | 14.7 | 9.3 | 17.2 | 19.4 | 18.9 | 7.5 | 7.8 |
| FDI outward stock | 595 | 1 763 | 6 866 | | 18.0 | 10.6 | 16.8 | 18.2 | 19.8 | 5.5 | 8.7 |
| Gross border M&As ^a | .. | 151 | 370 | | 25.9 ^b | 24.0 | 51.5 | 44.1 | 49.3 | -48.1 | -37.7 |
| Sales of foreign affiliates | 2 737 | 5 675 | 17 685 ^c | | 16.0 | 10.1 | 10.9 | 13.3 | 19.6 | 9.2 ^c | 7.4 ^c |
| Gross product of foreign affiliates | 640 | 1 458 | 3 437 ^d | | 17.3 | 6.7 | 7.9 | 12.8 | 16.2 | 14.7 ^d | 6.7 ^d |
| Total assets of foreign affiliates | 2 091 | 5 899 | 26 543 ^e | | 18.8 | 13.9 | 19.2 | 20.7 | 27.4 | 4.5 ^e | 8.3 ^e |
| Export of foreign affiliates | 722 | 1 197 | 2 613 ^f | | 13.5 | 7.6 | 9.6 | 3.3 | 11.4 | -3.3 ^f | 4.2 ^f |
| Employment of foreign aff's (000s) | 19 375 | 24 262 | 53 094 ^g | | 5.5 | 2.9 | 14.2 | 15.4 | 16.5 | -1.5 ^g | 5.7 ^g |
| GDP (in current prices) | 10 805 | 21 672 | 32 227 ^h | | 10.8 | 5.6 | 1.3 | 3.5 | 2.6 | -0.5 | 3.4 ^h |
| Gross fixed capital formation | 2 286 | 4 819 | 6 422 ⁱ | | 13.4 | 4.2 | 1.0 | 3.5 | 2.8 | -3.9 | 1.3 ⁱ |
| Royalties and licences fees receipts | 9 | 30 | 72 ^j | | 21.3 | 14.3 | 6.2 | 5.7 | 8.2 | -3.1 | .. |
| Export of goods and non-factor services | 2 053 | 4 300 | 7 838 ^k | | 15.6 | 5.4 | 3.4 | 3.3 | 11.4 | -3.3 | 4.2 ^j |

Source: WIR03, p.3.

^a Data are only available from 1987 onward.

^b 1987-1990 only.

^c Based on the following regression result of sales against FDI inward stock (in millions dollars) for the period 1980-2000: Sales=934.0435+2.351837*FDI inward stock.
^d Based on the following regression result of gross product against FDI inward stock (in millions dollars) for the period 1982-2000: Gross product=436.3332+0.421268*FDI inward stock.

^e Based on the following regression result of assets against FDI inward stock (in millions dollars) for the period 1980-2000: Assets=-1 443.239+3.929293*FDI inward stock.
^f For 1995-1998, based on the regression result of exports of foreign affiliates against FDI inward stock (in millions dollars) for the period 1982-1994: Exports=291.5394+0.453183*FDI inward stock. For 1999-2002, the share of exports of foreign affiliate

^g Based on the following regression result of employment (in thousands) against FDI inward stock (in millions dollars) for the period 1980-2000: Employment=13 865.43+5.507718*FDI inward stock.

^h Based data on data for the International Monetary Fund, International Financial Statistics, June 2003 and World Economic Outlook, April 2003.

ⁱ data for 2002 was extrapolated using the share of countries and economies with available 2002 data in 2001 world gross fixed capital formation.

^j 2001.

^k Based on the International Monetary Fund, World Economic Outlook, April 2003.

In the selection of the most important intellectual contributions by the UNCTAD Secretariat in the area of FDI, the focus here is on its publications and documents during the period 1991-2002.⁵ It may seem odd to start in 1991 given that the responsibility for analysis of TNC-related activities was transferred back to UNCTAD only in 1993.⁶ However, 1991 is used as the point of departure in order to capture the contribution of the *World Investment Report (WIR)*, which was published initially by the UNCTC but has subsequently become one of the flagship reports of the UNCTAD Secretariat.⁷ Today, the *WIR* often sets the parameters surrounding the policy analysis in the area of FDI and TNC activities. Indeed, the more than 700,000 downloads as of November 2003 of the *WIR03* (or parts of it) from the UNCTAD website after its launch in September is a rough indicator of its wide dissemination. The review of intellectual contributions furthermore covers also other work and publications.

UNCTAD's intellectual contribution in the field of FDI can be divided into three main categories:

- *Data development to measure the expansion of TNC activities.* Given that the area is relatively new to both researchers and policy makers, the development of data and their presentation in user-friendly ways have been a key and necessary contribution to a better measurement and understanding of the FDI phenomenon.
- *Conceptual development and economic analysis.* The various issues of the *WIR* as well as other publications have contributed to the development of new concepts and new approaches to analyzing ideas, facts, scholarly research etc.

⁵ For a review of UNCTAD's work during the period 1964-1984, see UNCTAD 1985.

⁶ Earlier work undertaken by the UNCTC will be covered in a forthcoming book, *The UN and Transnational Corporations: From Code to Compact: in the Eye of the Storm* by Tagi Sagafi-nejad, in collaboration with John H. Dunning.

⁷ The annual *WIRs* replace the previous quinquennial surveys produced by the UNCTC, the last of which was published in 1988 (UNCTC, 1988).

to form a coherent picture of particular aspects of TNC activities. This work has often involved the development of original ideas, as well as research or critique on, or about, various aspects of the determinants and consequences of TNC activities. It has formed a basis for policy analysis and international consensus building.

- *Policy analysis and normative work.* Based on the above, UNCTAD has been in a position to provide advice to governments and/or intergovernmental entities – and indeed to the international community as a whole – as to what action might be taken to ensure that FDI and TNC-related activities increase their contribution to world development and structural transformation in not only efficient but also socially acceptable ways and to ensure stakeholder confidence through increased transparency and accountability.

The remainder of this article examines UNCTAD's work and contribution in the three areas outlined above, with particular emphasis on the second component. Thus, the next section looks at the role the UNCTAD Secretariat has played in the collection, presentation and dissemination of data related to FDI and international production. The following section highlights important intellectual contributions in the form of economic analysis presented in various UNCTAD publications, and the *WIR* in particular. The subsequent section notes some of UNCTAD's contributions in terms of policy analysis and consensus building. The last section concludes.

Measuring the expansion of TNC activities

Without reliable and comprehensive data, it is impossible to measure and analyze accurately the implications of any economic phenomenon. Given that TNC activities and economic development and their links are relatively recent areas of economic research and policy analysis, the development of a database covering FDI and other TNC-related statistics represents a key contribution by the Secretariat.

There are different forms of data. First, UNCTAD's database (www.unctad.org/fdistatistics) contains global data for more than 190

economies on inward and outward flows and stocks of FDI as well as various ratios comparing them with the GDP or gross fixed capital formation of individual countries. A more recent addition is information on cross-border mergers and acquisitions (M&As). All these statistics are featured regularly in the statistical annex of the *WIR* and in other publications on FDI and TNCs. These data also form the basis for the analysis of global and regional trends presented in the Part One of the *WIR* and some standard tables in the *WIR* on the trends, scope and nature of FDI and TNC activity. Judging from the number of downloads from the UNCTAD website, UNCTAD's global and regional analyses of trends in FDI and international production are very much in demand.

This global picture is complemented by in-depth national data on up to 88 specific variables on inward and outward FDI flows and stocks, their composition and sectoral and geographical distribution. The information also covers the operations of foreign affiliates located in a country and TNCs based in a country, as well as the legal framework relevant for FDI in a country. Such information has been published in different forms, from UNCTAD's *World Investment Directories (WID)* to the *WID Country Profiles* available on-line (since 2003). Finally, depending on the focus of various publications and the special theme selected for the *WIR*, each year a wealth of data is collected and presented on an *ad-hoc* basis.

Second, in addition to FDI-related data, the UNCTAD Secretariat produces basic information on the largest TNCs. Some of the more important statistics include corporate information on the top 100 TNCs,⁸ the top 50 TNCs based in the developing world and, recently, the top 25 TNCs based in Central and Eastern Europe. These statistics have, for instance, allowed for the monitoring of the emergence of TNCs from developing countries. The first list of the world's top 100 TNCs was introduced in *WIR93* and was related to the situation in 1990. At that time, all of the firms included were based in developed countries. This state of affairs lasted until 1995

⁸ The largest TNCs are ranked according to the size of their foreign assets.

(WIR97), when *Daewoo Corporation* (Republic of Korea) and *Petróleos de Venezuela* (Venezuela) entered the top 100 list as the first developing country TNCs. By 2001 (WIR03), four companies from developing economies appeared in the list: Cemex (Mexico); Hutchison Whampoa (Hong Kong, China); LG Electronics (Republic of Korea); and Singtel (Singapore).

A third category of statistics relates to the evolving policy framework governing FDI. At the *national* level, the tracking of changes in FDI laws and regulations has shown the significant shift that has taken place in the attitude of countries vis-à-vis FDI. For example, between 1991 and 2002, out of the more than 1,640 changes that were made in national laws and that were observed by UNCTAD, 95% intended to create a more favourable investment climate for inward FDI. At the international level, UNCTAD monitors the evolving use of bilateral investment treaties, double taxation treaties and other international instruments related to FDI.⁹ As part of these efforts (starting in 1996), UNCTAD has published a total of twelve volumes of *International Investment Instruments: A Compendium*. They contain a comprehensive collection of relevant instruments on international investment law, conventions, treaties, declarations, codes and resolutions. The first three volumes start with the Havana Charter of 1948 and end with the 1994 Energy Charter Treaty and the Marrakesh Agreement of the World Trade Organization (WTO). In the subsequent volumes, more recent developments at the bilateral, regional and multilateral levels are captured.

While the data compiled by the Secretariat on FDI and international production activities are far from perfect and suffer from various limitations,¹⁰ they have provided valuable information to those wishing to know the facts about the growing significance of TNCs in the global economy. A comparison of the length of the statistical

⁹ The full listing of bilateral investment treaties is available on-line at <http://stats.unctad.org/fdi/eng/ReportFolders/Rfview/explorerp.asp>. The actual texts of BITs will be available on-line as of early 2004.

¹⁰ These are discussed at length in the methodological annex of each WIR.

annexes of the first few *WIRs* (25 pages) with the most recent one (80 pages) depicts the progress that has been made in this area during the past decade. A massive data collection effort takes place on a continuous basis, with the cooperation of numerous national data collecting agencies, to ensure that the data presented are as reliable, up to date and comprehensive as possible. In order to facilitate easy reference, more and more data are being made available on-line (see <http://stats.unctad.org/fdi>), as part of a major push by the secretariat to enhance their availability.

Based on the wealth of statistics, a number of novel analytical and statistical tools have been developed to measure and assess better globalization and its implication for developing countries. For example, in *WIR95* the *transnationality index for the largest TNCs* in the world was introduced. This index captures the average of three ratios: the shares of foreign to total assets; foreign employment to total employment; and foreign sales to total sales. Another innovation, the *transnationality index of host countries* (introduced in *WIR99*), and measures the degree of transnationalization of economic activities in host economies, taking into account the production potential created through inward FDI. More recent additions include the FDI performance and potential indices (see *WIR01* to *WIR03*). Moreover, its database has allowed the UNCTAD Secretariat to publish analytical monographs and key indications on topical and relevant areas, e.g. on the Asian financial crisis (UNCTAD, 1998a), the performance and potential of FDI in Africa (UNCTAD, 1999a) and FDI in least developed countries (LDCs) (UNCTAD, 2002a). Obviously, the database is of major importance to the research, policy analysis and technical assistance undertaken by the Secretariat.

Conceptual development and economic analysis

The Secretariat's work on FDI has contributed intellectually at both the conceptual and practical levels. At the conceptual level, it has introduced a number of new ideas and methodologies and broadened the scope or enabled innovative analysis of existing ones. It has explored new topics or shed new light on topics already

analyzed in the literature. At the practical level, numerous new policy recommendations and proposals have been put forward. Among the many facets of FDI and international production and their interaction with economic and social development, UNCTAD's publications, and especially the *WIR*, have provided new or more comprehensive analysis of what was available in the literature of several important issues, including the following ones:

- FDI determinants;
- the impact of FDI on growth and development;
- the geography of FDI;
- strategies and structures in the international organization of TNC activities;
- modes of FDI entry (especially the role of M&As);
- FDI and trade;
- linkages and clusters involving FDI; and
- economic development and outward FDI.

Against this background, selecting the most important contributions is no easy task. Indeed, since the audience UNCTAD caters to is heterogeneous – covering especially policy makers in developing countries, but also the research community and civil society at large – the views on what parts are the most important diverge. Thus, the selection below does not claim to be comprehensive, but it reflects discussions with some of those who have been involved either as contributors to UNCTAD's work or as readers of the output. An important source of guidance has been the many book reviews that have been published over the years, in which reviewers highlight the merits and weaknesses of individual *WIRs*.¹¹ All of the issues listed above remain high on the agenda of national and international policy making fora as well as in the academic community.

¹¹ For reviews of various *WIRs*, see www.unctad.org/wir.

FDI Determinants

Understanding what determines where companies invest is an important factor for attracting FDI and benefiting from it. *WIR98* took a close look at the determinants of FDI in one of its chapters. Whereas these determinants had been carefully studied in the literature, from various perspectives, UNCTAD's work added value in several ways. First, it explored the impact of globalization on the locational determinants of FDI. The volume found that the importance of traditional FDI determinants (e.g. natural resources, low-cost labour, national market size) was declining while access to "created assets" (such as skills and technology) and access to regional markets (such as the European Union and the North American Free Trade Agreement) had become critical. Second, the *Report* contributed by linking the discussion on determinants to the role of government policy. Third, it provided a careful examination of developments at regional levels. The question of what determines the location of FDI has been revisited to in many other publications, such as in *FDI Determinants and Brazil* (UNCTAD, 2000b) and throughout UNCTAD's technical assistance work.

The impact of FDI on growth and development

Analyzing the relationship between FDI and development and improving the understanding of how the international expansion of TNCs affects the growth prospects of developing countries are the overriding purpose of the work of the UNCTAD Secretariat on investment. Whereas the various issues of the *WIR* normally focus on a specific topic of importance, three *WIRs* have undertaken more comprehensive assessments of the impact of FDI on growth, competitiveness and development. The special topic of *WIR92* was *Transnational Corporations as Engines of Growth*, and contained the Organization's first full-scale assessment of the links between FDI and development. In *WIR99*, intended as an input to UNCTAD X, this topic was revisited under the title *FDI and the Challenge of Development*. The volume provided a comprehensive examination of the role of FDI in economic development through structural transformation and growth, focusing specifically on five areas in which TNCs can complement domestic efforts to meet development

objectives.¹² In an Issues Paper related to international investment agreements, one chapter provided a succinct survey of the direct effects of FDI on development (UNCTAD, 1999d). *WIR95* also covered relevant issues, although its focus was on how FDI influences the instrumental variables for growth (resources, markets and restructuring) without going to the next step and examining the impact on growth itself. *WIR01* too, contributed to the understanding of the links between FDI and development by examining the linkages that constitute the channels for the transmission of growth-enhancing factors from TNCs to host-country enterprises. The relevant parts of the *WIRs* mentioned are among the few comprehensive studies on this subject.

UNCTAD has also provided important intellectual contributions at critical moments in the form of economic analysis of the impact FDI has on various development-related aspects. In an in-depth study related to the Asian financial crisis for example, the Secretariat helped clarify the role and impact of FDI in the crisis and the subsequent recovery. The findings have since been used in various contexts, including as an input to a special high-level session of the Trade and Development Board in 1998.

The geography of FDI

The evolving geography of FDI has been a recurrent focus, partly reflected in the global and regional trends discussions that appear in each *WIR*. It was also the special topic of the very first issue of the *WIR* published in 1991. It applied the Triad (the United States, the European Community and Japan) concept to the geographical distribution of FDI and noted that these economies accounted for the bulk of both inward and outward FDI. With regard to FDI between developed and developing countries, *WIR91* described how TNC networks often have a strong regional dimension with significant links between individual home regions and associated

¹² The five areas are: increasing financial resources and investment; enhancing technological capabilities; boosting export competitiveness, generating employment and strengthening the skills base; and protecting the environment.

host countries (outside the Triad).¹³ Moreover, the geography of international production featured prominently in *WIR01*, in which an effort was made to map various geographical dimensions of TNC activities.

The international organization of TNC activities

In response to changes in the global environment, driven by technological progress, liberalization in the area of investment and trade and enhanced competition, corporate strategies have likewise evolved over time, affecting the way in which international production systems are organized. *WIR93* was described by some scholars as a “milestone” in that it documented the culmination of a process that had emerged over three decades – the ascension of international production over international trade in importance for the delivery of goods and services to foreign markets and the integration of national production systems.¹⁴ *WIR93* noted that the integration of international production had moved from “simple” to “complex” integration, reflecting a shift in management strategy and leading to new production structures. It showed the alternative structures and various phases many TNCs have gone through as regards structure when establishing international operations:

¹³ For example, TNCs from the United States played a dominant role in Latin American countries such as Argentina, Chile, Mexico, Panama and Venezuela as well as in the Philippines and Saudi Arabia; the European Community’s firms dominated FDI in many countries in Central and Eastern Europe, Brazil, Ghana and Indonesia; whereas Japanese firms accounted for more than 50% of total FDI into Hong Kong (China), Republic of Korea and Thailand. As of 2002, this picture had not changed much, which draws attention to the underlying geographical structure of FDI and international production (*WIR03*). While there have been some alterations in the composition of these associate partners over the past years, many of the block members still remain to be so. For example, the United States is still the dominant investor in Argentina, Chile, Mexico, Saudi Arabia and Venezuela, but recently also in the Russian Federation.

¹⁴ Behrman, 1993, p.188.

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- the “stand-alone” foreign affiliate, that operate largely as an independent concern within the host economy;
 - simple integration, involving international production through which the activities of the parent company to some extent rely on production activities undertaken either by a foreign affiliate abroad or outsourced to a foreign subcontractor but controlled by the parent firm;
 - complex integration, under which any affiliate operating anywhere may perform functions for the firm as a whole. These strategic dimensions were combined with the geographical scope of international production as well as with the functional scope of the firm to form the basis for what UNCTAD called *integrated international production*. The fact that FDI can take place in any part of the value-added chain has implications for attracting FDI.¹⁵

In this context, a distinction was also introduced between “shallow integration” (which occurs mainly through trade in goods and services and international movement of capital) and “deep integration” (which extends to the level of the production of goods and services and increases visible and invisible trade) (*WIR93*).

Several writers have subsequently tried to document empirically the integrated international production systems of TNCs, but the specific examples provided in *WIR93* remain among the most vivid and illustrative. The changing organizational structures of international production raise a number of issues, including that of the “nationality” of TNCs and their affiliates, criteria for taxation of multi-country activities, and the responsibilities of TNCs for generating and supporting sustainable production in the countries in which they operate. These issues remain at the centre of international discussions on the international strategies of TNCs and associated policy implications.

¹⁵ *WIR04* will explore the role of services in such international production systems.

Modes of entry

Understanding the strategy of TNCs is essential in order to formulate and implement an adequate policy response for the achievement of various development impacts. In this context, an important factor to consider is the mode of entry chosen by a firm when investing in a host location. Traditionally, most countries have sought to attract investment in new projects – so-called greenfield investment – as this mode of entry has been perceived to bring the greatest benefits in terms of additional resources and capabilities to the host economy, thereby contributing to its development. Over time, however, the share of greenfield investments in world FDI flows has declined while that of M&As has risen, sometimes giving rise to considerable concern among policy makers.¹⁶ When the *WIR2000*, which focused on *Cross-border Mergers and Acquisitions and Development*, was launched, the timing could not have been better. It coincided with the unprecedented boom in FDI (valued at \$1.4 trillion) – a boom that was fuelled primarily by M&As. Indeed, the volume showed that an international market for firms had emerged and that M&As now represent the dominant form of FDI in developed countries. In one of the chapters of this report, recent trends in cross-border M&As were explained, distinguishing between patterns of various countries and different levels of development, highlighting the largest M&A deals and comparing data on M&As and FDI to try to make sense of a very new area of international statistics that plays an increasingly important role in the globalizing world economy. In another chapter of the same volume, an evaluation of the impact of cross-border M&As on development is made, and a distinction was made between “normal” and “exceptional” situations on the one hand, and between short-term and longer-term impacts on the other. *WIR00* was the first full-blown examination of this topic. Among others, it raised questions as regards the explanatory power of the dominant FDI paradigm – the “ownership-location-internalization” explanation – for the phenomenon of cross-border M&As.

¹⁶ While the growing role of M&As in global FDI flows as well as in different regions is unquestioned, there is still no simple way of calculating the precise ratio of FDI that is accounted for by M&As (see *WIR00*).

FDI and trade

The linkages between trade and investment are a much researched area of international economics. UNCTAD has contributed in a number of ways in this process. A comprehensive assessments of this relationship was undertaken in *WIR96*, in which the old debate of whether FDI should be seen as a substitute or complement to trade was reexamined. It argued that the issue no longer is whether trade leads to FDI or FDI leads to trade. Rather, the principal question is rather where firms access resources and decide to locate their value-added activities – which then determines the direction of investment and trade flows. In *WIR99* one of the areas that was studied in depth was the role of FDI in boosting export competitiveness, a topic that was made the special theme of *WIR02*.¹⁷ These volumes showed that this role is pervasive and has led to dramatic shifts in the geographical composition of world trade. In this context, *WIR02* noted that just 20 economies together accounted for over three-quarters of the value of world trade, with the developed countries being the largest traders. However, during the period 1985-2000, mainly developing economies, such as China, Mexico, the Republic of Korea, Singapore, Taiwan Province of China and Thailand, and such economies in transition as the Czech Republic, Hungary and Poland, accounted for the largest *gains* in market share. The volume showed that the growth of exports from many of these countries was directly linked to the expansion of international production systems, especially in the electronics and automotive industries. Meanwhile, it was also noted that export-oriented foreign affiliates often rely on imported inputs to a high degree, sometimes implying a low level of local value-added in the exported products. Hence the importance of addressing various ways to augment the interaction between foreign affiliates and the local economy (see below). The analysis has been carried forward into the area of policy analysis and technical assistance, especially as regards possible instruments to ensure that a location is conducive to export-oriented FDI, and in terms of the organization of targeted investment promotion, an area in which UNCTAD has developed a specific technical assistance programme.

¹⁷ The role of FDI in the area of services will be reviewed in *WIR04*.

FDI, linkages and clusters

While FDI can bring important benefits to a host economy, it is merely a complement to what goes on in the domestic enterprise sector – the bedrock of a country’s economic development. Moreover, the capability of domestic enterprises and the absorptive capacity of a host economy affect the kind of FDI that is attracted as well as the extent to which knowledge and technology are disseminated by foreign affiliates and mastered by local firms. Perhaps the most important way to tap such benefits is through production linkages between foreign affiliates and domestic firms as well as clustering. Where such linkage creation takes place, production and exports by foreign affiliates are not only likely to be more sustainable and broadly beneficial for host countries, but also to involve higher domestic value added and contribute to strengthening the competitiveness of the domestic enterprise sector. The question of how best to promote linkages between foreign affiliates and domestic firms was addressed specifically in *WIRO1*. The work has been translated into concrete actions in the field, in the form of an UNCTAD linkage promotion programme. Such concrete actions are taking place through EMPRETEC, a technical cooperation programme started in 1988 at former UNCTC to help developing countries establish the institutional structures for the promotion of entrepreneurship and small and medium-sized enterprise (SME) development.

A closely related issue is that of enterprise development and industrial clusters development. Clusters are a significant unit of policy intervention aimed at upgrading local competitive advantages and creating a conducive environment for business activities and external investors. Such intervention can also serve to enhance the benefits from FDI by “embedding” foreign affiliates in the local context through long term productive linkages with indigenous firms. In this framework, three UNCTAD publications deserve special attention, as they were forerunners in bridging the vast and consolidated literature on clusters in developed countries and the scattered information from Latin America and Asia. More importantly, they pioneered the investigation of the issue from a developing country policy perspective at a time when most of the existing information

was of high analytical value but could not easily be translated into concrete policy recommendations in a developing country context.

The publication *Technological Dynamism in Industrial Districts: an Alternative Approach to Industrialization for Developing Countries* (UNCTAD, 1994) returned to the original cluster model, which can be traced in some regions of Northern and Central Italy. The book presented the industrial district model as a dynamic approach to local economic development, and emphasizes that a major challenge for developing countries is to use the related principles of industrial organization as a lever for local development. The “overview of activities in the area of inter-firm cooperation” (UNCTAD, 1997a) emphasized the importance of public awareness and support, as competitive enterprise clusters and networks do not emerge in a policy of institutional vacuum, but are often the result of deliberate economic and social policies at the local, regional and national level.¹⁸ However, not all clusters are innovative and dynamic by nature; nor should clusters be considered a panacea in terms of industrial or locational policies. The issues paper “Promoting and sustaining SMEs clusters and networks for development” (UNCTAD, 1998c) concluded that many clusters are caught in the spiral of stagnation and decline. A useful distinction was made between three different types of clusters: informal, organized and innovative. The paper recommended that policy interventions should be confined to revitalizing existing clusters with high growth potential rather than to create new clusters.

¹⁸ On the one hand, local forces are essential to stimulate the generation of common externalities and the creation of a support structure for providing innovative, value-adding services. Traditional habits and practices of local actors with respect to innovation and technology are also decisive in the transformation of simple agglomeration of firms into competitive clusters. On the other hand, focused measures (e.g. the creation of technical schools, research centres, export promotion boards, quality certification institutes) can be equally important in stimulating and supporting change, tacit knowledge flows and interactive learning. Therefore, all actors at the macro, meso and micro level have an appropriate role to play in the promotion of clusters.

Economic development and outward FDI

Given that developing countries are predominantly net recipients of FDI, UNCTAD has traditionally focused on inward FDI and its impact. It is recognized, however, that outward FDI can also bring important development benefits to home countries. In *WIR95*, one of the most important contributions in this volume was the section addressing the impact of outward FDI on a firm's competitiveness. The volume noted that outward FDI tends to increase firm competitiveness, which in turn improves the performance of their home countries. The issue of outward FDI has over time become increasingly relevant for a number of developing countries. Economies such as China, Hong Kong (China), Malaysia, Mexico, Republic of Korea, South Africa and Taiwan Province of China, have all become significant sources of outward FDI. Between 1985 and 2002, the total stock of outward FDI from developing economies rose from \$78 billion to \$849 billion, most of which emanated from Asia. In a globalizing world economy, firms face competition increasingly from both imports and inward investors. It therefore becomes more important for companies from developing countries too to invest abroad to maintain their competitiveness and to develop a portfolio of locational assets.

As internationalization has progressed, more and more companies have invested outside their home countries. As noted above, this has led to the emergence of a number of TNCs from developing countries. Moreover, while TNCs are generally perceived to be giant corporations controlling huge resources, the fact is that a growing number of all TNCs are relatively small in size. An analysis of *Small and Medium-sized Transnational Corporations: Role, Impact and Policy Implications* was made of the nature, scope and implications of transnationalization by SMEs (UNCTAD, 1993a).

Policy analysis and normative work

Policy matters. It matters whether a country is seeking to attract more inward FDI, maximize the benefits from FDI or address concerns related to FDI. Although the process of globalization has generated new opportunities and more space for companies to

reorganize their international activities, policy making at both the national and international levels in the area of investment remains crucial. Thus, while UNCTAD caters to a diverse audience, special efforts are made to reach out to one group in particular, namely, policy makers in developing countries. To this end, various publications have increasingly devoted attention to presenting clearly defined and concrete policy options derived from an economic analysis of key issues. As once called for in UNCTAD I (box 1), policy recommendations have addressed possible efforts by host countries, home countries, investors and the international community at large.

Host-country policies

The *WIR01* and *WIR02* went beyond policy recommendations at a fairly general level and presented in a concrete manner how countries have addressed the questions of linkage promotion and export promotion involving foreign affiliates. Taking into account the growing competition for especially export-oriented FDI, changing corporate strategies, new technological developments, as well as the evolving international regulatory framework, these reports explored various options governments can consider to promote export-oriented FDI and linkages between foreign affiliates and domestic companies. The message conveyed underlined the importance of domestic enterprise development and the need to “work with the market” and create the necessary conditions, coupled with proactive government intervention, to induce TNCs to forge local linkages and establish export platforms with a high local value added. In this context, UNCTAD also introduced the concept of three generations of investment promotion, from general liberalization and opening up to FDI (first generation), to setting up investment promotion agencies and related activities (second generation), and moving to the proactive marketing of investment opportunities in a targeted way (third generation).

Reflecting the expanded use of incentives to attract FDI, the 1996 publication *Incentives and Foreign Direct Investment* offered a comprehensive survey of their use for the attraction of FDI and to affect the behaviour of foreign affiliates (UNCTAD, 1996a). This

survey remains the most authoritative and cited source of information in this area. Another important publication in this field was *Tax Incentives and Foreign Direct Investment: A Global Survey*, which was published in 2000 (UNCTAD, 2000a).

Until the mid 1990s, the links between market structure, competition policy and cross-border M&As had been largely neglected by academic researchers and policy makers.¹⁹ It is particularly important in the context of FDI, since TNCs tend to be especially well represented in industries characterized by a high level of market concentration. By making sure that markets in which TNCs invest are competitive, host governments stand a better chance of reaping the full benefits from FDI. In this context, UNCTAD provided a new focus, with particular reference to policy formation and action by intergovernmental entities. The policy discussion in *WIR97* explored the balance between liberalization and competition policy, elements of competition and merger laws conducive to development, and the need for, and obstacles to, international cooperation. In *WIR00*, the impact on market structure and competition was identified as one of the key differences between FDI through M&As as opposed to greenfield investment. The volume observed the emergence of an international market for firms and called for adequate policy responses not only by national governments but also at the international level.

This policy analysis has formed the basis for technical assistance. Understanding what drives FDI is an important contribution to advisers on FDI policy and to providers of assistance on investment policy formulation and investment promotion. Equally important, technical assistance helps to keep a finger on the pulse of the times, i.e. what policy issues are important and relevant. UNCTAD's technical assistance work in the area of investment

¹⁹ As noted above, however, UNCTAD has for a long period worked actively on issues related to competition and to the control of restrictive business practices by TNCs. UNCTAD was *inter alia* responsible for the negotiations on and conclusion of the United Nations Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, which was approved by the United Nations General Assembly on 5 December 1980 in its resolution 35/63.

covers a diverse field, including *Investment Policy Reviews* (first advocated in the *WIR93*),¹⁹ investment promotion activities, the production of *Investment Guides for LDCs*²¹ and reports on *Best Practice in Investment Promotion* (UNCTAD, 1997b and 2001a).

Home country measures

UNCTAD also recognized the influence of home country policies and measures on the volume and nature of FDI flows. This is a subject that, even to date, has received little attention. An important question that has been addressed in several contexts is how these measures can help developing countries and economies in transition to attract and benefit more from FDI.

Many developed countries have made special efforts to facilitate their firms' foreign expansion through FDI. As was noted e.g. in *WIR03*, a number of measures could be identified:

- *Liberalize outflows.* Home countries can remove obstacles to FDI outflows.
- *Provide information.* They can assist developing countries in collecting and disseminating information related to investment opportunities through cooperation with investment promotion agencies (IPAs), the provision of technical assistance, the organization of investment missions and seminars and the like.
- *Encourage technology transfers.* Home countries can promote technology transfer by providing assistance to strengthen a host country's technological base, its capacity to act as a host to FDI and technology-intensive industries and its capacity in reaching specific technology-intensive goals.
- *Provide incentives to outward investors.* Various forms of financial and fiscal incentives can be provided to outward investors or to support feasibility studies and environmental assessments.

²⁰ For more information, see <http://r0.unctad.org/ipr/>.

²¹ For more information, see <http://r0.unctad.org/en/pub/investguide.en.htm>.

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- *Mitigate risk.* Home countries can help to mitigate risk—say, by providing investment insurance against losses arising from political or other non-commercial risks that may not normally be covered through the private insurance market.

While initiatives in many countries have been documented, policy declarations aimed at encouraging outward FDI have seldom been linked to any specific international commitments. Rather, these remain at the discretion of each developed country and are commonly shaped to serve a home country's own business interests along with general development objectives. This home country perspective is especially evident in the design of many financial or fiscal assistance programmes as well as preferential market access measures. Weak links between the explicit needs of developing countries and the design and execution of home country measures, as well as the often uncertain commitment to the duration of assistance, may diminish the beneficial impact such programmes can have on development.

In *WIR03*, one of the key messages in the context of the interface between national policy making and international investment agreements was the potential role home country commitments could play in enhancing the development dimension of international investment agreements. Indeed, the *Report* went as far as arguing that future international investment agreements “should contain commitments for home country measures” (*WIR03*, p. 163).

Good corporate citizenship

Much of the international discussions on the role of FDI in developing countries concerns the social responsibility of TNCs. The notion of “good corporate citizenship”, as used in *WIR03*, covers a number of aspects, such as development obligations, socio-political obligations, consumer protection as well as emerging issues related to corporate governance, ethical business standards and the observance of human rights. While the Code of Conduct negotiated by the Commission on Transnational Corporations was never completed, the social responsibility dimension of TNC activities is receiving increased attention in various international agreements and fora. In its last chapter, *WIR99* and again in *WIR03*, as well as in a

special issues paper (UNCTAD, 2001b), UNCTAD revisited this topic and offered an update of recent developments, including the challenge by the United Nations Secretary-General Kofi Annan to TNCs to form a new “Global Compact” with society, whereby they would become global citizens adhering to a set of principles that would protect especially the environment, human and labour rights. There are growing expectations that TNCs can contribute directly to the advance of development goals as one aspect of good corporate citizenship: not only should they abide by the laws of the host country, they should also pay greater attention to contributing to public revenues, creating and upgrading linkages with local enterprises, creating employment opportunities, raising skills levels and transferring technology.

When UNCTAD in 1993 took over the work programme of the UNCTC it also inherited the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR). This Group was formalized in 1982 by a United Nations Economic and Social Council (ECOSOC) resolution in response to the desire to increase the knowledge of what went on inside companies. It held its 20th session in 2003. It continues to offer guidance to policy makers, standard setters and the profession in the areas of accounting and reporting, and remains the only forum open to all developing countries and economies of transition on issues related to accounting and auditing. Since coming to UNCTAD, it has produced three guidelines: on integrating environmental costs and liabilities into financial statements (UNCTAD, 1999b); on the qualifications necessary for professional accountants (UNCTAD, 1999c); and yet another on accounting by SMEs. It is currently working on corporate governance and corporate social responsibility within the context of improving the transparency of information provided by enterprises and making them more accountable for their performance and impacts on society.

International rule making

An area in which UNCTAD has played a prominent role and one that has gradually moved up on the international agenda concerns international rule making on investment. In this regard, UNCTAD

continues a tradition started by the UNCTC, one of the most important projects of which involved servicing the then Commission on TNCs in the development of a Code of Conduct on TNCs. While this proposal eventually was abandoned, the discussion on the role of international rule making in the area of investment remains highly topical.

Mirroring international events, the special theme of the *WIR96* was “Investment, Trade and International Policy Arrangement”. It was a topic timely chosen as BITs proliferated, regional trade agreements expanded to cover investment, OECD negotiations on a Multilateral Agreement on Investment were on-going and some countries began to advocate the negotiation of an investment agreement in the WTO, as reflected in the 1996 Singapore Ministerial Declaration. In one section, the volume outlines the key issues under four topics requiring consideration as international arrangements develop: investment measures concerning the entry and operation of FDI; standards of treatment (especially national treatment, most-favoured-nation treatment and fair and equitable treatment); setting of appropriate standards to address such issues as transfer pricing, restrictive business practices, technology transfer, employment, environment and illicit payments; and, finally, investment protection and dispute settlement.

WIRO3 went into some detail to explore the implications of a number of key issues facing negotiators and policymakers in this regard. It focused in particular on policy measures aimed at attracting FDI (such as reducing obstacles to FDI (admission and establishment; improving standards of treatment for foreign investors (non-discrimination); protecting foreign investors (compensation for expropriation); and promoting FDI inflows (incentives)) and at benefiting more from FDI (such as increasing the contribution of foreign affiliates to a host country through mandatory measures (performance requirements) and by encouraging foreign affiliates to act in a desired way (incentives)). *WIRO3* stressed the importance of recognizing the need of developing countries to secure sufficient policy space for national policy making in order to promote development benefits from FDI. It also underlined the need to pay due attention to the balance of host and home country interests, as

well as to the potential treatment of good corporate citizenship in the context of international investment agreements (IIAs) – all with a view towards enhancing the development dimension of such agreements.

While multilateral negotiations in the OECD were abandoned in the end and discussions in the context of the WTO reached an impasse at the Organization's Cancún Ministerial in September 2003, investment agreements are proliferating at the bilateral and regional levels. As documented in *WIR03*, they are increasingly establishing parameters for national policy making:

- At the *bilateral* level, the most important instruments are BITs and double taxation treaties (DTTs), with 2,181 BITs and 2,256 DTTs by the end of 2002. The *WIR03* concluded that BITs as of 2002 covered an estimated 7% of the world stock of FDI and 22% of the FDI stock in developing countries and economies in transition, respectively. DTTs, meanwhile, covered some 87% of world FDI and 57% of FDI in developing countries and transition economies. In addition, more and more bilateral free trade agreements include investment provisions.
- At the *regional* level, few agreements deal exclusively with investment issues. The trend so far has been to address such issues in trade agreements. In effect, free trade agreements today are often also free investment agreements.
- At the *multilateral* level, finally, the few agreements deal with specific issues (such as trade-related investment measures, insurance, dispute settlement, social policy matters), or they are sectoral (such as the General Agreement on Trade in Services (GATS)).

UNCTAD has been actively following this trend, with a view towards assuring that developing countries are being put in a position that allows them actively and competently to engage themselves in discussions on, and negotiations of, international investment agreements at whichever level they wish to do so.

UNCTAD's analytical contributions have been widely appreciated and acknowledged. In addition to contributions through various *WIRs*, work on international investment agreements has resulted in a series of "issues papers" designed to address key concepts and issues relevant to international investment agreements. The completed series encompasses 27 papers, to date the most comprehensive analysis of key issues in IIAs.²² Another important UNCTAD contribution in this field of work is the report entitled *Bilateral Investment Treaties in the Mid-1990s*, which included a comprehensive analysis of the scope, nature and role of BITs in a globalizing world economy (UNCTAD, 1998b). UNCTAD has furthermore contributed to various conceptual innovations. For example, the concept of investment-related trade measures (IRTM) was first introduced in *WIR* in the early 1990s. The concepts of flexibility and national policy space in the area of FDI were developed over a cycle of three expert group meetings. Based on UNCTAD IX (89(b)), UNCTAD reviewed the development dimension of IIAs, starting in 1997 with an expert meeting on "Existing agreements on investment and their development dimension" (May 1997),²³ continuing with the meeting on "Existing regional and multilateral investment agreements and their development dimensions" (April 1998),²⁴ and culminating in the expert meeting on "International investment agreements: concepts allowing for a certain flexibility in the interest of promoting growth and development" (March 1999).²⁵ UNCTAD also introduced the idea that the concept of "transparency" – now central to international investment agreements – should not

²² The series will eventually cover the following topics: admission and establishment; competition; dispute settlement (investor-State); dispute settlement (State-State); employment; environment; fair and equitable treatment; FDI and development; home country measures; illicit payments; incentives; IIAs: flexibility for development; investment-related trade measures; lessons from the MAI; most-favoured-nation treatment; national treatment; scope and definition; social responsibility; state contracts; taking of property; taxation; transfer of funds; transfer of technology; transfer pricing; transparency; and trends in IIAs – an overview.

²³ TD/B/COM.2/EM.1/2; question 7, page 11; and TD/B/COM.2/5, TD/B/COM.2/EM.1/3 (report), para 8).

²⁴ TD/B/COM.2/EM.2/2, para 5; and TD/B/COM.2/11, TD/B/COM.2/EM3/3, para 4.

²⁵ TD/B/COM.2/EM.5/2 and TD/B/COM.2/17, TD/B/COM.2/EM.5/3.

only be seen in reference to host countries, but also in reference to home countries and TNCs.

UNCTAD's normative work and consensus-building are similarly well recognized. Special reference to UNCTAD was, for example, made in the WTO Ministerial Declaration in Singapore²⁶ and more recently also in the Doha Declaration.²⁷ Considerable work has been conducted in the form of facilitating negotiations and training in the area of international investment agreements. In fact, the interplay of research and policy analysis with technical assistance work and consensus-building, including close interaction with Governments via the intergovernmental machinery, constitutes one of UNCTAD's special strengths. The organization's active participation jointly with the WTO in a significant post-Doha technical assistance programme on investment reflects the strong reputation UNCTAD enjoys in this field. These joint activities were reported to the WTO Working Group on Trade and Investment,²⁸ where UNCTAD, as an observer, also made presentations on the issues under discussion, focusing on the development perspective.

²⁶ Paragraph 20 of the Singapore Ministerial Declaration deals with matters related to investment and competition policy and notes that two new working groups on trade and investment and on trade and competition shall "draw upon and be without prejudice to the work in UNCTAD and other appropriate intergovernmental fora. As regards UNCTAD, we welcome the work under way as provided for in the Midrand Declaration and the contribution it can make to the understanding of issues. In the conduct of the work of the working groups, we encourage cooperation with the above organizations to make the best use of available resources and to ensure that the development dimension is taken fully into account."

²⁷ Paragraph 21 of the Doha Declaration stated that "To this end, we shall work in cooperation with other relevant intergovernmental organisations, including UNCTAD, and through appropriate regional and bilateral channels, to provide strengthened and adequately resourced assistance to respond to these needs."

²⁸ See "Progress report. Work undertaken within UNCTAD's work programme on international investment agreements between the 10th Conference of UNCTAD, Bangkok, February 2000, and July 2002" (UNCTAD/ITE/Misc.58); and "Progress Report: Implementation of post-Doha technical assistance work in the area of investment" (UNCTAD/ITE/IIT/2003/3).

Concluding remarks

During the past forty years, the relative emphasis on the pros and cons of development strategies relying on inward FDI has oscillated but it is now widely recognized that FDI, as a complement to domestic investment, can bring important development benefits, for host as well as home economies. At the same time, this should not lead policy makers to rely simply on an open environment and market forces alone. Rather, the vast amount of the UNCTAD Secretariat's research and policy analysis underscores the crucial role of government policies to ensure that FDI brings development gains. FDI is no panacea to break out of underdevelopment. The scope for benefiting from inward FDI is closely linked to a country's ability to foster its domestic capabilities, but under the right circumstances, FDI can act as a catalyst for economic growth and development. The policy challenge is to identify the best approaches to leveraging such investment. Moreover, it is crucial that international agreements at various levels recognize fully the need for governments to be able to design and implement national policies that can help advance development objectives.

At both national and international levels, the expansion of TNC activities is today regarded as a critical factor for the formulation of policy responses to the challenge of globalization. Throughout its work, UNCTAD has emphasized, mainly through its *World Investment Report*, the importance of FDI, picked up key themes at an early stage as well as developed new concepts and kept following them over time. In this way, UNCTAD has helped to bring out the subject of FDI and TNC activities from the fairly small corner it occupied in the study of and policy formulation related to international economic relations and accorded it a more central place as a factor in those relations. The UNCTAD Secretariat (and earlier UNCTC) has developed the field in the international system of political economy; defined the mainstream in the policy area; and helped with consensus building.

UNCTAD's contributions in the area of FDI and development have relied on a combination of in-house knowledge and experience and close interaction with policy makers and academic expertise.

Over time, the Secretariat has developed a unique network of experts that play a critical role not only in providing inputs to the various publications and inter-governmental meeting that UNCTAD organizes but also as part of a rigorous peer review process that is crucial to guarantee high quality outputs. As can be seen from the acknowledgements at the beginning of each *WIR*, between 50 and 100 academics and officials from central banks, investment promotion agencies and representatives of non-governmental organizations are normally involved in providing ideas, data or even draft texts. The final output benefits from a genuine interaction between UNCTAD staff and external experts. In this context, it is worth mentioning the journal, *Transnational Corporations*, which is the only policy-oriented refereed journal with a clear policy-oriented focus related to the role of TNCs and development. This journal has helped the Secretariat to remain in close contact with the academic community and encourage state-of-the-art policy-oriented research in this area.

In every respect, UNCTAD has taken a hands-on approach to its tasks of advancing our understanding of the changing role of TNCs and FDI in economic development. The research and policy work has successfully interacted with technical assistance work in the field as well as with close links with national Governments through UNCTAD's intergovernmental machinery. In the area of FDI and development, there are no clear-cut answers or one-size-fits-all solutions. UNCTAD has fulfilled an important role in advancing the intellectual comprehension of this phenomenon and developed policies to deal with it. As regards UNCTAD's role in the policy making process, John H. Dunning, the long-standing Senior Adviser to the *WIR* team, summarized his views in the following way:

“Successive *WIRs* have helped governments, in a way no other publication has done, to know about TNCs – their nature, strategies and likely impact; and to guide them in their information gathering, policy formulation, institution building, and implementation devices.”²⁹

²⁹ Communication by John H. Dunning to UNCTAD, 19 December 2002.

The expansion of international production under the common governance of TNC activities underlines the importance of the objectives that were once set for the UNCTC: to improve the understanding of the nature of TNCs and to analyze some of their effects on home and host countries, including economic relationships between the two. UNCTAD's work (and earlier that of the UNCTC) has provided vital inputs to policy makers and academics around the world. By collecting, disseminating and analyzing data, developing knowledge, applying it to FDI with a distinct focus on developing countries and assessing policy options, UNCTAD has contributed to placing the relationship between FDI and economic development firmly on the international economic and political agenda. While forty years of research and policy analysis has brought new insights and knowledge as regards the impacts of TNC activities, the same challenges that faced policymakers in 1964 are still largely relevant today. As once underlined in the UNCTAD I resolution, in order to address them in a satisfactory way, and to maximize the developmental impact, all parties concerned – host countries, home countries, investors and the international community at large – need to assume their respective roles and responsibilities. ■

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Characteristics of failed FDI projects in Viet Nam

Ari Kokko, Katarina Kotoglou and Anna Krohwinkel-Karlsson*

This article examines the characteristics of licensed and unsuccessful foreign-direct-investment projects in Viet Nam during the period 1988-2000, focusing particularly on the problem of high failure rates. Using project-level data on licensed foreign direct investment provided by Vietnamese authorities, it analyzes how various project characteristics are related to the likelihood of failure. Applying a transaction cost approach, the article presents hypotheses regarding the characteristics of failed projects. Summarizing the results from a probit analysis, it appears that most of the failed projects were approved soon after 1988, in the form of joint ventures, located in poor areas and undertaken by non-East Asian investors. In addition, there is some evidence that small projects and projects in more protected industries exhibit higher failure rates.

Key words: FDI, Viet Nam

Introduction

Since the initiation of economic reforms in the mid-1980s, Viet Nam has made a rapid transition from a planned to an increasingly market-driven economy. Foreign direct investment (FDI) has played an important part in this process from early on. In fact, one of the first concrete steps towards renovation was to promulgate a law on foreign investment in 1987.¹ This resulted in the emergence of FDI as an important element of

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¹ The first Law of Foreign Investment in Viet Nam was dated 29 December 1987. Several amendments have been made since then. The current law is dated 12 November 1996 (Viet Nam, National Assembly, 1996).

Vietnamese economic development. FDI commitments increased rapidly, albeit from a low level, both in terms of the number of projects and the amount of funds. By 1993, Viet Nam had licensed over 700 projects with a nominal aggregate investment value of \$5.5 billion. By 2000, this had grown to nearly 2,400 projects with a planned investment capital of more than \$30 billion. However, the actual implementation of projects has fallen short of the plans and failure rates are high – over one-fourth of the licensed projects have been terminated prematurely. This is not surprising, given Viet Nam’s position on the development ladder. Viet Nam is not only in transition from plan to market, but is also suffering from many of the typical weaknesses of developing countries: poor infrastructure, shortages of physical and human capital, and weak institutions are only a few of the problems complicating project implementation (and national development).

One particular problem in the analysis of FDI in Viet Nam is the lack of information. It is hard to find comprehensive economic statistics – for instance, the State budget was considered a secret until 1999 – and the information that is available is subject to frequent revisions. The scarcity of reliable information is particularly notable when it comes to FDI. Viet Nam does not publish many data on the operations of foreign affiliates, and the statistical office did not even undertake regular surveys of foreign investors until the late 1990s. It is therefore impossible to undertake comprehensive analyses of actual investment, employment, productivity, and similar issues in a long-term perspective. However, Viet Nam does publish data on investment licenses, including information on investor characteristics and investment plans. In addition, the Ministry of Planning and Investment records instances in which investment licenses are withdrawn, either because the prospective investors decide not to realize their plans or because Vietnamese authorities are not satisfied with the implementation of the investment project.²

² In addition, various sources, ranging from international organizations to Vietnamese business newspapers, publish aggregate figures of approved and/or disbursed FDI capital. In general, estimates provided by domestic sources are substantially higher than the corresponding estimates by international organizations (see Freeman and Nestor (2004) for a careful comparison of the available secondary data).

This article uses the data on licensed and withdrawn FDI projects in Viet Nam during the period 1988-2000 in order to examine how various investor and project characteristics are related to the likelihood of investment failure (defined as withdrawal of the investment license) in a probit model. Identifying the particular characteristics of failed FDI projects may reveal some of the main problem areas for foreign investors. Any conclusions are likely to be relevant also for projects that are still in operation. The findings will also to some extent fill the void caused by the lack of data on project implementation. To the best of the authors' knowledge, Ari Kokko and Mario Zejan (1996) are the only ones analyzing systematically FDI failures in a similar manner.³

The article is structured as follows. The next section provides a brief overview of FDI-related issues in the economic reform process and presents the characteristics of licensed investment. The subsequent section discusses the problem of weak performance. The section that follows introduces the transaction cost perspective as an explanatory framework, and presents the hypotheses regarding the causes for investment failures. The next section outlines the characteristics of withdrawn projects, together with a probit analysis of the likelihood of investment failure. The final section discusses the results and how they can be linked to areas where further reforms would be desirable.

Economic reforms and FDI in Viet Nam

After the Sixth Congress of the Vietnamese Communist Party in 1986, a broad economic reform agenda was introduced to decentralize decision-making and replace central planning with markets and prices. The so-called *Doi Moi* programme

³ A number of studies have examined FDI in Viet Nam, but they suffer from the lack of detailed data on project implementation. There is a vast literature on FDI activity in other developing and/or transitional economies, but it mostly covers determinants of FDI, while little is known about factors contributing to project failure. Furthermore, the results are difficult to generalize given the specific institutional environment in each country.

aimed at “the development of a multi-sector commodity economy operating along a market mechanism with State management and with a socialist orientation” (McCullough, 1998, p. 1). The resulting reforms, covering agriculture, industry, as well as domestic and international trade, yielded impressive results. The Law on Foreign Investment, approved by the National Assembly in December 1987, was one of the earliest legislative steps in the implementation of *Doi Moi*. The law established for the first time a regime under which FDI could enter Viet Nam, and the country soon gained a reputation among foreign investors as a promising location in East Asia. Licensed FDI rose rapidly from 28 projects representing a total of \$140 million in 1988 to 345 new projects in 1995 and total licensed investments of \$8.4 billion in 1996 (table 1). With inflows reaching almost 10% of GDP between 1994 and 1997, Viet Nam became the number one recipient of FDI among all developing countries and economies in transition in proportion to the size of its economy (FIAS, 1999).

The attractiveness of Viet Nam can largely be attributed to macroeconomic stabilization resulting from *Doi Moi* and investor expectations of continuing reforms and improvements in the general investment climate. In 1995, the long-lasting United States embargo was lifted, and Viet Nam entered discussions about several international trade agreements.⁴ Further reform efforts were concentrated on restructuring the State-owned enterprises, the financial industry and public administration. The donor community welcomed these reforms, although due to conflicting political interests within the country, implementation was rather weak and several problems have remained until the present time (Hakkala *et al.*, 2001). For instance, the trade regime retains many import-substituting elements, and State-owned enterprises (SOEs) continue to dominate the economy at the expense of the private sector (despite a rapid increase in the number of private small and medium-sized companies and household enterprises over the past few years).⁵ From the point of view of foreign investors, it

⁴ Viet Nam joined ASEAN in 1995, APEC in 1998, and has applied for membership in the WTO.

Table 1. Foreign investment licenses per year and investment form, 1988-2000
(Million dollars and number)

| Licensed FDI | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|----------------------|-------|-------|-------|---------|---------|---------|---------|---------|---------|---------|---------|-------|-------|
| Joint ventures | | | | | | | | | | | | | |
| Value (million \$) | 140.6 | 180.6 | 346.5 | 813.2 | 1 188.9 | 1 854.7 | 2 835.0 | 4 975.3 | 6 803.2 | 2 229.2 | 2 526.3 | 606.7 | 45.3 |
| Number | 27 | 49 | 87 | 121 | 130 | 177 | 220 | 228 | 189 | 137 | 51 | 22 | 31 |
| Wholly-owned | | | | | | | | | | | | | |
| Value (million \$) | 0 | 9.1 | 6.2 | 217.0 | 185.7 | 625.6 | 535.0 | 1050.5 | 1621.2 | 1004.9 | 623.9 | 341.3 | 337.1 |
| Number | 1 | 6 | 6 | 12 | 36 | 75 | 100 | 117 | 128 | 113 | 78 | 72 | 155 |
| Total licensed FDI | | | | | | | | | | | | | |
| Value (million \$) | 140.7 | 189.7 | 352.7 | 1 030.2 | 1 374.5 | 2 480.3 | 3 370.0 | 6 025.8 | 8 425.9 | 3 234.1 | 3 150.2 | 948 | 382.4 |
| Number | 28 | 55 | 93 | 133 | 166 | 252 | 320 | 345 | 317 | 250 | 129 | 94 | 186 |
| Average project size | 5.0 | 3.4 | 3.8 | 7.7 | 8.3 | 9.8 | 10.5 | 17.5 | 26.6 | 12.9 | 24.4 | 10.1 | 2.1 |
| Actual inflow (M\$) | - | .. | .. | 168 | 316 | 922 | 1 636 | 2 260 | 1 963 | 2 074 | 800 | 700 | 800 |

Source: State Committee for Cooperation and Investment and Ministry of Planning and Investment, *List of Licensed Projects* (various years). Data on actual inflows (disbursements) are IMF estimates.

Note: A dash (-) indicates that there was no licensed FDI in the relevant category, 0.0 indicates that the FDI value accounted for less than 0.05 million \$.

is essential to note that Viet Nam's economic system is still in transition, with elements of both centrally planned and market-economy regimes. The Vietnamese economic and political climate has had implications not only for domestic industry but also for the profile of FDI in the country.

FDI commitments started to decrease sharply just before the Asian crisis and continued to do so until 2001. In 2000, licensed FDI had fallen back to \$380 million, close to the level of 1990. Although part of the fall was due to excess capacity and decreased liquidity in the region, Viet Nam's competitiveness was also hurt by domestic problems resulting in a slowdown in reforms after the mid-1990s. These problems seem to have eased since about 2000, and some signs of a rebound in FDI inflows were seen in 2001 and 2002.

The structure of licensed FDI

The Foreign Investment Law allows foreign investors to enter Viet Nam in one of three forms: contractual business cooperation, joint venture enterprises, and enterprises with 100% foreign ownership.⁶ Excluded are business contracts from most of the subsequent discussion and analysis, since it is not clear to what extent these transactions make up foreign *direct* investment.⁷ The numbers include the share of Vietnamese partners in joint ventures, leading to an overestimate in the total FDI amounts. Most Vietnamese joint venture partners have little or no financial resources, and contribute their part of the capital in the form of land and expertise.

⁵ The introduction of a new Enterprise Law in 2000 was particularly important for the boom in private enterprise. It has led to the registration of tens of thousands of new formal enterprises: many of these are likely to be entirely new entities, although the majority probably existed in the informal sector prior to the simplification and liberalization of the rules.

⁶ In addition, the Foreign Investment Law provides some details on build-operate-transfer (BOT), build-transfer-operate (BTO) and build-transfer (BT) project. See McCollough (1998) for further details on the law.

⁷ In many cases, business contracts are likely to require foreign investment, but the foreign party may have little formal control over the operations in Viet Nam.

Since Viet Nam opened up for FDI in 1988, joint ventures have been the most common form of investment, often with an SOE as the Vietnamese partner. The International Monetary Fund estimated (IMF, 1999) that two-thirds of total FDI commitments during 1991-1998 were made in joint ventures with SOEs, and only 2% in joint ventures with the private sector. There are several reasons for this distribution. In the early years after the introduction of *Doi Moi*, SOEs were the only legal partners for foreign investors desiring to enter a joint venture. Even after that time, the privileged position of SOEs has left no other choices for many foreign investors seeking a Vietnamese partner. Private enterprises do not only account for a small share of the economy, but are often too small to meet the requirements of large foreign investors. Moreover, the various privileges of SOEs may appear useful to companies seeking a smooth entry into the Vietnamese market. The political contacts favouring SOEs in areas where rule of the law is not fully established, as well as their superior access to commercial land, contribute significantly to the attractiveness of SOEs as joint venture partners.

Some changes in the relative importance of the different investment forms have occurred in recent years. The share of wholly owned affiliates has increased, while the share of joint-venture projects has decreased. As can be seen in table 1, wholly owned affiliates have outnumbered joint ventures since 1998 and, in 2000, the licensed capital for wholly owned projects was for the first time larger than that for joint ventures. Before 1992, the number of wholly owned affiliates was small but started to increase soon thereafter. One explanation is an amendment to the Foreign Investment Law in 1992: it gave wholly owned projects the same status as joint ventures. Another reason is that information about Viet Nam was so scarce in the early years that almost all foreign investors needed local partners. In 1991, wholly owned foreign affiliates accounted for about 20% of total invested capital and 10% of the number of projects; by 2000 these proportions had risen to almost 90% and 83%, respectively. Wholly owned affiliates are typically greenfield investments – there are few suitable acquisition objects because the level of local technology is low compared to that of potential foreign investors, and because Vietnamese regulations have prohibited outright acquisitions of national firms.

The industry distribution of FDI has changed over the years. Construction was one of the most important industries at the beginning of the period, with a peak in 1996. The average project size in this industry has been large, with projects focusing on hotels, office construction and infrastructure. The decline in the share of that industry is a sign of a saturated market. Manufacturing industries (e.g. chemicals, construction materials and electric equipment) and services (mainly transportation, communication and finance) have become important in recent years. FDI in agriculture and textiles and clothing has been low but stable, with small average project size. Official Vietnamese figures also include a substantial amount of FDI in oil and gas exploration, although almost all projects in this industry are undertaken in the form of business contracts.

The Vietnamese trade regime has biased FDI towards import-substituting industries (heavy industry and production of consumer goods) and non-tradables (construction, transportation and telecommunications, office property and apartments). The majority of FDI projects involve industries with high effective rates of protection (ERPs). Over 60% of FDI during 1988-2000 was made in industries with an ERP of above 50%.⁸ Moreover, exports have, until the most recent years, represented only a small share of the turnover of foreign affiliates. This pattern is the opposite of what has been declared as the preferred or ideal pattern in various policy documents. The Law of Foreign Investment (Viet Nam, National Assembly, 1996) presents a “List of favoured projects”, in which production of export goods is given priority. Until recently, the export potential of industries such as textiles and garments, footwear and agriculture was hardly exploited by FDI, although Viet Nam has a comparative advantage in these labour-intensive industries (IMF, 1999). It is positive however that FDI in the export-processing zones seems to have focused on light manufacturing.

The geographical distribution of FDI is highly concentrated in urban areas such as Hanoi-Haiphong and Ho

⁸ For a detailed account of the ERPs in different industries, see annex 2.

Chi Minh City. These provinces, with only 12% of the total population (Viet Nam, General Statistical Office, 2000), received more than half of total FDI capital during the period of study.⁹ All in all, the ten richest provinces (mainly in the South) attracted almost 80% of total FDI during 1988-2000, while the six poorest provinces (all in the North) received only 1%. The concentration of FDI is seen as a problem by the Government. In the so-called “List of favoured projects”, priority is given to mountainous and remote regions, and regions with difficult economic and social conditions, but in reality the bias in favour of the metropolitan regions remains. However, there is no reason to expect any perfectly balanced distribution, since FDI is unlikely to go into regions in which purchasing power and transport networks are weak. As expected, agriculture and food processing are dominant activities in the rural areas, while construction and other services are almost exclusively located in the cities. Textiles and other manufacturing industries are equally spread between rural and urban areas.

During the period of 1988-2000, firms from 50 economies invested in Viet Nam. Asia is now the most important source of capital. The main home economies during the study period were Taiwan Province of China, with 14% of the total licensed investment capital, and Hong Kong (China), with 11%. Japan, Singapore and the Republic of Korea are also among the larger actors. The predominance of Asian investors partly explains why FDI inflows fell so sharply following the onset of the Asian crisis in 1997.¹⁰ Outside of Asia, the main early investments came from the former colonial power of France. The United Kingdom is another important European investor. The United States appeared among the investors after the embargo was lifted in 1995, while the relative importance of Australia, one of the leading investors in the early years, has declined.

⁹ The peak in 1998 observed for the central regions was due to one Russian project of \$1.3 billion aimed at building a petroleum refinery in the province of Quang Ngai.

¹⁰ Since the failure data presented in this article cover only years up until 1998, the effects of the Asian crisis will not be fully reflected in the subsequent analysis.

The distribution of FDI across industries has been similar for Asian and non-Asian investors, except for a somewhat higher presence of Asian firms in textile industries and non-Asian investors in other services. There does not appear to be any clear difference in the rural-urban distribution of investments for actors from Asia and the rest of the world, although Asian investors have been somewhat more concentrated in the southern regions. This may be due to the fact that there is a larger ethnic Chinese minority in the southern parts (especially in Ho Chi Minh City), and that these ethnic Chinese have been better integrated in the business networks of Southeast and East Asia. In recent years, Taiwan Province of China has been the leading investor in export-processing zones. One reason is that many of these zones were built and managed by Taiwanese entrepreneurs.

FDI performance

The figures described above capture *licensed* (also known as approved, authorized or planned) FDI. However, the amount of funds committed in licensing agreements does not necessarily say anything about how much has actually been *disbursed* (implemented or realized). The implementation rate of licensed FDI has been low. Comprehensive information in this respect is however not available. But there have been several attempts to estimate the realization rates on the basis on the limited surveys and reports available from the Vietnamese authorities. The World Bank's Foreign Investment Advisory Service calculated (FIAS, 1999), on the basis of official Vietnamese figures, that the implementation rate was only 34% for the period of 1991-1998. Prema-chandra Athukorala (1999) used an alternative data series for the period 1991-1996, based on a sample of individual project records. His findings suggested somewhat higher, but still disappointing, implementation rates.

However, low implementation rates do not necessarily say very much about the performance of FDI in Viet Nam. One reason is that a lag between approval and implementation is to be expected in any country, even if most projects turn out to be successful. Moreover, in a country that has just opened up to

FDI, and in which far-reaching reforms continuously change the character of the economy, early foreign investors must not only build up most of the production facilities from scratch, but are also forced to establish markets for material inputs, labour and final goods. In this kind of environment, it is not unreasonable that many investments require implementation times of several years.

Another problem for the estimation of implementation rates is that it is difficult to assess the value of actually implemented capital. Investors may overstate the value of their FDI to obtain a better bargaining position and to ensure that no new license has to be approved in the case of future expansion. Authorities may also exaggerate the value of investment to meet planning targets.¹¹

A more meaningful picture of the conditions facing foreign investors may therefore be provided by data on the *survival* of licensed investment (Kokko and Zejan, 1996). By the end of 2000, the Vietnamese authorities or foreign investors had withdrawn 488 licenses granted by the Ministry of Planning and Investment between 1988 and 1998, while the remaining 1,600 projects approved during the period were formally still under implementation or in operation. The total investment value of the withdrawn projects was \$6.7 billion, or about 23% of total licensed FDI during the period. Table 2 summarizes the data on cancelled FDI for the period 1988-1998. The most immediate observation should concern the very high failure rates during the first years of the study period. About half of all projects licensed during 1988-1990 were withdrawn. More recent investments appear to have been more successful.¹²

Most previous studies have estimated total *funds*

¹¹ Monthly data reveals an interesting pattern in the distribution of licensed investment capital over the year. Significantly more capital is licensed in the month of December, which raises concern about the quality of some of the projects approved in the end of the year.

¹² As pointed out by one of the referees, one of the reasons behind the high failure rates during the early years could be that the license applicant had no intention of enacting the project, but aimed to sell the license to some other foreign affiliate.

Table 2. Withdrawn foreign investment licenses per year, 1988-1998
(Million dollars and number)

| Withdrawn FDI | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|-------|------|-------|-------|-------|------|-------|---------|---------|-------|------|
| Total withdrawn FDI Value (million \$) | 117.8 | 95.4 | 126.5 | 224.8 | 130.2 | 92.0 | 881.3 | 1 492.7 | 2 875.0 | 656.4 | 17.7 |
| Number | 12 | 28 | 47 | 45 | 30 | 44 | 80 | 84 | 75 | 38 | 5 |
| Value-based failure rate | 0.84 | 0.50 | 0.36 | 0.22 | 0.09 | 0.04 | 0.26 | 0.25 | 0.34 | 0.21 | 0.01 |
| Number-based failure rate | 0.43 | 0.51 | 0.51 | 0.34 | 0.18 | 0.17 | 0.25 | 0.24 | 0.24 | 0.18 | 0.08 |

Source: State Committee for Cooperation and Investment and Ministry of Planning and Investment, *List of Licensed Projects* (various years).

Note: The value-based failure rate is the ratio of withdrawn FDI capital to total licensed FDI capital. The number-based failure rate is the ratio of withdrawn FDI projects to the total number of licensed FDI projects. The data include FDI projects licensed by the MPI. In 1997 and 1998, some projects were also licensed by local authorities, but we have no information regarding withdrawn FDI from these sources.

implemented or withdrawn, i.e. value-based failure rates. This measure may be adequate when trying to assess the overall effects or impact of FDI in an economy, but less useful when looking at the risk of failure for individual projects. Moreover, reported amounts of FDI may sometimes be exaggerated to make the project look more important, and size may therefore not be suitable to use as a weight when calculating failure rates. Number-based failure rates will therefore be used throughout the rest of this study.

A few additional caveats should be noted. Firstly, it may be wrong to assume that all projects not included in table 2 are in operation. In fact, many projects may have been cancelled without the knowledge of Vietnamese authorities. Secondly, some projects included in table 2 may not be true investment failures. No causes for license withdrawals are given in the data, but it is likely that a small number of the expired licenses refer to investments that have been completed and terminated according to plan. Thirdly, although most projects seem to fail during the first five years after licensing, with a peak in the second and third years, the observed failure rates for the last few years in the sample period are somewhat lower than what might be expected, even taking into account that the Vietnamese investment environment has improved over the years. One possible reason is simply that investors and authorities have had less time to recognize all failures of the most recently licensed projects. To circumvent the risk of classifying successful – but completed – investment projects as failures and to avoid truncation errors, only *projects that were withdrawn within five years after the licensing date* are classified as failures. Fourthly, this article has not been able to identify investors whose project plans failed before they received an investment license. Investors may abandon their project plans if the application requirements are considered too rigorous, if the licensing process takes too long time, or if they are not granted a license for the project. However, no information on project applications that were rejected or withdrawn before the completion of the licensing process is available.

Barring these caveats, the data used in this article identify those projects that have definitely been terminated, either because the investors gave up their plans or because the Vietnamese authorities cancelled their license due to slow implementation or other complaints.

Theories of investment failure

Even though most transnational corporations mainly look for locations with large markets and favourable factor costs, it is also clear that their investment decisions are often related to the relative *transaction costs* of doing business in the potential host country (Tejinder and Newhouse, 1995). In FDI, there are significant transaction costs related to the negotiation and enforcement of contracts, as well as costs connected to the day-to-day operations of business.

The transaction cost approach is relevant for the analysis of FDI in developing and transitional economies, since the general investment climate is not as stable as in industrialized countries. According to Douglass C. North (1990), efficient markets depend on supporting institutions that can provide the formal and informal rules of the game of a market economy. If institutions are unstable or unfamiliar, foreign investors face greater uncertainty and higher costs in negotiation and enforcement of contracts. They lack information about local partners, they must deal with agents inexperienced with business negotiations, and they are exposed to unclear regulatory frameworks, complex bureaucracies and corruption (Meyer, 2001). Consequently, countries in which market-based institutions are inefficient may have greater difficulties in attracting FDI. However, existing policies and conditions, although obstacles to the efficient conduct of business, do not necessarily deter a firm from FDI. Inherent localization advantages in the host country, such as a large domestic market or low wages, may outweigh high transaction costs. Investors' evaluations of expected profit opportunities will be directly reflected in application and licensing rates. After entry, previously unexpected risks may disturb implementation and

adversely affect the performance of investment projects. These *unpredicted* transaction costs would then affect failure rates.

Earlier studies have examined how transaction costs influence the decision to undertake FDI and the choice of location or entry mode.¹³ This article employs the transaction cost approach to investigate how different project characteristics are related to transaction costs and hence to the risk for failure of licensed investments. It is hypothesized that investment failures are related to various kinds of unforeseen transaction costs that reduce the expected profitability of a planned project. The transaction costs influencing FDI in Viet Nam may be related to various economic, political, social or legal factors. The hypotheses regarding the characteristics of failed FDI projects, based on the transaction costs that these characteristics induce are presented below.

Some hypotheses

- (a) Early entrance into an emerging market is often seen as a success factor since it is possible to start building a brand early, choose the best partners and block the entry of competitors if the market for a certain product is limited.¹⁴ However, the fact that Viet Nam was totally closed to foreign investors prior to *Doi Moi* made entry and establishment for first-movers especially complicated, since the costs of gathering relevant and accurate information about investment conditions were high.¹⁵

¹³ See for example Hennart (1989) on the choice of entry mode in general, Tejinder and Newhouse (1995) on the allocation of FDI in developing countries and Meyer (2001) on entry mode choice in transition economies.

¹⁴ Mascarenhas (1992) and Rivoli and Salorio (1996) prepared early studies identifying timing as a critical factor in FDI strategies. Both stress the importance of a context-dependent analysis of the costs and benefits associated with different timing decisions.

¹⁵ Luo (1998) argues that the costs of being early may be larger in economies in transition and emerging economies. However, empirical evidence from the Chinese market has been ambivalent: Pan and Chi (1999) found that early entrants outperform late movers, while Luo (1998) found that late movers are superior to early entrants with regard to the first three years' risk reduction and profitability.

These transaction costs have been falling over time, as more foreign investors have entered the country and newcomers learn from the experience of earlier entrants. The amount of information supplied by Vietnamese authorities about business conditions in Viet Nam has also increased over time. Moreover, revisions of the Foreign Investment Law have somewhat reduced the extent of bureaucracy involved in approval and implementation of projects in later years. All these factors should contribute to reducing transaction costs over time. Hence, it is hypothesized that failure rates should be lower for the most recent projects. However, one should be cautious when interpreting results due to the time lag in failure recognition mentioned earlier.

- (b) Some transaction costs can be expected to depend on the size of an investment project. Some fixed costs related to investment licenses and search for information about investment legislation and other conditions have to be incurred irrespective of the size of the investment. These fixed transaction costs are more significant for smaller projects. Moreover, larger projects are often undertaken by larger firms with more resources. These projects may therefore be preceded by more thorough evaluation and information collection, and may also be granted financial support from the foreign parent company if needed. In addition, there is evidence that larger projects enjoy preferential treatment in the licensing process, which reduces the time elapsed between application and granting.¹⁶ A related measure of investment magnitude is the expected duration of a project, i.e. the time horizon of the investor. The impact of some transaction costs, especially those stemming from post-approval problems, may decrease with the expected duration. A few years' delay due to cumbersome bureaucracy may be disastrous for a short-term project, while the damage may not be as

¹⁶ In 1994, the Prime Minister's Office took the authority to approve the more important FDI projects in terms of funds committed (those with an investment capital larger than \$40 million).

large for a long-term project. Altogether, we expect transaction costs and hence failure rates to be lower for projects of larger magnitude, measured both as size of investment capital and expected duration.

- (c) The transaction costs related to various kinds of contacts between an FDI project and Vietnamese enterprises and authorities are likely to depend on the ownership structure of the project. However, the exact relation between the investment form and these transaction costs is not obvious. On the one hand, it is reasonable to expect that interactions with Vietnamese authorities, suppliers and customers are less costly for joint ventures than for wholly owned affiliates, since the Vietnamese partner may use its existing network of business and bureaucratic contacts to the benefit of the joint venture. On the other hand, a joint venture imposes additional transaction costs for the coordination of activities between the foreign investor and the Vietnamese partner. Earlier studies have emphasized the potential cost savings from joint ventures (e.g. Pan and Chi 1999 on China). But in the case of Viet Nam, many investors have complained about the difficulties involved in cooperating with Vietnamese partners. An explanation may be that most joint ventures are with SOEs that are not used to operating in a market economy and are often inefficient and uncompetitive by international standards. They may also have other objectives than profit maximization (Kokko and Sjöholm, 2000). All in all, it is hypothesized that these latter problems are more serious, and that the failure rates are higher for projects with a small foreign share.
- (d) The location in the host country is likely to affect both the production and transaction costs encountered by the foreign affiliate. Wages are higher in urban areas, but transport costs are lower because of proximity to the markets. There are other transaction costs that tend to favour the centre. For instance, the supply of trained labour is larger, since labour tends to migrate to locations with many firms. Moreover, there are large regional differences

in the availability, cost and quality of infrastructure (transportation, telecommunications, electric power etc.) and various other services in Viet Nam. In particular, costs are higher and supply is more erratic in rural areas, which will again favour the centre.¹⁷ A more detailed picture of how location affects FDI is given by studying income levels. This article has categorized the provinces of Viet Nam into different income groups, based on a World Bank poverty map.¹⁸ Each FDI project has been assigned a poverty rate according to its geographical location. It is hypothesized that transaction costs are larger for projects located in poorer areas, since these locations are less urbanized and provide poor infrastructure. Also, poverty is likely to have a negative impact on the human capital characteristics of the population, including health and education.¹⁹ Altogether, we expect that failure rates are higher outside Hanoi and Ho Chi Minh City, and that FDI located in poorer areas is more likely to fail.

- (e) Viet Nam's historical legacy of a division into a northern and a southern part may influence the transaction costs of doing business. The traditionally more conservative, bureaucratic North has operated under socialism since the 1940s. The "renegade" South was heavily influenced by the United States and other Western countries until the

¹⁷ In a study of United States investors in developing countries, Wheeler and Mody (1998) found that agglomeration-related factors, notably infrastructure quality, were critical for locational decisions. Wei *et al.* (1999) and Cheng and Kwan (2000) examined the determinants of the location of FDI in China. They found that the magnitude of national and regional markets, the level of international trade, good infrastructure, and preferential policies have positive effects on FDI, while wage costs have negative effects. They also found strong evidence for an agglomeration effect.

¹⁸ See annex 1 for a detailed presentation of the poverty measures used.

¹⁹ Anh and Meyer (1999) investigated the locational decisions of joint ventures in Viet Nam in 1988-1993. They found that investors committed greater capital to provinces with higher levels of literacy, which may reflect human capital considerations. On the other hand, in a survey of FDI in China, Cheng and Kwan (2000) found no significant effect of the education variable on FDI location.

mid-1970s. Judging by data on FDI licensing, the South seems to be the more popular location among foreign investors. This may be due to transaction costs related to contacts with Vietnamese companies being lower in the South. The transition of the South into a market economy has been smoother, creating a more dynamic and open business environment.²⁰ It is examined if the North-South division has any effect on failure rates, and hypothesized that FDI in the Northern regions is more likely to fail.

- (f) In addition to formal constraints, such as economic, political and judicial rules, firms are also affected by informal constraints, for example culture (North, 1990). Viet Nam has attracted investors from many economies, and some cultural characteristics are likely to influence the transaction costs of conducting business in the country. The vaguely defined concept of *Confucianist traditions* has emerged as a possible non-economic factor influencing firm performance. It suggests that investors from other East Asian economies with a similar cultural heritage may encounter fewer problems to adapt to the Vietnamese society.²¹ Also, the organizational culture may be more similar among firms stemming from the same geographical region, making cooperation smoother and hence reducing transaction costs.²² It is hypothesized that FDI by East

²⁰ Anh and Meyer (1999) suggest that the business environment is perceived as more positive in the South, but that Northerners have a higher level of education. Northerners may therefore be better positioned to take jobs that require technical skills, leaving manual labour and informal sector jobs to less-educated Southerners.

²¹ Mead (1994) notes that the greater cultural differences between the partners, the more difficult it is to attain successful business relationships.

²² Many authors have attempted to describe the special features of Asian business organization. For example, Redding (1996) argues that there are three common cultural determinants that affect the way Asian organizations are structured: (i) paternalism, which implies a more or less authoritarian societal structure with a strong sense of vertical social order, discipline and dependence upwards; (ii) personalism, which refers to the reliance on specific relationships as the means of ensuring trust in business dealings; and (iii) collectivism (whereas Western societies tend to be individualistic).

Asian investors (ASEAN, the newly industrializing economies and Japan) should exhibit lower failure rates.

- (g) The trade policies of the host country, notably the promotion of import substitution through tariff and non-tariff barriers, can affect the prospective rate of return of investments. The ERP measures the extent to which value added in domestic industries is altered by the various taxes and subsidies on trade. A positive ERP indicates that the returns to capital and labour are higher than they would have been in the absence of government policies. A negative ERP means that a firm or industry is worse off than under free trade. Firms with high ERPs should consequently be able to charge higher prices and lead a more comfortable life as a result of protection. However, there is a risk that soft budget constraints and inefficient production in industries with comparative disadvantages dominate any potential benefits from protectionism. Moreover, when companies rely on bureaucratic decisions and are not under competitive pressure, resources that should have been used for productive means may go to unproductive activities such as lobbying and corruption. In such a climate, the “hassle” of doing business, as perceived by foreigners, increases. Applying the transaction cost approach, one could therefore argue that transaction costs are likely to be higher in more protected industries. Using ERP estimates for Vietnamese industries calculated by the Centre for International Economics (CIE, 1998), each FDI project has been assigned a tariff rate according to the type of product to be produced.²³ Due to the ambiguous theoretical effects of protection, one cannot define any strong *a priori* hypothesis for the relationship between ERP and investment failure, and this matter has to be left for the empirical analysis.

²³ For an account of ERP measures at the industry level, see annex 2. No account has been taken of policy changes affecting ERPs, since continuous data on ERPs are not readily available.

The characteristics of failed FDI

It has been hypothesized that the risk for failure should be higher for joint-venture projects because this form of investment may be exposed to higher transaction costs. Table 3 shows that the failure rates for joint ventures in Viet Nam have constantly been higher than those for wholly owned affiliates during the period of study. It appears that, in many cases, cooperation problems outweigh positive effects such as smoother entry to market and use of the Vietnamese partners' existing network. The low failure rates for wholly owned projects may also be explained by the fact that only foreign investors with low-risk projects have been willing to establish wholly owned affiliates. Investors coming to Viet Nam in recent years seem to be aware of the troubles with joint ventures and have therefore preferred the wholly owned investment form (see table 1).

Data in table 4 indicate that labour-intensive industries such as agriculture and food processing exhibited high failure rates in the early years but that performance has improved recently. Failure rates were also high for the construction industry during the earlier years. "Other manufacturing" and "other services" industries, which received the largest shares of FDI, have exhibited low failure rates in recent years.

Yearly failure rates for different regions are shown in table 5. It is clear that the northern and central regions had the highest failure rates throughout the whole study period, except for the years 1992 and 1993. This may indicate support for the hypothesis that investment in poorer areas is less successful, since the southern provinces are on average richer. There is no support however in the table for the hypothesis that rural areas

Table 3. Failure rates per year and investment form, 1988-1998

| Failure rates | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|----------------|------|------|------|------|------|------|------|------|------|------|------|
| Joint ventures | 0.44 | 0.53 | 0.53 | 0.36 | 0.20 | 0.18 | 0.31 | 0.31 | 0.29 | 0.24 | 0.10 |
| Wholly owned | - | 0.33 | 0.17 | 0.17 | 0.11 | 0.16 | 0.12 | 0.12 | 0.16 | 0.09 | 0.07 |

Notes and sources: see table 2.

in general should exhibit higher failure rates. One explanation can be that investors are already aware of the higher transaction costs in the countryside and therefore account for them when planning their projects.

There seems to be no clear pattern in failure rates between foreign investors of different national origin (table 6). According to the hypothesis, projects undertaken by investors from East Asian economies should exhibit lower failure rates. Taiwan Province of China and Hong Kong (China) seem to have been able to improve performance in recent years, but so do European investors. Australian projects seem to have been less successful in recent years, but the figures should be interpreted with caution due to the small number of observations for investments from Australia and New Zealand.

Table 4. Failure rates per year and industry, 1988-1998

| Failure rates | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|------|------|------|------|------|------|------|------|------|------|------|
| Agriculture, fishing, forestry and mining | 0.80 | 0.50 | 0.53 | 0.29 | 0.26 | 0.27 | 0.46 | 0.30 | 0.33 | 0.25 | 0.13 |
| Food products, beverages and tobacco | - | 0.60 | 0.67 | 0.47 | 0.30 | 0.50 | 0.25 | 0.37 | 0.33 | 0.21 | 0.23 |
| Textiles and clothing | 0.43 | 0.33 | 0.22 | 0.37 | 0.17 | 0.19 | 0.17 | 0.11 | 0.29 | 0.08 | - |
| Other manufacturing industries | 0.33 | 0.53 | 0.42 | 0.33 | 0.18 | 0.15 | 0.20 | 0.18 | 0.19 | 0.20 | - |
| Construction, hotels and restaurants | 0.50 | 0.57 | 0.64 | 0.38 | 0.11 | 0.09 | 0.33 | 0.39 | 0.29 | 0.15 | - |
| Other service industries | 0.00 | 0.45 | 0.54 | 0.22 | 0.08 | 0.05 | 0.25 | 0.27 | 0.16 | 0.11 | 0.06 |

Notes and sources: see table 2.

Table 5. Failure rates per year and region, 1988-1998

| Failure rates | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--------------------|------|------|------|------|------|------|------|------|------|------|------|
| Ho Chi Minh City | 0.36 | 0.52 | 0.41 | 0.35 | 0.18 | 0.17 | 0.15 | 0.24 | 0.21 | 0.09 | - |
| Hanoi-Haiphong | - | 0.45 | 0.40 | 0.32 | 0.15 | 0.08 | 0.29 | 0.25 | 0.23 | 0.09 | - |
| Southern provinces | 0.45 | 0.50 | 0.65 | 0.23 | 0.25 | 0.01 | 0.22 | 0.23 | 0.19 | 0.19 | 0.09 |
| Central provinces | 1.00 | 0.67 | 0.70 | 0.50 | 0.13 | 0.05 | 0.44 | 0.38 | 0.29 | 0.24 | 0.14 |
| Northern provinces | 0.50 | 1.00 | 0.56 | 1.00 | 0.17 | 0.14 | 0.47 | 0.19 | 0.44 | 0.35 | 0.20 |

Notes and sources: see table 2.

Table 6. Failure rates per year and foreign party, 1988-1998

| Failure Rates | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|------------------------------|------|------|------|------|------|------|------|------|------|------|------|
| Taiwan Pr. China | - | 1.00 | 0.39 | 0.31 | 0.30 | 0.24 | 0.18 | 0.17 | 0.15 | 0.17 | 0.00 |
| Hong Kong (China) | 0.25 | 0.53 | 0.57 | 0.40 | 0.11 | 0.24 | 0.23 | 0.42 | 0.18 | 0.06 | 0.00 |
| Other Asia | 0.67 | 0.20 | 0.48 | 0.33 | 0.21 | 0.15 | 0.21 | 0.15 | 0.26 | 0.18 | 0.11 |
| Australia and New Zealand | 0.67 | 0.67 | 0.50 | - | 0.10 | 0.07 | 0.30 | 0.18 | 0.44 | 1.00 | 0.50 |
| Europe | 0.38 | 0.48 | 0.56 | 0.36 | 0.16 | 0.15 | 0.38 | 0.37 | 0.25 | 0.15 | 0.00 |
| North and South America | 0.33 | 0.60 | 0.60 | - | 0.13 | 0.33 | 0.47 | 0.45 | 0.12 | 0.31 | 0.33 |

Notes and sources: see table 2.

Judging from the tables, it appears that the FDI projects most likely to be withdrawn were joint ventures, approved soon after 1988, without any clear characteristics regarding size, industry, location, or foreign party. However, it should be noted that, since several investment characteristics coincide in the projects, it is difficult to tell from these descriptive statistics what kind of features actually contributed to increasing the risk of failure. For example, if investments by Asian investors are on average small, it is difficult to determine if investor nationality or size has been the major factor influencing failure. Therefore a multiple probit regression has been conducted to estimate the likelihood of an FDI project to be withdrawn.

Probit analysis of investment failures

The database shows whether or not a foreign investment license has been recalled. Labelling this characteristic as 1 in the case of failure and 0 otherwise, allows obtaining a dichotomous dependent variable, *FAIL*, that requires an appropriate estimation method. The existence of a continuous variable y^* , linearly dependent on a vector of explanatory variables X is postulated, corresponding to a set of attributes relating to age, size, expected duration, entry mode, industry, location and nationality of the foreign investor – and a vector of parameters β . That is:

$$y^* = X'\beta$$

The variable y^* could be interpreted as an index of the negative impact that transaction costs have on an investment project. When the index is positive, the project fails. y^* cannot be observed, but it is assumed that there is a certain threshold value, such that y^* is greater than this threshold value for failed projects. On the other hand, the outcome of this process is observed, that is, if a license has been withdrawn or not. Labelling the event *failed* with 1 and *not failed* with 0, allows getting a proxy variable for y^* . It is assumed that the probability of a given investment to fail is given by:

$$p(y^* > 0) = p(y = 1) = F(X'\beta)$$

where (F) is the standard normal cumulative distribution function. This case is known as the *probit model*, and maximum likelihood estimates can be computed. The hypotheses regarding the causes for investment failures were presented above. To test them, the following explanatory variables have been defined.²⁴

- (a) *AGE* measures the time since an individual investment license was approved (in logs).²⁵ *AGE* is expected to be positively related to the likelihood of investment failure.
- (b) *SIZE* measures the size of the project by total investment capital (in log). *SIZE* is expected to have a negative impact on investment failure.
- (c) *DUR* measures the expected duration of the project in years (in log). *DUR* is expected to have a negative sign.
- (d) *JV* is a dummy variable equal to 1 for joint ventures and 0 for wholly owned projects. *JV* is expected to be positively related to the probability of project failure.
- (e) *OWN* measures the equity share of the foreign investor in a project. For wholly owned projects, the share is always

²⁴ Descriptive statistics for the independent variables can be found in annex 3.

²⁵ It seems realistic to assume that transaction costs decreased faster in the years soon after the initiation of reforms than today. This is why the time variable is used in its logarithmic form. Year 1999 = t_0 . Corresponding arguments apply for several of the other continuous variables that are also used in logarithmic form.

-
- 100%. For joint ventures, it may vary but is at maximum 70%.²⁶ *OWN* is expected too have a negative effect on project failure.
- (f) *CITY* is a dummy variable taking the value 1 if the project is located in the Ho Chi Minh City or Hanoi-Haiphong regions and 0 otherwise. *CITY* is expected to have a negative impact on the likelihood for a project to fail.
 - (g) *POOR* measures the poverty level for Vietnamese provinces (in log). The variable has categorical values of ordinal properties.²⁷ It is hypothesized that projects located in poorer provinces are more likely to fail, and thus the coefficient for *POOR* is expected to be positive.
 - (h) *SOUTH* is a dummy variable equal to 1 if the project is located in the southern part of Vietnam and 0 if it is located in the north. *SOUTH* is expected to be negatively related to the probability to fail.
 - (i) *ASIA* is a dummy variable equal to 1 if the foreign investor stems from an East Asian country and 0 otherwise. *ASIA* is expected to have a negative impact on the likelihood to fail.
 - (j) *ERP* measures the effective rate of protection for different industries of the Vietnamese economy. The variable has categorical values of ordinal properties.²⁸ As discussed earlier, we cannot assign any definite *a priori* hypothesis for the relation between *ERP* and *FAIL*.

When checking the level of correlation between the descriptive variables, one finds that the variable pairs *SIZE* and *DUR*, *JV* and *OWN*, and *CITY* and *POOR* are highly correlated (with correlation coefficients of 0,5 or higher).²⁹ These correlations were expected, since these variables measure related project characteristics: large projects often have a long expected duration; joint ventures per definition have a foreign share of less than 100% while the opposite is true for wholly owned

²⁶ This is because the legal requirement for establishment of a joint venture includes the obligation of a 30% Vietnamese equity share.

²⁷ See annex 1.

²⁸ See annex 2 and 3.

²⁹ For a complete correlation matrix, see annex 4.

projects, and city regions are richer than countryside provinces. However, high correlations make it difficult to distinguish the separate effects of the correlated variables. Therefore it has been decided to run separate test regressions with different combinations of the variables above, to avoid including highly correlated variables in any model.

In the final model, among the variables measuring investment magnitude, *SIZE* has been chosen over *DUR*. This is because duration may be somewhat problematic to interpret as a characteristic related to failure. It can be assumed that investors and authorities, for various reasons, may hesitate to recognize a long-term project as failed during the first few years after licensing. They may simply keep up hope since there is still much time left for the project to be implemented in the future. Also, the more fundamental question of whether the duration stated in investment licenses is based on investor expectations of full project length or appointed by authorities weakens the variable. Among the variables measuring ownership structure, *JV* has been chosen since the continuous variable *OWN* did not appear to have any significant effect when disregarding wholly owned projects. This suggests that foreign share *within* a joint venture does not influence the risk for investment failure, and the dummy variable *JV* is therefore better suited to explain the effect of ownership. Among the variables measuring the impact of location, it has been found that *POOR* was significant also when disregarding projects in the cities. This means that even when comparing countryside provinces, high poverty levels have a negative effect on investment survival. The categorical variable *POOR* is therefore better suited than the dummy variable *CITY* to measure the influence of location on investment failure. Moreover, one of the variables, *SOUTH*, was not used in the final model because it did not gain significance in any of the test estimations. The weak result for *SOUTH* indicates that the difference in investment climate between the northern and southern parts of Viet Nam that is often put forward may be exaggerated.

Taking into account the above-mentioned relations, a model has been postulated in which the likelihood of investment failure is a function of the explanatory variables, with expected effects in parentheses:

$$FAIL = f[AGE (+), SIZE (-), JV (+), POOR (+), ASIA (-), ERP (?)]$$

The regression results are presented in table 7 below.

The column entitled Regression 1 shows the results of an estimation that excludes the variable ERP, which is missing for about one-quarter of the observations (where the investment project concerns non-tradables, like infrastructure and services, for which it is not possible to calculate effective rates of protection). The column Regression 2 includes only those 1,406 observations for which the variable ERP is defined. The results confirm that, within the first five years after licensing, projects approved in the early years of transition, in the form of joint ventures, located in poor areas, and undertaken by non-East Asian investors, were more likely to fail during 1988-1998. Moreover, there is some evidence that small projects and projects in more protected industries exhibited higher failure rates. These

Table 7. Probit analysis of the probability of investment failure
Dependent variable: *FAIL*

| Independent variables | Regression 1 | Regression 2 |
|------------------------|-----------------|-----------------|
| AGE | 0,273 (4,06)*** | 0,219 (2,74)*** |
| SIZE | -0,034 (1,63) | -0,067 (2,46)** |
| JV | 0,508 (6,58)*** | 0,641 (7,46)*** |
| POOR | 0,192 (3,85)*** | 0,150 (2,63)*** |
| ASIA | -0,166 (2,43)** | -0,152 (1,84)* |
| ERP | — | 0,077 (1,91)* |
| Number of observations | 1977 | 1406 |
| Pseudo R2 | 0,051 | 0,072 |
| Log likelihood | -1046,651 | -735,221 |

Note: Figures in parentheses are z-statistics. ***, ** and * denote significance at the 1, 5 and 10 % levels of confidence. Critical values of the z-statistic are 1,645, 1,96 and 2,575 for the 10, 5 and 1 % significance levels.

findings are consistent with the corresponding hypotheses regarding the transaction costs related to these characteristics.³⁰

In addition, some interesting findings emerge when controlling for dummy variables. When controlling for *JV*, the performance of wholly owned projects is found to be less sensitive for nationality of the investor (*ASIA*) and year of licensing (*AGE*). Apparently, these factors were more important for investors who cooperate closely with Vietnamese partners. Holding *CITY* constant, *ASIA* had no significance for projects located in rural regions. Controlling for *SOUTH*, *AGE* and *JV* were less significant for investments in the North. The weakness of *AGE* may result from the fact that economic conditions have not improved as rapidly in the northern parts of Viet Nam, and the year of entry therefore has had little importance for investment performance. Finally, controlling for *ASIA*, none of the variables *SIZE* and *POOR* had any significant impact on investment failure for non-Asian investors. This may indicate that for investors from a very different economic and cultural climate, investment magnitude or location does not matter as much for performance. Possibly, the ability to adapt to the new environment is more important than specific investment characteristics.

Summary and conclusions

This article examined the characteristics of licensed and failed investment projects in Viet Nam between 1988 and 1998. A first concluding observation is that the likelihood of failure is determined by a host of different investment characteristics. None of the variables examined above stands out as a dominant explanation for failure, which means that no simple solution to the problem of low implementation can be given. FDI in Viet Nam is influenced by a variety of economic, political, social

³⁰ Tests for robustness over time were done since underlying conditions have not been stable over the period of study, and one could expect changes in the impact of some variables due to policy changes, new regulations etc. However, no support has been found for a non-monotonous relationship for any of the variables in the final model.

and legal factors, which are difficult to condense into a few quantitative dimensions. Still, the results regarding the characteristics of failed projects provide some hints about the performance of FDI in Viet Nam.

One explanation for the high failure rates observed for joint ventures are difficulties in cooperation between the foreign investors and their Vietnamese partners. Knowing that most Vietnamese joint venture partners are SOEs, these findings highlight the need to improve the performance of the State-owned enterprise sector. However, this is not easily done and will take time. Yet, many FDI projects, in particular smaller projects, might be better suited to collaborate with a private Vietnamese enterprise in the future (although the weak position of the private sector in Viet Nam has made it difficult to do so until recently). To become more attractive for foreign investors, it is likely that the Vietnamese private sector must first be allowed to compete on equal terms with the SOEs. This requires reform in several areas, for instance concerning access to formal credit institutions and legislation regarding land use rights.

A related problem is the remaining import substitution bias in Vietnamese trade policy. The results of this article show that foreign affiliates in protected industries exhibited higher failure rates, which underlines the negative effects of operating in industries with comparative disadvantages. If protection levels were reduced and companies made subject to stronger competitive pressure, rent-seeking activities would decrease and resources would be reallocated to labour-intensive industries in which Viet Nam has its comparative advantage.

The results also show that investments located in richer areas are less likely to fail. This reflects the positive effects of agglomeration, since the richer areas are more urbanized and provide better infrastructure, closeness to markets, and better possibilities to cooperate with other enterprises. Attempts to attract FDI to poor (rural) areas have not proved successful.

In summary, it can be argued that to make FDI more successful, Viet Nam might do well to focus on broad economic

and institutional reforms to create a sound investment climate rather than directing FDI into special forms, industries or regions. An important ingredient in a sound investment climate is a stable and transparent legal framework. Improvements in infrastructure and a more predictable legal framework would probably be more efficient in attracting new FDI than any financial incentives that the Government can afford to provide. Furthermore, FDI licensing policies could be simplified to allow faster entry. In a somewhat longer perspective, it can be questioned whether the approval process has a function to fill, or if it is possible to rely on the natural selection that results from investors' own decisions. The main conclusions from the perspective of foreign investors refer to the risks and transaction costs involved in joint ventures with SOEs, and the agglomeration benefits related to locating in the main urban centres. Both these conclusions should, of course, be tempered by the expected benefits from collaborating with SOEs (which are likely to be particularly important if the public sector is a major customer) and by any preferences gained from investing outside the main urban centres.

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Annex 1. Poverty levels, by region

| Province | Poverty level | Province | Poverty level |
|----------------------------------|---------------|---------------------------------|---------------|
| <i>Southern region (Bac Bo)</i> | | Quang Ngai | 3 |
| Minh Hai | 2 | Quang Nam (Da Nang) | 2 |
| Soc Trang | 2 | Thua Thien | 3 |
| Kien Giang | 2 | Quang Tri | 3 |
| Vinh Long | 2 | Quang Binh | 3 |
| An Giang | 2 | Ha Tinh | 3 |
| Dong Thap | 2 | Nghe An | 3 |
| Tra Vinh | 2 | <i>Northern region (Nam Bo)</i> | |
| Ben Tre | 2 | Thanh Hoa | 3 |
| Long An | 2 | Ninh Binh | 3 |
| Tien Giang | 1 | Hoa Binh | 3 |
| Ho Chi Minh City | 1 | Nam Ha (Ha Nam) | 2 |
| Tay Ninh | 1 | Thai Binh | 2 |
| Ba Ria Vung Tau | 1 | Ha Tay | 2 |
| Dong Nai | 1 | Hanoi | 1 |
| Can Tho | 1 | Haiphong | 2 |
| Song Be | 1 | Hai Hung | 2 |
| Lam Dong | 1 | Vinh Phu | 3 |
| Ninh Thuan | 2 | Ha Bac | 3 |
| <i>Central region (Trung Bo)</i> | | Quang Ninh | 2 |
| Binh Thuan | 1 | Lang Son | 4 |
| Dac Lac | 2 | Cao Bang | 4 |
| Khan Hoa | 2 | Ha Tuyen | 4 |
| Phu Yen | 3 | Yen Bai | 3 |
| Gia Lai | 3 | Lao Cai | 4 |
| Binh Dinh | 2 | Son La | 4 |
| Kon Tum | 3 | Lai Chau | 4 |

Source: World Bank 2000.

Note 1. The poverty levels used for construction of the variable *POOR* are based on the percentage share of poor individuals in each province. In provinces with poverty level 1, 0-25% of the population can be considered poor; poverty level 2: 25-45%; poverty level 3: 45-60%; and poverty level 4: 60-100% (according to a World Bank headcount).

Note 2. For construction of the dummy variable *SOUTH*, the division line between north and south was drawn between the provinces Thua Thien and Quang Nam (Da Nang), where the latter belongs to the southern part.

Annex 2. Effective rates of protection, by industry (Per cent)

| Industry | ERP |
|------------------------------------|--------------------|
| Forestry | 0.0 |
| Fishing | 24.1 |
| Mining | 0.8 |
| Fuels | 17.3 |
| Tea and coffee processing | 91.6 |
| Sugar | 90.0* |
| Tobacco, alcohol and beverages | 185.4 |
| Other foodstuffs | 65.0 |
| Leather, footwear and bleaching | 23.3 |
| Paper and paper products | 127.4 |
| Petroleum and natural gas | n/a |
| Fertilizers and pesticides | -5.6 |
| Chemical products | -2.2 |
| Pharmaceuticals | 22.7 |
| Soaps and detergents | 162.5 |
| Rubber and rubber products | 179.0 |
| Plastic and plastic products | 139.9 |
| Other chemical products | 44.4 |
| Ceramics, glass and porcelain | 102.4 |
| Cement | 133.0 ^a |
| Other non-metallic minerals | 20.0 |
| Manufacture of non-ferrous metals | -4.7 |
| Manufacture of ferrous metals | 416.1 |
| Equipment and machinery | 9.9 |
| Electrical and electronic products | 59.8 |
| Other metallic products | 50.2 |
| Other industry | 65.1 |

Source: CIE (1998).

Note: The list excludes non-traded industries.

^a Estimated ERP has been adjusted for quantitative restrictions.

Note 1. For construction on the variable *ERP*, industries were classified into four groups according to the ERP in % (as calculated by CIE, 1998). The groups were given a value 1-4, where 1 represents a level of protection as measured by the ERP of less than 0%; protection level 2: ERP 0-50%, protection level 3: ERP 50-100%; and protection level 4: more than 100%. Industries producing non-tradable goods (mainly belonging to the tertiary sector) were excluded.

Annex 3. Additional statistics: explanatory variables

| <i>AGE</i> | Min. | Max. | Mean | Std. dev. |
|------------|------|------|------|-----------|
| years | 1 | 11 | 4.97 | 2.30 |

Note: A log transformation of the variable was used in the regression.

| <i>SIZE</i> | Min. | Max. | Mean | Std. dev. |
|-------------|------|---------|-------|-----------|
| \$millions | 0.02 | 2110.67 | 14.88 | 71.28 |

Note: A log transformation of the variable was used in the regression.

| <i>DUR</i> | Min. | Max. | Mean | Std. dev. |
|------------|------|------|-------|-----------|
| Years | 2 | 70 | 22.30 | 10.03 |

Note: A log transformation of the variable was used in the regression.

| <i>JV</i> | Min. | Max. | Mean | Std. dev. | N=0 | N=1 |
|-----------|------|------|------|-----------|-----|------|
| | 0 | 1 | 0.70 | 0.46 | 601 | 1384 |

| <i>OWN</i> | Min. | Max. | Mean | Std. dev. |
|------------|------|------|-------|-----------|
| Per cent | 0 | 100 | 73.90 | 19.46 |

| <i>CITY</i> | Min. | Max. | Mean | Std. dev. | N=0 | N=1 |
|-------------|------|------|------|-----------|-----|------|
| | 0 | 1 | 0.51 | 0.50 | 974 | 1009 |

| <i>POOR</i> | Min. | Max. | Mean | Std. dev. | N=1 | N=2 | N=3 | N=4 |
|-------------|------|------|------|-----------|------|-----|-----|-----|
| | 1 | 4 | 1.34 | 0.61 | 1451 | 417 | 98 | 18 |

Note: A log transformation of the variable was used in the regression.

| <i>SOUTH</i> | Min. | Max. | Mean | Std. dev. | N=0 | N=1 |
|--------------|------|------|------|-----------|-----|------|
| | 0 | 1 | 0.69 | 0.46 | 607 | 1377 |

| <i>ASIA</i> | Min. | Max. | Mean | Std. dev. | N=0 | N=1 |
|-------------|------|------|------|-----------|-----|------|
| | 0 | 1 | 0.71 | 0.45 | 578 | 1407 |

| <i>ERP</i> | Min. | Max. | Mean | Std. dev. | N=1 | N=2 | N=3 | N=4 |
|------------|------|------|------|-----------|-----|-----|-----|-----|
| | 1 | 4 | 2.75 | 0.96 | 154 | 403 | 495 | 359 |

Annex 4. Correlations
(Bivariate correlations between dependent variables)

| | <i>AGE</i> | <i>SIZE</i> | <i>DUR</i> | <i>JV</i> | <i>OWN</i> | <i>CITY</i> | <i>POOR</i> | <i>SOUTH</i> | <i>ASIA</i> | <i>ERP</i> |
|--------------|------------|-------------|------------|-----------|------------|-------------|-------------|--------------|-------------|------------|
| <i>AGE</i> | 1.00 | -0.23** | -0.38** | 0.22** | -0.23** | 0.16** | -0.10** | 0.07** | -0.02 | -0.04 |
| <i>SIZE</i> | -0.23** | 1.00 | 0.66** | 0.09** | 0.00 | -0.04* | -0.02 | -0.03 | -0.01 | 0.15** |
| <i>DUR</i> | -0.38** | 0.66** | 1.00 | -0.13** | 0.22** | -0.09** | -0.01 | -0.07** | 0.05** | 0.08** |
| <i>JV</i> | 0.22** | 0.09** | -0.13** | 1.00 | -0.89** | 0.23** | 0.08** | -0.20** | -0.09** | 0.06* |
| <i>OWN</i> | -0.23** | 0.00 | 0.22** | -0.87** | 1.00 | -0.21** | -0.09** | 0.17** | 0.13** | -0.05** |
| <i>CITY</i> | 0.16** | -0.04* | -0.09** | 0.23** | -0.21** | 1.00 | -0.45** | -0.21** | -0.05* | 0.03 |
| <i>POOR</i> | -0.10** | -0.02 | -0.01 | 0.08** | -0.09** | -0.45** | 1.00 | -0.33** | -0.05* | -0.04 |
| <i>SOUTH</i> | 0.07** | -0.03 | -0.07** | -0.20** | 0.17** | -0.21** | -0.33** | 1.00 | 0.05* | -0.01 |
| <i>ASIA</i> | -0.02 | -0.01 | 0.05 | -0.09** | 0.13** | -0.05* | -0.05* | 0.05* | 1.00 | 0.04 |
| <i>ERP</i> | -0.04 | 0.15** | 0.08** | 0.06* | -0.05** | 0.03 | -0.04 | -0.01 | 0.04 | 1.00 |



A comparative analysis of inward and outward FDI in Turkey

Asim Erdilek*

This article presents a comparative analysis of the inward and outward foreign direct investment in Turkey. It is hypothesized that the country's negative business climate caused by both economic and political factors is a major determinant of both. This article investigates why, compared to many developing countries that have attracted and benefited from significant inflows of foreign direct investment, Turkey is conspicuous as a country that has not done so, despite its increasing openness to international trade. After showing that Turkey's outward investment has surged recently, it relates the causes of such surge, especially compared to the meagre inward investment flows. It concludes that recent institutional reforms and increasing economic and political stability can make Turkey an important host country for foreign direct investment in the future.

Key words: inward FDI, outward FDI, Turkey

Introduction

Foreign direct investment (FDI), which has played a significant role in globalization, has enabled many developing countries to accelerate their development. The benefits of inward FDI for developing countries have been widely analyzed and empirically researched in the literature (UNCTAD, 2001; Lipsey, 2002; OECD, 2002a; UNCTAD, 2002a). Although some recent

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theoretical and empirical research has been skeptical of this benign view of FDI, the overwhelming evidence supports it (Moran, 1998; Loungani and Razin, 2001; Moran, 2001; Lipsey, 2002; OECD, 2002b).

Compared to many developing countries that have attracted and benefited from significant inflows of FDI, Turkey is conspicuous as a country that has not done so. What are the reasons for this? What needs to change for Turkey to attract and benefit from significant inflows of FDI? What is the Government of Turkey doing, with the help of international institutions such as the Foreign Investment Advisory Service (FIAS), to make Turkey a more attractive host country? Does Turkey really want inward FDI or has it been seeking inward FDI out of desperation and under foreign pressure? What are Turkey's prospects in becoming an attractive and successful FDI host country?

Before 1980, Turkey had essentially a closed economy based on import substituting industrialization behind tariff and non-tariff barriers. Since 1980, Turkey's globalization has been impressive but one sided. The economy has become much more open to international trade. The customs union with the European Union (EU) has reinforced openness to trade since 1996. But Turkey's integration with the world economy through FDI has lagged relative to other developing countries.

Turkey's failure to attract FDI has both economic and non-economic causes (SPO, 2000; FIAS, 2001a; FIAS, 2001b). Economic causes include high transactions costs of entry and operation for foreign investors (due to excessive bureaucracy and red tape, and widespread corruption), chronic high inflation, increasing economic instability, inward orientation until 1980, lack of protection of intellectual property rights, lack of inflation accounting and internationally acceptable accounting standards, failure of privatization, insufficient legal structure and inadequate infrastructure (especially energy).

Non-economic causes include chronic political instability, internal conflicts (especially the Kurdish problem), historical

animosity towards foreign economic presence (dating back to the Capitulations during the Ottoman Empire), fear of foreign political domination within the civilian and the military bureaucracy, lack of FDI promotion (indicating an unwillingness or reluctance to attract FDI), and the structure of Turkish business (family-owned and controlled and closed to foreign takeovers).

On the other hand, Turkey's outward FDI has surged recently, increasing much faster than inward FDI. Why have Turkish firms begun to invest abroad? What are the characteristics of these firms? In which countries and in which industries do they invest mostly? Do they favour joint ventures with local partners or wholly owned affiliates?

FDI outflows have been caused by both economic and political factors. New markets in the EU, the United States, the Balkans, West Asia, North Africa, the Russian Federation and the newly independent Turkic Republics in Central Asia, and the ability of the Turkish private sector to exploit them are important positive factors. Recent back-to-back domestic economic crises and political uncertainty, as well as rising unit labour costs, are important negative factors. These same factors have also been behind divestments by foreign investors in Turkey. Another cause behind divestments has been the increasing openness to trade. Several foreign affiliates that had been attracted by import-substitution have decided to divest faced with rising competition from imports, especially those from the EU since 1996.

This article is organized as follows. The next section outlines the conceptual framework. Then follows a review of Turkey's globalization, which has favoured international trade and labour migration over inward FDI. The subsequent section offers a comparative analysis of Turkey's inward and outward FDI performance. It is followed by two sections presenting more detailed analyses of inward and outward FDI trends, respectively. The last section contains a summary and the conclusions.

Conceptual framework

This article presents a comparative analysis of the inward and outward FDI in Turkey. It is hypothesized that the country's negative business climate caused by both economic and political factors is a major determinant of both. The focus is on the determinants, not the effects, of inward and outward FDI. The methodology used is descriptive and institutional, relying on original documents, reports, graphs, tables, and their interpretation. The conceptual framework draws on John H. Dunning's eclectic ownership-location-internalization (OLI) paradigm and its dynamic version, the Investment Development Path model (Dunning, 1993, pp. 76-89; Dunning, 2000), as well as the industrial organization-based FDI theory surveyed by Richard Caves (1996).

There is a growing econometric literature, which is not surveyed here due to space limitations, on inward, although not on outward, FDI in Turkey. The Turkish inward FDI literature deals with the causes and effects of FDI (Erdilek, 1982; Erden, 1996; Tatoglu and Glaiser, 2000; Erdilek, 2001; Berköz, 2001; Dutz et al., 2003; Erdilek, 2003). Some of the studies in this literature use macro data, some use industry data at various levels of aggregation, and others use either firm-level or plant-level micro data. To the knowledge of this author, this is the first published study that deals with outward FDI from Turkey at an economy-wide level, with emphasis on the manufacturing sector.¹

Turkey's globalization and FDI

Since 1980, Turkey has become increasingly open to international trade. In 2001, exports and imports accounted for 21% and 27% of the GNP, respectively, up from 4% and 11%, respectively, in 1980 (SPO, 2002). It has not yet, however, taken

¹ Several earlier studies on outward FDI dealt with the internationalization of Turkish construction companies (see e.g. Kaynak and Dalgic, 1991).

full advantage of globalization in terms of inward FDI.² Turkey's preference for foreign trade has deprived the country of the full benefits of globalization.

Besides failing to become a major emerging market for international portfolio investors, Turkey has failed spectacularly in attracting FDI. Turkey's failure to attract FDI reflects the general mismanagement of the economy over decades, as well as the reluctance to admit and promote FDI. Chronic and ratcheting inflation and increasingly erratic and low economic growth, the main symptoms of perpetual crisis, were caused by the mismanagement of the economy.

Chronic high inflation, economic and political instability, widespread corruption, a weak and unpredictable legal system have acted as major deterrents of FDI. The progressive liberalization of the FDI regime since 1980 has not neutralized these powerful disincentives. Failure of privatization, inadequate protection of intellectual property rights such as patents, trademarks and copyrights as well as the lack of inflation accounting have been other obstacles to inward FDI.

Turkey's ambivalence, if not hostility, towards FDI and reluctance to promote it can be traced to the Capitulations that permitted foreign governments to exercise extraterritorial jurisdiction over their nationals living in the Ottoman Empire (Lewis, 1965, p. 449). Abolished by the Treaty of Lausanne in 1923, Capitulations have been regarded since the founding of the Turkish Republic in 1923 as humiliating derogations from national sovereignty. The fear of economic domination and control is still deeply embedded in the collective conscience of the Turkish civilian and military elite.

Therefore, it comes not as a surprise that there has been no official promotion of inward FDI in Turkey. Without an

²The relationship between openness to trade and openness to inward FDI in developing countries is complex and ambiguous according to recent empirical evidence (Nunnenkamp and Spatz, 2002).

investment promotion agency (IPA) of its own, not surprisingly Turkey was not a member of the World Association of Investment Promotion Agencies (WAIPA) until 2002. On WAIPA's website (<http://www.waipa.org>), Turkish membership is identified as "Invest in Turkey". When you click on "Invest in Turkey", however, you go to the website of the Turkish Treasury. There is no "Invest in Turkey" yet.

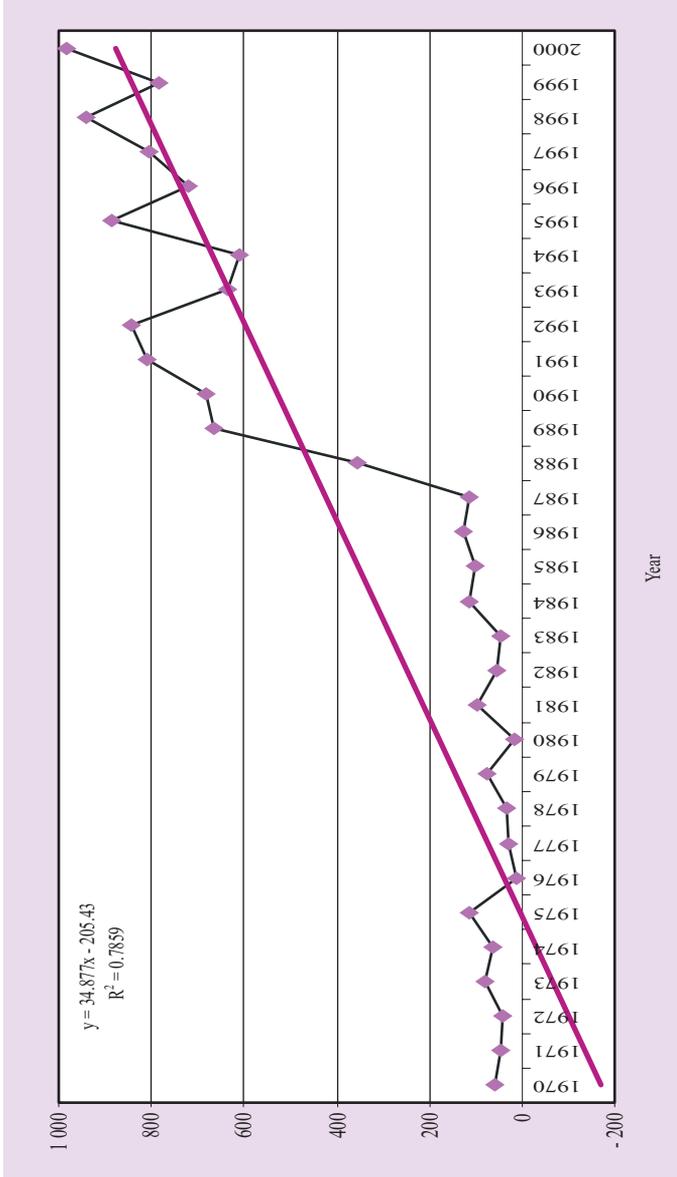
One major expected but disappointing catalyst for Turkey's realization of its potential as an FDI host has been its increasingly close relations with the EU. The recognition of its candidacy by the EU's Helsinki Summit in December 1999 raised unrealistic expectations, which have not been sustained by the less clear outcome of the December 2002 Copenhagen Summit. Because Turkey has lacked macroeconomic and political stability and because it has been cool if not hostile to foreign investors, there has been no upsurge in inward FDI either from the EU or elsewhere since the customs union with the EU went into effect in 1996.

Turkey's inward and outward FDI performance

Turkey's inward FDI performance has been disappointing by all measures based on UNCTAD data.³ According to figure 1, inward FDI in absolute terms shows an upsurge at the end of the 1980s. In relative terms, however, this upsurge does not seem that impressive as much of the rest of the world, including other developing countries, was much more successful than Turkey in attracting FDI, as indicated by figure 2.

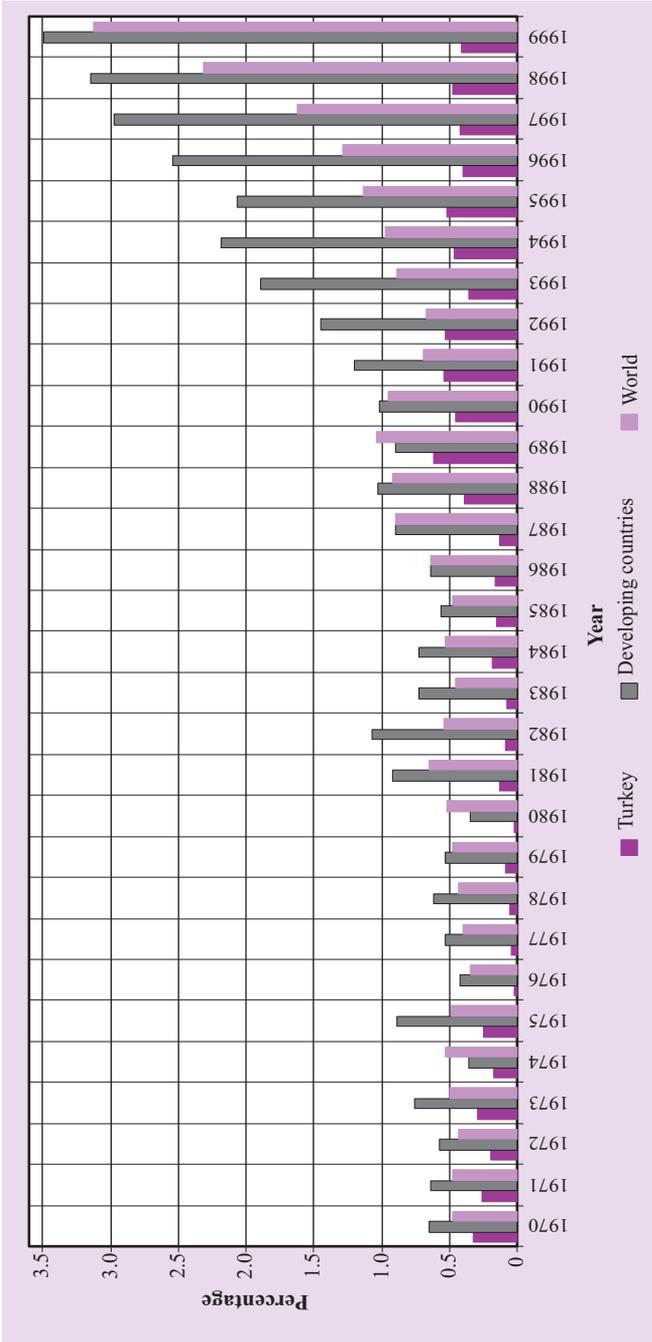
³ The macro approach taken here to analyze the importance of FDI in terms of FDI flows and stocks has several shortcomings. The micro approach that analyzes the importance of FDI in terms of international production, the shares of world and domestic production that are accounted by foreign operations, is preferable (Lipse, 2001). Unfortunately, comparable and reliable time series data on both inward and outward FDI that are required for the micro approach are unavailable yet. UNCTAD's Transnationality Index, however, takes international production into account to some extent.

Figure 1. FDI inflows into Turkey, 1970 – 2001
(\$ million)



Source: UNCTAD 2002b.

Figure 2. FDI inflows as percentage of gross domestic product, 1970-1999



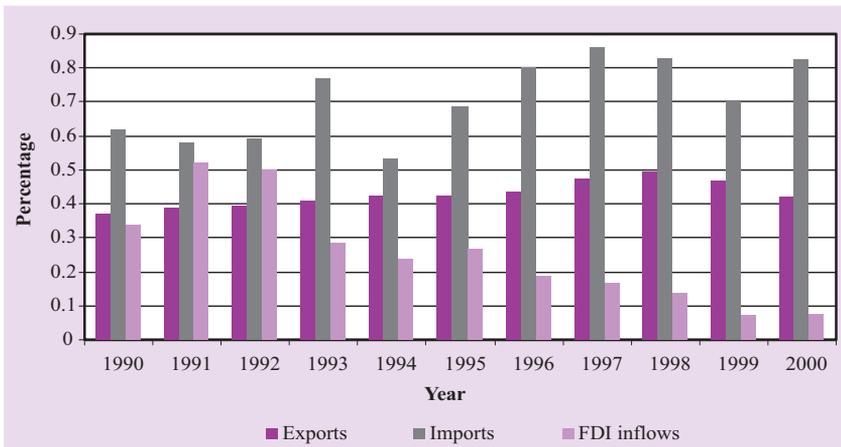
Source: UNCTAD 2002b.

According to figure 3, although Turkey's share in world trade was quite stable, its share of world FDI inflows went down in the 1990s.

Another way to view Turkey's relative performance as an FDI host country is in terms of three indices developed by UNCTAD: Transnationality Index, FDI Performance Index and FDI Potential Index. According to the Transnationality Index, in 1999, among developing countries, Turkey ranked third from the bottom; only India and United Arab Emirates had lower indices (UNCTAD, 2002a, p. 275). UNCTAD divides countries into four groups according to their FDI Performance and Potential Indices: 1. front runners; 2. above potential economies; 3. below potential economies; and 4. under-performers (with both indices low). Turkey is listed among the under-performers, which are generally poor countries, for both the 1988-1990 and the 1998-2000 periods (UNCTAD, 2002a, p. 31).

As for FDI outflows, figure 4 shows clearly that Turkish outward FDI accelerated following the 1994 economic crisis. It

Figure 3. Turkey's share in world exports, imports and FDI inflows, 1990-2000
(%)



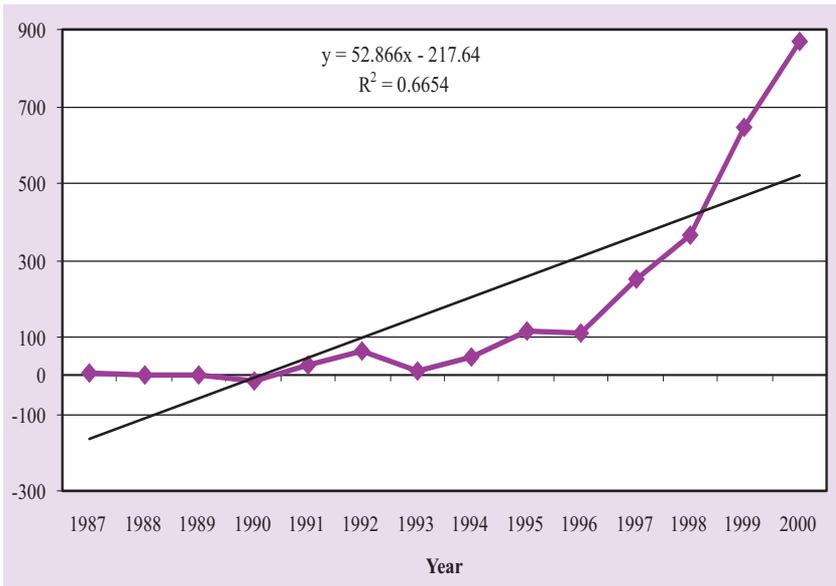
Sources: UNCTAD 2002b and UNCTAD 2002c.

is still quite low but rising relative to the rest of the world, including developing countries.

Turkish FDI outward stocks have been increasing exponentially in both absolute and relative terms. While FDI inflows into Turkey have been low, FDI outflows from Turkey, relative to the rest of the world, have grown quite successfully.

Table 1 provides additional data on the absolute and relative performance of Turkey as a host and home country. It contains new information that expresses inward and outward FDI inflows as percentage of gross capital fixed capital formation (GFCF). Relative to the rest of the world, both inflows and outflows have been insignificant as percentages of GFCF. Outflows, however, have increased as percentage of GFCF very rapidly.

Figure 4. Turkish FDI outflows, 1987-2000
(\$ billion)



Source: UNCTAD 2002b.

Table 1. Turkey: inward and outward FDI flows, 1985-2001
(\$ million and %)

| | Millions of dollars | | | | | Percentage of gross fixed capital formation | | | | | | | | | |
|----------------------|-------------------------------|---------|---------|-----------|-----------|---|-------------------------------|------|------|------|------|------|--|--|--|
| | 1985-1995 (Annual average) | 1997 | 1998 | 1999 | 2000 | 2001 | 1985-1995 (Annual average) | | | | | | | | |
| Turkey | | | | | | | | | | | | | | | |
| Inward | 529 | 805 | 940 | 783 | 982 | 3 266 | 1.7 | 1.6 | 1.9 | 1.9 | 1.9 | 2.2 | | | |
| Outward | 24 | 251 | 367 | 645 | 870 | 497 | 0.1 | 0.5 | 0.7 | 1.6 | 1.6 | 2.0 | | | |
| Developing countries | | | | | | | | | | | | | | | |
| Inward | 50 912 | 191 022 | 187 611 | 225 140 | 237 894 | 204 801 | 4.4 | 11.1 | 11.4 | 13.4 | 13.4 | 13.4 | | | |
| Outward | 21 512 | 74 797 | 50 256 | 73 636 | 104 207 | 36 571 | 2.0 | 4.0 | 3.1 | 3.5 | 5.8 | | | | |
| World | | | | | | | | | | | | | | | |
| Inward | 181 101 | 478 082 | 694 457 | 1 088 263 | 1 491 934 | 735 146 | 3.9 | 7.4 | 11.0 | 16.5 | 22.0 | | | | |
| Outward | 202 481 | 474 010 | 684 039 | 1 042 051 | 1 379 493 | 620 713 | 4.5 | 7.4 | 11.0 | 15.9 | 20.6 | | | | |

Source: UNCTAD 2002d.

Turkey's business environment

Two decades ago it was concluded that Turkey's FDI environment had been suboptimal and unstable throughout the post-World War II period (Erdilek, 1982). In the 1980s, the environment improved somewhat as Turkey began to liberalize its economy internally and externally (Erdilek, 1986; Erdilek, 1987; Erdilek, 1988). But overall the earlier conclusion still holds, as confirmed by recent diagnoses by the Organisation for Economic Co-operation and Development (OECD) and FIAS (OECD, 2002b, p. 103; FIAS, 2001a, p. viii).

First let us look at the chronic macroeconomic instability that has deprived Turkey of an attractive FDI environment. The 1990s was Turkey's lost decade in the middle of which it suffered another major economic crisis. At the end of 1999, Turkey began a comprehensive International Monetary Fund (IMF)-supported three-year economic stabilization and structural reform programme. Opening up to FDI was not an explicitly stated component of this programme according to the Letter of Intent, dated December 1999, submitted by the Government of Turkey to the IMF (IMF, 1999).

The IMF programme made significant progress till the second half of November 2000, with sharp drops in inflation and interest rates. For the first time Turkey made it into the top 25 countries (ranked 23rd between Malaysia and Argentina) in A. T. Kearney's annual FDI Confidence Index, reflecting the FDI intentions and preferences of the world's major transnational corporations (TNCs) (Global Business Council, 2001).⁴

In November 2000 the programme experienced its first crisis, mitigated by an IMF emergency package. After its second crisis in February 2001, the programme collapsed. In March 2001, Turkey needed the IMF and the World Bank to continue their support for its economy on a knife-edge facing default.

⁴ Following the twin economic crises it experienced in late 2000 and early 2001, however, Turkey dropped out of the top 25 in the next annual FDI Confidence Index (Global Business Council, 2002).

One of the conditions was evidently to have Turkey commit explicitly to opening up to FDI.

An in-depth review of the IMF documents (Letters of Intent, Staff Reports, Article IV consultations, and Stand-By Arrangement reviews) on Turkey since March 2001 shows that, following its economic crises in November 2000 and February 2001, and in need for IMF and World Bank support, Turkey was constantly encouraged to improve its FDI environment as part of the conditionality for IMF financial assistance. Actually, this pressure dates back to October 2000, with the initial involvement of FIAS in Turkey, as part of the World Bank Group's 2001-2003 Country Assistance Strategy for Turkey, which stressed the importance of FDI repeatedly and underscored the role of FIAS in improving Turkey's FDI environment (World Bank, 2000 and World Bank, 2001).

FIAS 2001b, building on FIAS 2001a, documents and analyzes at length Turkey's administrative barriers to investment according to different benchmarks. It is at 250 pages and with 10 appendices by far the most exhaustive recent study of the Turkish FDI regime and environment, based on extensive field work consisting of surveys and interviews. It is right on target with its hard hitting charge that the Turkish administration has been fixated on control instead of service and enforcement. This control, combined with lack of accountability and transparency, and exercise of discretion, has resulted in widespread corruption, concludes FIAS 2000b.

FIAS 2001b deals with a long list of issues relating to employment of both foreign and domestic labour, company registration and reporting, location and operation of FDI companies; among the operational issues are taxation, trade and customs regime, ex-post monitoring and site inspections, intellectual and industrial property rights. The analyses of these issues are followed by specific recommendations for reform. Its conclusions emphasize the need to build the political will required for an action plan with broad support and to monitor improvements as that plan is implemented.

The two FIAS studies have provided the basis of the recent changes in Turkey's FDI environment and policies. Following a meeting in September 2001 at the Turkish Treasury to discuss FIAS 2001a, a Programme to Improve the Investment Environment in Turkey was announced in November 2001. A Coordination Council for Improving the Investment Climate (CCIIC), consisting of government and private sector representatives, was formed to implement the Program to Improve the Investment Environment in Turkey.

The CCIIC decided to form an Advisory Investor Council (AIC), consisting of the chief executive officers or chairpersons of about 15 foreign affiliates such as Toyota, Hyundai, Siemens, Daimler-Chrysler, and Citigroup. It scheduled its first meeting for July 2002. However, this meeting had to be postponed as the coalition Government, which had failed to enact the showcase legislation required by the IMF, was falling apart. The AIC is yet to hold its first meeting.

To summarize the discussion thus far, under the previous Government of Turkey, a coalition of three parties, Turkey made tentative attempts to improve its FDI environment. These attempts did not bear fruit. Much of what the previous Government had done, including the Constitutional amendment in 1999 to allow foreign affiliates to seek international arbitration in disputes involving Turkey was due to foreign pressures. That Government's responsiveness to those pressures had increased as it moved from one economic crisis to another, needing foreign financial support to avoid default. It did not appear to believe in, and voluntarily seek, inward FDI. It was a Government in difficulties whose major concerns were its own survival and the prevention of the country's economic collapse.

Since November 2002, Turkey has had a single party Government with a sizeable majority in Parliament that recognizes the importance of FDI. The Justice and Development (AK) Party's programme is clearly pro-FDI (AK Party, 2003a). Accordingly, the current AK Party programme recognizes the importance of inward FDI as an essential factor in the country's

economic development (AK Party, 2003b). The Government has shown through its actions that its pro-FDI stance is not just rhetoric meant to please the IMF and the World Bank. Soon after taking office, the Government reorganized the CCIIC and restated its operational principles (Undersecretariat of Treasury, 2003a). Government ministers, in contrast to those in previous Governments, have repeatedly met with and listened to the views of major business organizations that wish to improve Turkey's business environment for both national and foreign investors.

The major achievement of the AK Party in its quest to improve the FDI environment has been the enactment of the new FDI law, Law 4875, in June 2003, to replace the old FDI law, Law 6224, which dates back to 1954 (Undersecretariat of Treasury, 2003c). This law replaces the old FDI approval and screening system with a notification and registration system, bans nationalization without fair compensation, guarantees national treatment to foreign investors, does not restrict FDI in any sectors or impose any performance requirements, eliminates the old minimum capital limit, grants foreign investors full convertibility in their transfers of capital and earnings, allows them to own property without any restrictions, and recognizes foreign investors' right to international arbitration. The new FDI legislation demonstrates the present Government's determination to make Turkey an attractive host country; but its effective implementation, which requires a radical change in Turkish bureaucracy's mindset, will be the real test.

Turkey's outward FDI

According to the Investment Development Path model, based on the eclectic OLI paradigm (Dunning, 1993, pp. 88-89; Dunning, 2000), a country passes through five development stages in its evolution from a host to a source country for FDI.⁵ According to this model, Turkey appears to be in stage 3 in

⁵ The extended product life cycle hypothesis, with seven phases, is an alternative model for the conceptualization of outward FDI from developing countries (Yeung, 2000a, pp. 18-20).

which outward FDI rises, inward FDI falls, but net outward FDI is still negative. Either the negative or the positive role of the State in the rise and strategies of emerging economy TNCs has been particularly important (Yeung, 2000a, pp. 20-26). In the case of Turkey, like in those of Japan and the Republic of Korea, its evolution as a source country seems to have been accelerated not only by deliberate policy discouraging inward FDI (as in Japan and the Republic of Korea), but also by the chronic macroeconomic and political instability over more than three decades to which especially larger Turkish companies have adapted remarkably. This adaptation to instability and risk has enabled them to evolve into TNCs themselves by developing ownership specific assets, reacting to the eroding location-specific advantage of their home country by internalizing those ownership specific assets through outward FDI. The rise of Turkish TNCs belongs to the “second wave” of Third-World TNCs whose “...globalization is less driven by cost factors per se, but more by a search for markets and technological innovations to compete successfully in the global economy” (Yeung, 2000a, p. 12). There is a growing literature on emerging economy TNCs (Yeung, 2000b) which is not surveyed here due to space limitations.

This article compares the situation in Turkey to that of Korean outward FDI in the electronics industry in the 1990s, as analysed by Byung-Hwa Lee (2002). That study found that Korean TNCs have integrated FDI into their business strategies, especially in searching for new markets in both developing and developed countries. According to Lee, these firms have pursued outward FDI in developed countries not only for new markets and to bypass import restrictions but also to acquire advanced technology, modern research and development (R&D) facilities and highly skilled labour. Lee (2002, pp. 56-59) divides outward FDI from developing countries, on the basis of different market and technology conditions, into three categories: horizontal integration, vertical integration and delocalization.

Horizontal integration takes advantage of the closeness to foreign markets and scale economies. Vertical integration takes

advantage of factor cost differences and scale economies. Delocalization is the transfer of production abroad and the complete or partial closure of domestic facilities. Horizontal integration is divided into two subcategories, voluntary (offensive) and involuntary (defensive), depending on whether it is based on proactive rationalization strategy or a reactive response to domestic and foreign challenges. On the whole, vertical FDI is offensive but delocalization FDI is defensive.

Unlike Lee (2002), this article could not base its findings on an econometric investigation of Turkish outward FDI at the firm level since data are not available. This discussion, as an exploratory study, is based on anecdotal and case study evidence. It seems that the outward FDI by three of Turkey's largest conglomerates, Koc Holding, Sabanci Holding and Anadolu Group, discussed below, has been primarily a mixture of involuntary (defensive) as well as voluntary (offensive) horizontal FDI and delocalization FDI. Some of the negative factors that account for Turkey's difficult FDI environment lie behind the upsurge in outward FDI from Turkey (NTVMSNBC, 2002).

The political and bureaucratic culture in Ankara that has been unfriendly to foreign investors has been unfriendly to domestic investors as well. Speaking of Turkish bureaucracy, a businessperson, who had participated in the meetings of the CCIIC observed, "I have to be fair to them. They were equally hostile to Turkish investors. In their eyes they were the protectors of the sacred state – we were ogres who thought of nothing but profit" (Munir, 2002).

Outward FDI by Koc Holding, Turkey's largest industrial and financial conglomerate with consolidated revenues of \$6.7 billion and exports of \$2.2 billion in 2002 (Koc Holding, 2003) consists of various parts.⁶ Koc Holding's white goods producer Arcelik⁷ acquired, in July 2002, two United Kingdom cooker

⁶ This analysis is based on the information presented by the Koc parent company's (<http://www.koc.com.tr>) and its affiliates' websites.

⁷ <http://www.arcelik.com.tr>.

brands, Leisure and Flavel, after buying two affiliates of the bankrupt appliance maker Brandt group of France; in April 2002 the Blomberg unit in Germany (which produces washing machines and dryers); and, in May 2002, the Elektra Bregenz unit in Austria (which produces cookers, stoves, and vacuum cleaners). In September 2002, Arcelik bought a majority stake in the Romanian refrigerator maker Arctic. Arcelik also announced plans to establish a washing machine factory in Russian Federation and two refrigerator factories in Central and Eastern Europe.

For a large Turkish company such as Koc Holding's Arcelik, whose long-term objective is to become one of the world's largest appliance companies, the domestic market is too small. It has been also very volatile due to the severe macroeconomic instability of recent years. Moreover, producing in developed countries, especially in the EU, enables a company such as Arcelik to overcome the perceived liability of the "Made in Turkey" label. Having production abroad can also improve the international image of a Turkish company, helping it in various ways, e.g. in raising funds and attracting investors in international capital markets.

Arcelik's outward FDI, which appears to be a mixture of involuntary (defensive) horizontal expansion and delocalization FDI, has been primarily in the form of wholly owned "brownfield" affiliates. Koc Holding's other outward FDI, however, seems to have been at least partly based on voluntary (offensive) horizontal expansion. For Sabanci Holding, whose outward FDI has been primarily in both green- and brownfield joint ventures with DuPont, motivated largely by the acquisition of DuPont technology, the vertical expansion seems to have also played a role. Anadolu Group's outward FDI seems to have been motivated by both voluntary (offensive) horizontal expansion and delocalization.

Besides Arcelik's production facilities, Koc Holding has several marketing companies in Europe such as Beko UK, Beko Deutschland, Beko France, Beko Espana, and Beko Polska to

distribute its white goods under its international Beko brand. Europe's third largest selling television brand, Beko, which had been an original equipment manufacturer for the German electronics producer Grundig, considered in 2002 but rejected the acquisition of that ailing company, which went bankrupt in 2003. Recently, Beko established in England an R&D and marketing affiliate, Fusion Digital Technologies, of which it owns 70%. This venture, aimed at developing digital technologies, is to help Beko in its plan to become the leader in Europe's TV market by 2005 (Aksam, 2003).

Koc Holding has outward FDI in the services sector. In financial services, Kocbank Nederland N.V., established in May 1996, is an affiliate of Koc Financial Services (KFS), with a major focus on commercial banking, treasury and private banking activities. In May 2001, Kocbank Nederland NV opened its first branch in Frankfurt, Germany. In March 2002, it established Koc Asset Management (Suisse) SA in Geneva to enhance its private banking activities.

In retail services, Koc Holding, on the basis of its 48 years of experience with its joint venture with Swiss Migros in Turkey,⁸ has developed since 1996 supermarkets, hypermarkets, and shopping centres (Ramstores) in Azerbaijan, Bulgaria, Kazakhstan and the Russian Federation. There are now three Ramstores in Baku, Azerbaijan; 5 Ramstore shopping centres and 20 Ramstores in Moscow; one Ramstore shopping centre and two Ramstores in Kazakhstan; and two Ramstores in Sofia, Bulgaria. Koc also has several distribution, servicing and trading affiliates in the United States, Europe and Asia. According to Koc Holding's 2002 Annual Report (Koc Holding, 2003), Koc Holding's 23 foreign affiliates' total sales amounted to \$1.1 billion.

Sabancı Holding, Turkey's second largest industrial and financial conglomerate,⁹ with consolidated revenues of \$5.2

⁸ <http://www.migros.com.tr>.

⁹ On the basis of information presented on its website (<http://www.sabanci.com.tr>) and other sources.

billion in 2002, has also been a major outward investor (Gardner, 2002). It has operations in Europe, the United States, West Asia, and North Africa. It plans to expand into other countries in Asia, including China.

In 1999, DuPont and Sabanci merged their polyester fibre, resin and intermediates into DuPontSA (DuPont Sabanci Polyester Europe) B.V., based in the Netherlands, the largest polyester company in Europe. DuPontSA develops, makes and sells polyester filament, staple, resins, and intermediates throughout Europe, West Asia and Africa. DuPont and Sabanci are equal partners in this joint venture with annual sales of about \$1 billion and about 4,500 employees. The joint venture owns, besides several operations inside Turkey, the following ones outside Turkey: DuPont's pure terephthalic acid and resins businesses at Wilton, United Kingdom, and dacron filament and staple businesses at Pontypool, United Kingdom, and Uentrop, Germany, as well as Sabanci's texturizing plant in Garforth, United Kingdom.

Dusa International LLC, another 50/50 joint venture between DuPont and Sabanci Holding, is the world's biggest industrial nylon yarn and cord fabric producer. It accounts for 40% of total nylon and 66% of total yarn and cord fabric production of the world. This joint venture, headquartered in Wilmington, Delaware, United States, started operations in late 2000. It operates nine manufacturing sites worldwide. Its manufacturing facilities outside Turkey are: DuPont Sabanci Dusa (Brazil), DuPont Sabanci Dusa (Argentina), Interkordsa (United States), DuPont Sabanci (United States), Kordsa (United States), Interkordsa GmbH (Germany), Nile-Kordsa Co. (Egypt) and Kian Kordsa (Islamic Republic of Iran). With a capital of \$592 billion, Dusa International has 2,300 employees worldwide.

As for other business segments, recently Sabanci Holding's Cement Group has been searching for acquisition candidates in Europe and the United States to produce white cement abroad (Erk, 2003).

Anadolu Group, founded in 1969 with origins in the early 1950s, is another large Turkish conglomerate, with total net sales over \$1 billion (excluding financial services) in 2001.¹⁰ It is active in manufacturing, financial services, and tourism, has joint ventures in Turkey with several foreign investors. In soft drinks, it is partnered with Coca Cola. It owns 40% of all seven bottling and distribution Coca Cola plants in Turkey. It has a joint venture in Turkey with Germany's A.W. Faber Castell to produce writing instruments (pens, pencils, erasers, etc.).

Anadolu Group's automotive division has joint ventures in Turkey with Isuzu, Itochu, Honda, Kia, Lada, and Lombardini to produce passenger cars, commercial vehicles, motorcycles and industrial engines. Anadolu Group holds the sales, marketing and distribution rights for Kia and Lada vehicles in the Commonwealth of Independent States (CIS) countries. These vehicles, imported from the Republic of Korea and the Russian Federation, respectively, are sold in Kazakhstan, Azerbaijan, Armenia, Georgia, Turkmenistan, and Ukraine after pre-delivery inspection.

Anadolu Group's international presence is largely in beverages. It began producing beer in Turkey in 1969, with the Efes Pilsen brand, one of Turkey's widely known trade marks. Efes Pilsen, Turkey's beer market leader, is exported to more than 35 countries in five continents. Efes Pilsener has been producing beer in the Russian Federation (Moscow) since 1999, Romania (Bucharest) since 1998, Kazakhstan (Karaganda) since 1999, and Ukraine (Odessa) since 2001. Efes Breweries International B.V., the Netherlands-based affiliate of the Efes Beverage Group, which conducts the Group's international beer operations, won, in December 2002, the right to acquire the Vitanta Intravest S.A. brewery located in Chisinau, the Republic of Moldova, through a tender offer.

¹⁰ On the basis of information presented on its website (<http://www.anadolugroup.com>).

Efes Beverage Group, which includes Efes Pilsen, the leader in the Turkish brewing and malt industry, consists of 31 companies, producing and marketing beer, malt and soft drinks. It has 12 breweries, 4 malteries, and 9 Coca-Cola bottling facilities in nine countries. It was the 11th largest European brewer by sales volume in 2001. While marketing its own brands outside of Turkey, it produces the leading global brands inside and outside Turkey. It produces, under licensing agreements, Miller Genuine Draft and Beck's in Turkey, and Warsteiner Premium Verum in the Russian Federation.

Efes Beverage Group has an extensive regional relationship with Coca-Cola that began with bottling franchises in CIS countries and the Russian Federation. It has invested since 1993 in the production and distribution of Coca-Cola products in Azerbaijan, Kazakhstan, Kyrgyzstan, the Southern part of the Russian Federation, and Turkmenistan. These activities are part of an integrated operation ranging from production to marketing. The partnership with Coca-Cola expanded to the Turkish market with Anadolu Group's purchase of a 40% stake in Coca-Cola's seven bottling and distribution companies in Turkey.

Not all Turkish outward FDI, however, is carried out by large Turkish firms. Many small firms, especially in the textile and apparel sector, which still accounts for the lion's share of Turkish manufacturing exports, have been investing in Central and Eastern Europe, especially in the Czech Republic, Bulgaria and Romania, attracted by these countries' more favourable business environments and in anticipation of their EU membership ahead of Turkey. Much of this outward FDI appears to be primarily a mixture of involuntary (defensive) horizontal FDI and delocalization FDI.

Summary and conclusions

Compared to many developing countries that have attracted and benefited from significant inflows of FDI, Turkey is conspicuous as a country that has not done so. Turkey's

integration with the world economy through inward FDI has lagged relative to other developing countries. Turkey's unattractive FDI environment, caused by political and economic instability as well as a historical fear and suspicion of foreign economic presence, is the explanation.

Turkey's outward FDI, on the other hand, has surged recently, increasing much faster than inward FDI. Outflows have been caused by both economic and political factors. New markets outside Turkey and the ability of the Turkish private sector to exploit them are important positive factors. Recent back-to-back domestic economic crises, rising unit labour costs, and political uncertainty, are important negative factors. Turkey, along with Turkish companies, can benefit from outward FDI. But if it is involuntary and results in delocalization, as the anecdotal evidence suggests that it is to some extent, there may be reason for concern from a public if not a private viewpoint.

There is reason to be optimistic about the Government's plans to improve the environment for inward FDI. The AK Party has a comfortable parliamentary majority, and it has had positive pronouncements and actions so far. If it provides the much-needed political and economic stability, if it overcomes the bureaucratic opposition to FDI and if it makes good use of the technical work of FIAS, it can succeed. It remains to be seen, however, whether the AK Party will be able to govern effectively, given all the obstacles it has faced during its first months in office, and whether it will remain true to its pro-FDI stance.

Turkey can and should overcome its fear of inward FDI, notwithstanding all the understandable historical reasons for that fear. That fear is at odds with its quest for EU membership. It is at odds with globalization without which Turkey can not survive as a modern country. China has overcome its similar experience with foreign economic domination and control. Its spectacular success with inward FDI is well known. Turkey can become another such success if it wants to.

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RESEARCH NOTE

World Investment Report 2003 FDI Policies for Development: National and International Perspectives Overview

United Nations Conference on Trade and Development*

FDI FALLS AGAIN—UNEVENLY

Global FDI flows fall again in 2002 amid weak economic performance.

Global FDI inflows declined in 2002 for the second consecutive year, falling by a fifth to \$651 billion—the lowest level since 1998 (table 1). Flows declined in 108 of 195 economies (see figures 1 and 2 for the economies that experienced the biggest decline, as well as the top recipients). The main factor behind the decline was slow economic growth in most parts of the world and dim prospects for recovery, at least in the short term. Also important were falling stock market valuations, lower corporate profitability, a slowdown in the pace of corporate restructuring in some industries and the winding down of privatization in some countries. A big drop in the value of cross-border mergers and acquisitions (M&As) figured heavily in the overall decline. The number of M&As fell from a high of 7,894 cases in 2000 to 4,493 cases in 2002—and their

* The *World Investment Report 2003 (WIR03)* was prepared — under the overall direction of Karl P. Sauvant — by a team comprising Americo Beviglia Zampetti, Persephone Economou, Kumi Endo, Torbjörn Fredriksson, Masataka Fujita, Kálmán Kalotay, Michael Lim, Padma Mallampally, Abraham Negash, Hilary Nwokeabia, Ludger Odenthal, Miguel Pérez-Ludeña, Kee Hwee Wee, Katja Weigl and Zbigniew Zimny. Specific inputs were prepared by Rory Allan, Victoria Aranda, Douglas van den Berghe, Sirn Byung Kim, Anh-Nga Tran-Nguyen, Jörg Simon, James Xiaoning Zhan and Yong Zhang. This is a reprint of pages 1-23 of the *World Investment Report 2003: FDI Policies for Development: National and International Perspectives. Overview* (New York and Geneva: United Nations), UNCTAD/WIR/2003(Overview).

Table 1. Selected indicators of FDI and international production, 1982-2002
(Billions of dollars and percentage)

| Item | Value at current prices (Billion dollars) | | | | Annual growth rate (Per cent) | | | | | | |
|--|--|--------|--------|--|----------------------------------|-----------|-----------|------|------|-------|-------|
| | 1982 | 1990 | 2002 | | 1986-1990 | 1991-1995 | 1996-2000 | 1999 | 2000 | 2001 | 2002 |
| FDI inflows | 59 | 209 | 651 | | 23.1 | 21.1 | 40.2 | 57.3 | 29.1 | -40.9 | -21.0 |
| FDI outflows | 28 | 242 | 647 | | 25.7 | 16.5 | 35.7 | 60.5 | 9.5 | -40.8 | -9.0 |
| FDI inward stock | 802 | 1 954 | 7 123 | | 14.7 | 9.3 | 17.2 | 19.4 | 18.9 | 7.5 | 7.8 |
| FDI outward stock | 595 | 1 763 | 6 866 | | 18.0 | 10.6 | 16.8 | 18.2 | 19.8 | 5.5 | 8.7 |
| Cross border M&As | .. | 151 | 370 | | 25.9 | 24.0 | 51.5 | 44.1 | 49.3 | -48.1 | -37.7 |
| Sales of foreign affiliates | 2 737 | 5 675 | 17 685 | | 16.0 | 10.1 | 10.9 | 13.3 | 19.6 | 9.2 | 7.4 |
| Gross product of foreign affiliates | 640 | 1 458 | 3 437 | | 17.3 | 6.7 | 7.9 | 12.8 | 16.2 | 14.7 | 6.7 |
| Total assets of foreign affiliates | 2 091 | 5 899 | 26 543 | | 18.8 | 13.9 | 19.2 | 20.7 | 27.4 | 4.5 | 8.3 |
| Export of foreign affiliates | 722 | 1 197 | 2 613 | | 13.5 | 7.6 | 9.6 | 3.3 | 11.4 | -3.3 | 4.2 |
| Employment of foreign affiliates (thousands) | 19 375 | 24 262 | 53 094 | | 5.5 | 2.9 | 14.2 | 15.4 | 16.5 | -1.5 | 5.7 |
| GDP (in current prices) | 10 805 | 21 672 | 32 227 | | 10.8 | 5.6 | 1.3 | 3.5 | 2.6 | -0.5 | 3.4 |
| Gross fixed capital formation | 2 286 | 4 819 | 6 422 | | 13.4 | 4.2 | 1.0 | 3.5 | 2.8 | -3.9 | 1.3 |
| Royalties and licences fees receipts | 9 | 30 | 72 | | 21.3 | 14.3 | 6.2 | 5.7 | 8.2 | 3.1 | .. |
| Export of goods and non-factor services | 2 053 | 4 300 | 7 838 | | 15.6 | 5.4 | 3.4 | 3.3 | 11.4 | -3.3 | 4.2 |

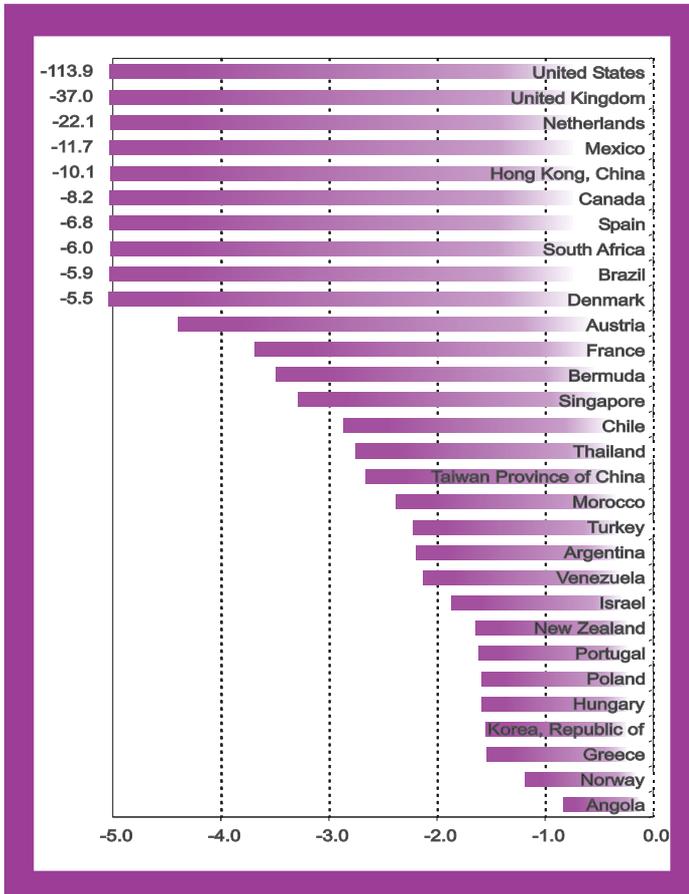
Source: UNCTAD, World Investment Report 2003. FDI Policies for Development: National and International Perspectives, table I.1, p. 3.

average value, from \$145 million in 2000 to \$82 million in 2002. The number of M&A deals worth more than \$1 billion declined from 175 in 2000 to only 81 in 2002—again, the lowest since 1998.

For the largest transnational corporations (TNCs) most indicators of the size of their foreign operations declined slightly in 2001 (the latest year for which data are available), the

Figure 1. The 30 economies most affected by the downturn, 2002

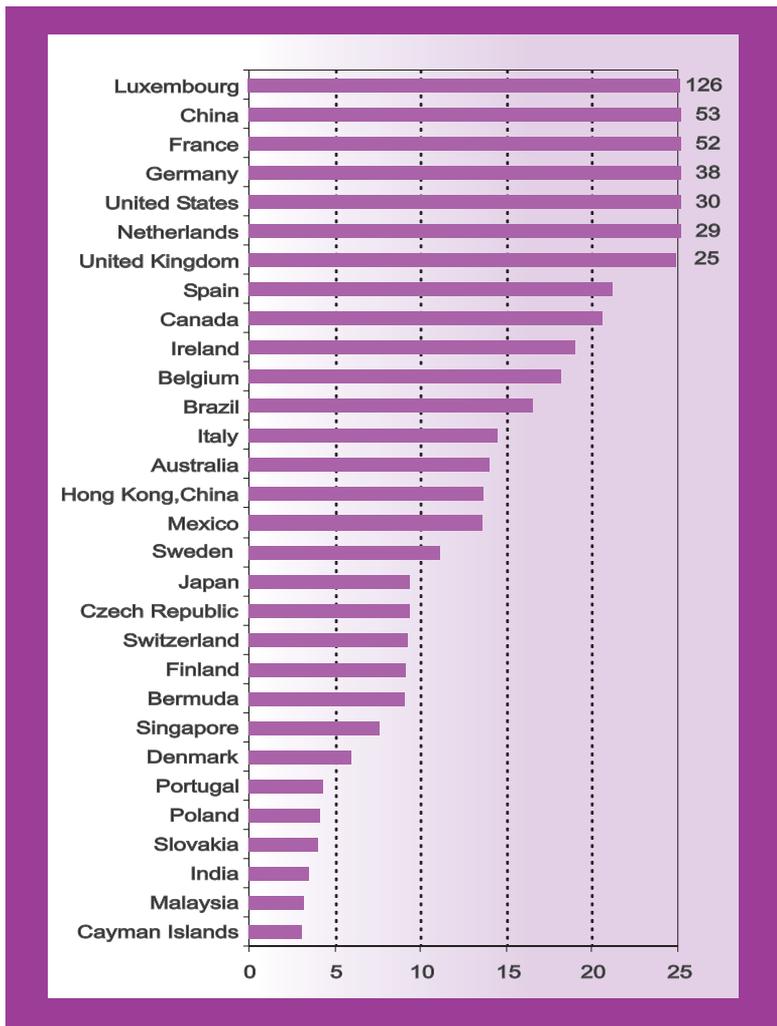
(Decline in absolute amounts of FDI in billions of dollars)



Source: UNCTAD, FDI/TNC database.
<http://www.unctad.org/fdistatistics>

beginning of the FDI downturn. Despite the burst of the bubble in the information and communication technology market, there has been no significant shift in the industrial composition of FDI—nor in the ranking of the world's top 100 TNCs (see table 2 for the top 25 of these firms), the top 50 TNCs from developing

Figure 2. World's top 30 FDI recipients, 2002
(Billions of dollars)



Source: UNCTAD, FDI/TNC database.
<http://www.unctad.org/fdistatistics>

Table 2. The world's top 25 non-financial TNCs, ranked by foreign assets, 2001
(Millions of dollars and number of employees)

| Ranking in 2001: | Ranking in 2000: | Foreign assets | TNI ^a | Foreign assets | TNI ^a | Corporation | Home economy | Industry | Assets | | Sales | | Employment | | TNI ^a |
|------------------|------------------|----------------|------------------|---------------------------|----------------------------|------------------|-----------------------------------|----------|---------|---------|---------|---------|------------|-------|------------------|
| | | | | | | | | | Foreign | Total | Foreign | Total | Foreign | Total | |
| 1 | 13 | 1 | 15 | Vodafone | United Kingdom | United Kingdom | Telecommunications | 187 792 | 207 458 | 24 602 | 32 744 | 56 430 | 67 178 | 83.2 | |
| 2 | 83 | 2 | 73 | General Electric | United States | United States | Electrical & electronic equipment | 180 031 | 495 210 | 39 914 | 125 913 | 152 000 | 310 000 | 39.0 | |
| 3 | 15 | 7 | 24 | BP | United Kingdom | United Kingdom | Petroleum expl./ref./distr. | 111 207 | 141 158 | 141 225 | 175 389 | 90 500 | 110 150 | 80.5 | |
| 4 | 36 | 4 | 42 | Vivendi Universal | France | France | Diversified | 91 120 | 123 156 | 29 652 | 51 423 | 256 725 | 381 504 | 66.3 | |
| 5 | 82 | - | - | Deutsche Telekom AG | Germany | Germany | Telecommunications | 90 657 | 145 802 | 11 836 | 43 309 | 78 722 | 257 058 | 40.0 | |
| 6 | 39 | 3 | 30 | Exxonmobil Corporation | United States | United States | Petroleum expl./ref./distr. | 89 426 | 143 174 | 145 814 | 209 417 | 61 148 | 97 900 | 64.8 | |
| 7 | 85 | 38 | 85 | Ford Motor Company | United States | United States | Motor vehicles | 81 169 | 276 543 | 52 983 | 162 412 | 188 919 | 354 431 | 38.4 | |
| 8 | 87 | 5 | 84 | General Motors | United States | United States | Motor vehicles | 75 379 | 323 969 | 45 256 | 177 260 | 148 000 | 345 000 | 29.8 | |
| 9 | 48 | 6 | 46 | Royal Dutch/Shell Group | United Kingdom/Netherlands | Netherlands | Petroleum expl./ref./distr. | 73 492 | 111 543 | 72 952 | 135 211 | 52 109 | 89 939 | 59.3 | |
| 10 | 21 | 19 | 62 | TotalFinaElf | France | France | Petroleum expl./ref./distr. | 70 030 | 78 500 | 74 647 | 94 418 | 69 037 | 122 025 | 74.9 | |
| 11 | 18 | 15 | 23 | Suez | France | France | Electricity, gas and water | 69 345 | 79 280 | 29 919 | 37 975 | 128 750 | 188 050 | 78.2 | |
| 12 | 47 | 8 | 80 | Toyota Motor Corporation | Japan | Japan | Motor vehicles | 68 400 | 144 793 | 59 880 | 108 808 | 186 911 | 246 702 | 59.3 | |
| 13 | 63 | 10 | 47 | Fiat Spa | Italy | Italy | Motor vehicles | 48 749 | 89 264 | 24 860 | 52 002 | 103 565 | 198 764 | 51.5 | |
| 14 | 52 | 9 | 55 | Telefonica SA | Spain | Spain | Telecommunications | 48 122 | 77 011 | 14 303 | 27 775 | 93 517 | 161 527 | 57.3 | |
| 15 | 51 | 12 | 23 | Volkswagen Group | Germany | Germany | Motor vehicles | 47 480 | 92 520 | 57 426 | 79 376 | 157 579 | 324 413 | 57.4 | |
| 16 | 57 | 13 | 93 | ChevronTexaco Corp. | United States | United States | Petroleum expl./ref./distr. | 44 943 | 77 572 | 57 673 | 104 409 | 35 569 | 67 569 | 55.3 | |
| 17 | 38 | 14 | 52 | Hutchison Whampoa Limited | Hong Kong, China | Hong Kong, China | Diversified | 40 989 | 55 281 | 6 092 | 11 415 | 53 478 | 77 253 | 65.6 | |
| 18 | 11 | 17 | 11 | News Corporation | Australia | Australia | Media | 35 650 | 40 007 | 13 880 | 15 087 | 24 700 | 33 800 | 84.7 | |
| 19 | 44 | 29 | 43 | Honda Motor Co Ltd | Japan | Japan | Motor vehicles | 35 257 | 52 056 | 40 088 | 55 955 | 59 000 | 120 600 | 62.8 | |
| 20 | 86 | 23 | 77 | E-On | Germany | Germany | Electricity, gas and water | 33 990 | 87 755 | 22 744 | 71 419 | 64 285 | 151 953 | 37.6 | |
| 21 | 20 | 18 | 4 | Nestle SA | Switzerland | Switzerland | Food & beverages | 33 065 | 55 821 | 34 704 | 50 717 | 223 324 | 229 765 | 75.0 | |
| 22 | 81 | 61 | 86 | RWE Group | Germany | Germany | Electricity, gas and water | 32 809 | 81 024 | 23 151 | 58 039 | 65 609 | 155 634 | 40.8 | |
| 23 | 65 | 11 | 57 | IBM | United States | United States | Electrical & electronic equipment | 32 800 | 88 313 | 50 651 | 85 866 | 173 969 | 319 876 | 50.2 | |
| 24 | 3 | 24 | 3 | ABB | Switzerland | Switzerland | Machinery and equipment | 30 586 | 32 305 | 18 876 | 19 382 | 148 486 | 156 865 | 95.6 | |
| 25 | 35 | 37 | 49 | Unilever | United Kingdom/Netherlands | Netherlands | Diversified | 30 529 | 46 922 | 28 675 | 46 803 | 204 000 | 279 000 | 66.5 | |

Source: UNCTAD, World Investment Report 2003. FDI Policies for Development: National and International Perspectives, annex table A.1.2.

^a TNI is the abbreviation for "transnationality index". The transnationality index is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

countries (see table 3 for the top 25 of these firms) and the top 25 TNCs from Central and Eastern Europe (CEE) (table 4).

The decline in FDI in 2002 was uneven across regions and countries. It was also uneven sectorally: flows into manufacturing and services declined, while those into the primary sector rose. The equity and intra-company loan components of FDI declined more than reinvested earnings. FDI entering host economies through M&As went down more than that through greenfield projects.

Geographically, flows to developed and developing countries each fell by 22% (to \$460 billion and \$162 billion, respectively). Two countries, the United States and the United Kingdom, accounted for half of the decline in the countries with reduced inflows. Among developing regions, Latin America and the Caribbean was hit hard, suffering its third consecutive annual decline in FDI with a fall in inflows of 33% in 2002. Africa registered a decline of 41%; but after adjusting for the exceptional FDI inflows in 2001, there was no decline. FDI in Asia and the Pacific declined the least in the developing world because of China, which with a record inflow of \$53 billion became the world's biggest host country. CEE did the best of all regions, increasing its FDI inflows to a record \$29 billion.

The main developments by region were:

- There was a sizable decline in FDI inflows to developed countries, accompanying a continuing slowdown in corporate investment, declining stock prices and a slowdown in the consolidation of activities in some industries—all influenced by weak economic conditions. In several countries, repayments of intra-company loans contributed to lower FDI flows. For instance, a large part of the decline in the United States was due to repayments of loans by foreign affiliates to parent companies, presumably to take advantage of the lower interest rates in the United States as well as for other reasons (such as improving the debt-to-

Table 3. The top 25 non-financial TNCs from developing economies, ranked by foreign assets, 2001
(Millions of dollars and number of employees)

| Ranking by Foreign assets | TNI ^a | Corporation (Per cent) | Home economy | Industry | Assets | | Sales | | Employment | | TNI ^a Total |
|---------------------------------|------------------|--------------------------------|--------------------|-----------------------------------|---------|--------|---------|--------|------------|---------|---------------------------|
| | | | | | Foreign | Total | Foreign | Total | Foreign | Total | |
| 1 | 12 | Hutchison Whampoa Limited | Hong Kong, China | Diversified | 40 989 | 55 281 | 6 092 | 11 415 | 53 478 | 77 253 | 65.6 |
| 2 | 11 | Singtel Ltd. | Singapore | Telecommunications | 15 594 | 19 108 | 1 362 | 4 054 | 17 574 | 21 535 | 65.6 |
| 3 | 9 | Cemex S.A. | Mexico | Non-metallic mineral products | 12 645 | 17 449 | 4 390 | 6 730 | 17 449 | 25 519 | 70.4 |
| 4 | 22 | LG Electronics Inc. | Korea, Republic of | Electrical & electronic equipment | 11 561 | 20 304 | 10 009 | 22 528 | 21 017 | 42 512 | 50.3 |
| 5 | 41 | Petroleos De Venezuela | Venezuela | Petroleum exp./ref./distr. | 7 964 | 57 542 | 19 801 | 46 250 | 5 480 | 46 425 | 22.8 |
| 6 | 42 | Petromas - Petrolim Nasional | Berhad | Petroleum exp./ref./distr. | 7 877 | 37 933 | 5 359 | 17 681 | 4 006 | 25 724 | 22.2 |
| 7 | 45 | NewWorld Development Co., Ltd. | Hong Kong, China | Diversified | 4 715 | 16 253 | 565 | 2 933 | 800 | 26 100 | 17.1 |
| 8 | 4 | Nepune Orient Lines Ltd. | Singapore | Transport and storage | 4 674 | 4 951 | 2 970 | 4 737 | 10 412 | 11 777 | 81.8 |
| 9 | 16 | Citic Pacific Ltd. | Hong Kong, China | Diversified | 4 184 | 7 798 | 1 109 | 2 212 | 7 354 | 11 733 | 55.5 |
| 10 | 14 | Jardine Matheson Holdings Ltd | Hong Kong, China | Diversified | 4 080 | 7 166 | 6 297 | 9 413 | 62 629 | 110 000 | 60.3 |
| 11 | 28 | Samsung Electronics Co., Ltd. | Korea, Republic of | Electrical & electronic equipment | 3 840 | 41 692 | 25 112 | 37 155 | 23 953 | 73 682 | 36.4 |
| 12 | 2 | Guangdong Investment Ltd. | Hong Kong, China | Diversified | 3 694 | 4 042 | 854 | 932 | 6 869 | 7 641 | 91.0 |
| 13 | 5 | Shangri-La Asia Ltd. | Hong Kong, China | Hotels and motels | 3 606 | 4 565 | 458 | 560 | 13 033 | 16 500 | 79.9 |
| 14 | 10 | Sappi Ltd. | South Africa | Paper | 3 463 | 4 504 | 3 223 | 4 184 | 10 429 | 18 231 | 70.4 |
| 15 | 46 | Hyundai Motor Company | Korea, Republic of | Motor vehicles | 3 210 | 33 216 | 6 943 | 33 199 | 5 516 | 91 958 | 12.2 |
| 16 | 8 | Electronics International Ltd. | Singapore | Electrical & electronic equipment | 2 983 | 4 115 | 5 363 | 6 691 | 50 734 | 70 000 | 75.0 |
| 17 | 13 | City Developments Ltd. | Singapore | Hotels | 2 870 | 6 454 | 857 | 1 302 | 11 457 | 14 337 | 63.4 |
| 18 | 44 | Samsung Corporation | Korea, Republic of | Electrical & electronic equipment | 2 800 | 9 400 | 5 800 | 32 300 | .. | 4 164 | 17.4 |
| 19 | 26 | China National Chemicals | China | Diversified | 2 788 | 4 928 | 9 145 | 16 165 | 350 | 7 950 | 39.2 |
| 20 | 18 | Imp. & Exp. Corp. | South Africa | Food & beverages | 2 785 | 4 399 | 2 433 | 4 364 | 15 450 | 33 230 | 55.2 |
| 21 | 34 | South African Breweries Plc | Mexico | Telecommunications | 2 323 | 10 137 | 919 | 4 385 | 7 142 | 14 786 | 30.7 |
| 22 | 31 | Perez Companc | Argentina | Petroleum exp./ref./distr. | 2 154 | 6 244 | 471 | 1 655 | 1 182 | 3 427 | 32.5 |
| 23 | 3 | Guangzhou Investment | Hong Kong, China | Paper | 2 129 | 2 559 | 362 | 433 | 12 920 | 13 120 | 88.4 |
| 24 | 49 | Taiwan Semiconductor | Taiwan Province | Electrical & electronic equipment | 2 033 | 10 446 | .. | 3 751 | .. | 13 669 | 7.0 |
| 25 | 1 | Manufacturing Co Ltd | of China | Electrical & electronic equipment | 2 007 | 2 046 | 1 852 | 1 852 | 47 998 | 48 046 | 99.3 |
| | | First Pacific Company Limited | Hong Kong, China | Electrical & electronic equipment | 2 007 | 2 046 | 1 852 | 1 852 | 47 998 | 48 046 | 99.3 |

Source: UNCTAD, World Investment Report 2003. FDI Policies for Development: National and International Perspectives, annex table A.I.2.

^a TNI is the abbreviation for "transnationality index". The transnationality index is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

Table 4. The top 25 non-financial TNCs from Central and Eastern Europe, ranked by foreign assets, 2001
(Millions of dollars and number of employees)

| Ranking by Foreign assets | TNI ^a | Corporation | Home country | Industry | Assets | | Sales | | Employment | | TNI ^a (Per cent) |
|---------------------------------|------------------|--|--------------------|--|---------|----------|---------|----------|------------|---------|--------------------------------|
| | | | | | Foreign | Total | Foreign | Total | Foreign | Total | |
| 1 | 10 | Lukoil Oil Co. | Russian Federation | Petroleum and natural gas | 5830.0 | 15 859.0 | 8 771.0 | 14 892.0 | 13 000 | 140 000 | 35.0 |
| 2 | 4 | Novoship Co. | Russian Federation | Transport | 998.9 | 1 133.6 | 302.3 | 392.1 | 85 | 6 976 | 55.5 |
| 3 | 1 | Latvian Shipping Co. | Latvia | Transport | | 491.2 | | 172.9 | 1 313 | 1 762 | 77.7 |
| 4 | 5 | Pilva Group | Croatia | Pharmaceuticals | 281.1 | 967.6 | 477.3 | 632.2 | 2 900 | 7 208 | 48.3 |
| 5 | 25 | Hivatska Elektroprivreda d.d. | Croatia | Energy | 272.0 | 2 357.0 | 8.0 | 775.0 | - | 15 071 | 4.2 |
| 6 | 2 | Primorsk Shipping Co. | Russian Federation | Transport | 267.3 | 437.9 | 114.9 | 145.7 | 1 305 | 2 629 | 63.2 |
| 7 | 7 | Gorenje Group | Slovenia | Domestic appliances | 231.5 | 486.1 | 231.5 | 661.3 | 670 | 8 186 | 42.6 |
| 8 | 6 | Krka d.d. | Slovenia | Pharmaceuticals | 190.8 | 476.6 | 235.4 | 296.0 | 595 | 3 520 | 45.5 |
| 9 | 15 | Far Eastern Shipping Co. | Russian Federation | Transport | 123.0 | 377.0 | 101.0 | 318.0 | 233 | 5 608 | 22.8 |
| 10 | 21 | Mercator d.d. | Slovenia | Retail trade | 112.7 | 868.5 | 53.0 | 1 171.5 | 1 279 | 13 692 | 8.9 |
| 11 | 20 | MOL Hungarian Oil and Gas Plc. | Hungary | Petroleum and natural gas | 95.9 | 3 243.2 | 819.2 | 3 850.0 | 776 | 15 218 | 9.8 |
| 12 | 14 | Podravka Group | Croatia | Food and beverages/ pharmaceuticals | 69.3 | 357.2 | 134.3 | 303.5 | 790 | 6 885 | 25.0 |
| 13 | 22 | Petrol Group | Slovenia | Petroleum and natural gas | 66.9 | 478.4 | 80.0 | 1 122.8 | 24 | 1 572 | 7.5 |
| 14 | 3 | Zalakeramia Rt. | Hungary | Clay product and refractory | 65.0 | 120.0 | 39.0 | 64.0 | 1 889 | 2 921 | 59.9 |
| 15 | 19 | Richter Gedeon Ltd. | Hungary | Pharmaceuticals | 55.9 | 496.5 | 43.5 | 309.6 | 884 | 5 007 | 14.3 |
| 16 | 11 | Malev Hungarian Airlines Ltd. ^b | Hungary | Transport | 41.4 | 187.0 | 299.0 | 383.4 | 49 | 2 952 | 33.9 |
| 17 | 17 | Intereuropa d.d. | Slovenia | Trade | 34.0 | 200.0 | 25.0 | 163.0 | 662 | 2 230 | 20.7 |
| 18 | 12 | Lek d.d. | Slovenia | Pharmaceuticals | 28.1 | 332.4 | 219.7 | 281.2 | 252 | 2 663 | 32.0 |
| 19 | 24 | Petrom SA National Oil Co. ^b | Romania | Petroleum and natural gas | 28.0 | 3 151.0 | 303.0 | 2 423.0 | 149 | 77 630 | 4.5 |
| 20 | 13 | Croatia Airlines d.d. | Croatia | Transportation | 26.3 | 328.4 | 90.4 | 141.8 | 63 | 977 | 26.1 |
| 21 | 23 | Merkur d.d. | Slovenia | Trade | 26.1 | 397.9 | 44.8 | 436.7 | 89 | 2 824 | 6.7 |
| 22 | 9 | Budimex Capital Group | Poland | Construction | 372.6 | 372.6 | 50.4 | 610.0 | 1 076 | 1 189 | 35.0 |
| 23 | 8 | BLRT Grupp AS | Estonia | Shipbuilding | 22.6 | 83.7 | 31.5 | 83.8 | 1 521 | 3 415 | 36.4 |
| 24 | 16 | Iskraemeco d.d. | Slovenia | Electrical machinery | 19.0 | 86.5 | 32.8 | 115.0 | 267 | 2 114 | 21.0 |
| 25 | 18 | Tiszai Vegyi Kombinát Ltd. | Hungary | Chemicals | 16.6 | 462.5 | 245.6 | 489.9 | 182 | 2 987 | 19.9 |
| Averages | | | | | 373.2 | 1 350.1 | 525.2 | 1 209.4 | 1 252 | 13 409 | 30.3 |
| Change from 2000 (in per cent) | | | | | 15.2 | 9.7 | 8.8 | 1.6 | -10.6 | -5.3 | -1.9 |

Source: UNCTAD, World Investment Report 2003. FDI Policies for Development: National and International Perspectives, annex table A.1.3.

^a The transnationality index (TNI) is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

^b 2000 data.

equity ratio of parent firms). The most notable feature of the decline in FDI in the developed countries was the plunge in cross-border M&As, especially in the United States and the United Kingdom. In all, FDI inflows declined in 16 of the 26 developed countries. Australia, Germany, Finland and Japan were among the countries with higher FDI inflows in 2002.

FDI outflows from the developed countries also declined in 2002 to \$600 billion; the fall was concentrated in France, the Netherlands and the United Kingdom. Outflows from Austria, Finland, Greece, Norway, Sweden and the United States increased. In both outflows and inflows Luxembourg headed the list of largest host and home countries (for special reasons). The prospects for 2003 depend on the strength of the economic recovery, investor confidence and a resumption of cross-border M&As. With many TNCs continuing to follow cautious growth and consolidation strategies, M&As are not yet showing much dynamism. As a group, developed countries are not likely to improve their FDI performance in 2003.

- Africa suffered a dramatic decline in FDI inflows—from \$19 billion in 2001 to \$11 billion in 2002, largely the result of exceptionally high inflows in 2001 (two M&As in South Africa and Morocco, not repeated in 2002). Flows to 23 of the continent's 53 countries declined. FDI in the oil industry remained dominant. Angola, Algeria, Chad, Nigeria and Tunisia accounted for more than half the 2002 inflows. Only South African enterprises made significant investments abroad. Oil exploration by major TNCs in several oil-rich countries makes the 2003 outlook for FDI inflows more promising.
- The Asia-Pacific region was not spared either from the global decline in FDI inflows in 2002. FDI inflows to the region declined for the second consecutive year—from \$107 billion in 2001 to \$95 billion, uneven by

subregion, country and industry. All subregions, except Central Asia and South Asia, received lower FDI flows than in 2001. Flows to 31 of the region's 57 economies declined. However, several countries received significantly higher flows. Intra-regional investment flows, particularly in South-East Asia and North-East Asia, remained strong, partly as a result of the relocation of production activities, expanding regional production networks and continued regional integration efforts. FDI in the electronics industry continued to decline due to the rationalization of production activities in the region and adjustments to weak global demand. While long-term prospects for an increase in FDI flows to the region remain promising, the short-term outlook is uncertain.

- In Latin America and the Caribbean, FDI flows declined for the third consecutive year, from \$84 billion in 2001 to \$56 billion, affecting all subregions and 28 of the region's 40 economies. Factors specific to the region contributed to this decline, especially the acute economic crisis in Argentina and economic and political uncertainty in some other countries. The services sector was affected most by the decline. Manufacturing FDI proved to be quite resilient, with barely any change, despite the slowdown from the region's major export destination, the United States, and the growing relocation of labour-intensive activities to Asia. FDI is expected to remain at the same level in 2003 and to start rising thereafter.
- CEE again bucked the global trend by reaching a new high of \$29 billion in FDI inflows, compared to \$25 billion in 2001. That increase masked divergent trends, however, with FDI falling in 10 countries and rising in 9. FDI flows varied across industries as well, with the automobile industry doing quite well, and the electronics industry facing problems. There was also a tendency of firms (including foreign affiliates) in several CEE countries, particularly those slated for

accession to the EU, to shed activities based on unskilled labour and to expand into higher value-added activities, taking advantage of the educational level of the local labour force. Led by a surge of flows into the Russian Federation, and fuelled by the momentum of EU enlargement, the region's FDI inflows are likely to increase further in 2003. Of the two factors determining this trend, the surge of FDI into the Russian Federation seems to be more fragile in the medium and long term than the spur of EU enlargement. In the short term, however, both factors are helping overcome the impact of the completion of privatization programmes and the slowdown of GDP growth expected in some key CEE countries.

UNCTAD's Inward FDI Performance Index ranks countries by the FDI they receive relative to their economic size, calculated as the ratio of the country's share in global FDI inflows to its share in global GDP. The Index for 1999-2001 indicates that Belgium and Luxembourg remained the top performer. Of the top 20 performers, 6 are industrialized, 2 are mature East-Asian tiger economies, 3 are economies in transition and the remaining 9 are developing economies, including three from sub-Saharan Africa. UNCTAD's 1999-2001 Inward FDI Potential Index, measuring the potential—based on a set of structural variables—of countries in attracting FDI, indicates that 16 of the 20 leading countries are developed countries and four of them, mature East-Asian tiger economies.

Many industrial, newly industrializing and advanced transition economies are in the *front-runner* category (with high FDI potential and performance), while most poor (or unstable) economies are in the *under-performer* category (with both low FDI potential and performance). Economies in the *above-potential* category (with low FDI potential but strong FDI performance) include Brazil, Kazakhstan and Viet Nam. Economies in the *below-potential* category (with high FDI potential but low FDI performance) include Australia, Italy, Japan, Republic of Korea, Taiwan Province of China and the United States.

Prospects remain dim for 2003, but should improve thereafter.

All in all, UNCTAD predicts that FDI flows will stabilize in 2003. Flows to the developing countries and developed countries are likely to remain at levels comparable to those in 2002, while those to CEE are likely to continue to rise. In the longer run, beginning with 2004, global flows should rebound and return to an upward trend. The prospects for a future rise depend on factors at the macro-, micro- and institutional levels.

The fundamental economic forces driving FDI growth remain largely unchanged. Intense competition continues to force TNCs to invest in new markets and to seek access to low-cost resources and factors of production. Whether these forces lead to significantly higher FDI in the medium term depends on a recovery in world economic growth and a revival in stock markets, as well as the resurgence of cross-border M&As. Privatization may also be a factor. FDI policies continue to be more favourable, and new bilateral and regional arrangements could provide a better enabling framework for cross-border investment.

Findings of surveys of TNCs and investment promotion agencies (IPAs) carried out by UNCTAD and other organizations paint an optimistic picture for the medium term. IPAs in developing countries are far more sanguine than their developed world counterparts. Developing countries are also expected to be more active in outward FDI. IPAs expect greenfield investment to become more important as a mode of entry, especially in developing countries and CEE. Tourism and telecom are expected to lead the recovery.

Government policies are becoming more open, involving more incentives and focused promotion strategies...

Facing diminished FDI inflows, many governments accelerated the liberalization of FDI regimes, with 236 of 248 regulatory changes in 70 countries in 2002 facilitating FDI (table 5). Asia is one of the most rapidly liberalizing host regions. An

Table 5. Changes in national regulations of FDI, 1991-2002

| Item | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|------|------|------|------|------|------|------|------|------|------|------|------|
| Number of countries that introduced changes in their investment regimes | 35 | 43 | 57 | 49 | 64 | 65 | 76 | 60 | 63 | 69 | 71 | 70 |
| Number of regulatory changes of which: | 82 | 79 | 102 | 110 | 112 | 114 | 151 | 145 | 140 | 150 | 208 | 248 |
| More favourable to FDI | 80 | 79 | 101 | 108 | 106 | 98 | 135 | 136 | 131 | 147 | 194 | 236 |
| Less favourable to FDI | 2 | - | 1 | 2 | 6 | 16 | 16 | 9 | 9 | 3 | 14 | 12 |

Source: UNCTAD, World Investment Report 2003. FDI Policies for Development: National and International Perspectives, table I.8.

increasing number of countries, including those in Latin America and the Caribbean, are moving beyond opening to foreign investment to adopting more focused and selective targeting and promotion strategies.

Financial incentives and bidding wars for large FDI projects have increased as competition intensified. IPAs, growing apace in recent years, are devoting more resources to targeting greenfield investors and to mounting after-care services for existing ones.

... as well as participation in more investment and trade agreements.

More countries are concluding bilateral investment treaties (BITs) and double taxation treaties (DTTs), as part of a longer trend, and not solely in response to the FDI downturn. In 2002, 82 BITs were concluded by 76 countries, and 68 DTTs by 64 countries. Many countries are concluding BITs with countries in their own region to promote intra-regional FDI. Asian and Pacific countries, for instance, were party to 45 BITs, including 10 signed with other countries in that region.

There has also been an increase in the number of trade and investment agreements. Many recent trade agreements address investment directly—or have indirect implications for investment, a trend conspicuously different from earlier regional and bilateral trade agreements. The largest number in developed countries were concluded by the EU, mainly involving partners in CEE and Mediterranean countries. The EU enlargement through the accession of 10 new members in 2004 and the forthcoming negotiations of ACP-EU Economic Partnership Agreements might also have an impact on FDI in the respective regions.

In Asia and the Pacific, the number of such agreements has increased rapidly—to improve competitiveness, attract more FDI and better meet the challenges emanating from heightened competition. ASEAN is taking the lead. In Latin America and

the Caribbean, NAFTA has been the most prominent example, leading to increased FDI flows especially into the assembly of manufactured goods for the United States market. The Free Trade Area of the Americas, now under negotiation, could expand market access, promoting efficiency-seeking FDI. In Africa, progress towards the creation of functioning free trade and investment areas has been slow, though several agreements, mostly subregional, have been concluded. AGOA (not a free trade agreement but a unilateral preference scheme) holds some promise for the expansion of trade and investment in the region.

For the EU-accession countries of CEE, a policy challenge is to harmonize FDI regimes with EU regulations, with the twin aims of conforming to EU regulations and maximizing the potential benefits from EU instruments, such as regional development funds. Successful adjustment to EU membership in the accession countries will also depend on their ability to establish and develop the institutional framework required to administer and properly channel the variety of funds available from European Community sources for assisting economic development. The non-accession countries face the challenge of updating and modernizing their FDI promotion to optimize the potential benefits being on a “new frontier” for efficiency-seeking FDI—by attracting firms choosing to switch to lower cost locations within CEE.

Converging patterns of FDI links and investment and trade agreements are generating mega blocks.

The global stock of FDI, owned by some 64,000 TNCs and controlling 870,000 of their foreign affiliates, increased by 10% in 2002—to more than \$7 trillion. Technology payments, mostly internal to TNCs, held steady in 2001 despite the near halving of FDI flows. Value added by foreign affiliates in 2002 (\$3.4 trillion) is estimated to account for about a tenth of world GDP. FDI continues to be more important than trade in delivering goods and services abroad: global sales by TNCs reached \$18 trillion, as compared with world exports of \$8 trillion in 2002. TNCs employed more than 53 million people abroad.

The developed world accounts for two-thirds of the world FDI stock, in both ownership and location. Firms from the EU have become by far the largest owners of outward FDI stock, some \$3.4 trillion in 2002, more than twice that of the United States (\$1.5 trillion). In developing countries, the inward FDI stock came to nearly one-third of GDP in 2001, up from a mere 13% in 1980. Outward FDI stocks held by developing countries have grown even more dramatically, from 3% of their GDP in 1980 to 13% in 2002.

Over time, the concentration of outward and inward FDI in the Triad (EU, Japan and the United States) has remained fairly stable. By 2002 the pattern of DTTs was quite similar to the Triad pattern of FDI flows, while the pattern of BITs had a weaker resemblance. For both BITs and DTTs, the Triad's associate partners (countries with more than 30% of their FDI with a Triad member) score higher than non-associate partners. This suggests that the "economic space" for Triad members and their developing country associates is being enlarged from national to regional—and that treaties are making investment blocks stronger. The emerging nexus of mutually reinforcing trade and investment agreements may be providing gains for the developing countries that are "insiders" in such mega blocks.

ENHANCING THE DEVELOPMENT DIMENSION OF INTERNATIONAL INVESTMENT AGREEMENTS

Countries seek FDI to help them grow and develop. Their national policies are key to attracting FDI and increasing its benefits.

To help attract FDI, countries increasingly conclude IIAs ...

Countries conclude international investment agreements (IIAs)—at the bilateral, regional and multilateral levels—for various reasons. For most host countries, it is mainly to help attract FDI. For most home countries, it is mainly to make the regulatory framework for FDI in host countries more transparent,

stable, predictable and secure—and to reduce obstacles to future FDI flows. In either case, the regulatory framework for FDI, at whatever level, is at best enabling. Whether FDI flows actually take place depends in the main on economic determinants.

The number of IIAs, especially at the bilateral and regional levels, has greatly increased in the past decade, reflecting the importance of FDI in the world economy (see Part One of this WIR).

At the bilateral level, the most important instruments are bilateral investment treaties (BITs) and double taxation treaties (DTTs), with 2,181 BITs and 2,256 DTTs signed by the end of 2002. BITs are primarily instruments to protect investors, although recent agreements by a few countries also have more of a liberalizing effect. (They are not concluded between developed countries.) They cover an estimated 7% of the stock of world FDI and 22% of the FDI stock in developing and CEE countries. DTTs are primarily instruments to address the allocation of taxable income, including to reduce the incidence of double taxation. They cover some 87% of world FDI and some 57% of FDI in developing and CEE countries.

Although a few regional agreements deal exclusively with investment issues, the trend so far has been to address such issues in trade agreements. (The same applies to bilateral trade agreements.) In effect, free trade agreements today are often also free investment agreements.

At the multilateral level the few agreements that exist deal with specific investment-related issues (such as trade-related investment measures, insurance, dispute settlement, social policy matters) or they are sectoral (such as the General Agreement on Trade in Services (GATS)). There is no comprehensive multilateral agreement for investment, although issues pertaining to such an idea are currently being discussed in the WTO.

Overall, the growth in the number of IIAs and their nature reflect the fact that national policies in the past decade have

become more welcoming to FDI. During 1991–2002, 95% of 1,641 FDI policy changes had that effect.

Issues relating to IIAs are therefore coming to the fore in international economic diplomacy. This is so irrespective of what will or will not happen at the multilateral level, simply because of what *is* happening *now* at the bilateral and regional levels. But if negotiations should take place at the multilateral level, these issues will acquire even greater importance. Whether governments negotiate IIAs, at what level and for what purpose is their sovereign decision. The objective of this *WIR* is simply to throw light on a range of issues that needs to be considered when negotiating IIAs, seeking to clarify them from a development perspective (and regardless of the outcome of the ongoing multilateral investment discussions).

Almost by definition, IIAs affect, to a greater or lesser extent, the regulatory framework for FDI, depending on their exact content. As a rule, they tend to make the regulatory framework more transparent, stable and predictable—allowing the economic determinants to assert themselves. The expectation is that, if the economic determinants are right, FDI will increase. In that respect, therefore, IIAs can influence FDI flows when they affect their determinants.

... which, by their nature, entail a loss of policy space.

Experience shows that the best way of attracting FDI and drawing more benefits from it is not passive liberalization alone. Liberalization can help get more FDI. But it is certainly not enough to get the most from it. Attracting types of FDI with greater potential for benefiting host countries (such as FDI in technologically advanced or export oriented activities) is a more demanding task than just liberalizing FDI entry and operations. And, once countries succeed in attracting foreign investors, national policies are crucial to ensure that FDI brings more benefits. Policies can induce faster upgrading of technologies and skills, raise local procurement, secure more reinvestment of profits, better protect the environment and consumers and so

on. They can also counter the potential dangers related to FDI. For example, they can contain anticompetitive practices and prevent foreign affiliates from crowding out viable local firms or acting in ways that upset local sensitivities. The instruments needed to put these policies in place tend to be limited—or excluded altogether—by entering into IIAs.

The challenge for developing countries is to find a development-oriented balance...

What are the issues?

For developing countries, the most important challenge in future IIAs is to strike a balance between the potential contribution of such agreements to increasing FDI flows and the preservation of the ability to pursue development-oriented FDI policies that allow them to benefit more from them—that is, the right to regulate in the public interest. This requires maintaining sufficient policy space to give governments the flexibility to use such policies within the framework of the obligations established by the IIAs to which they are parties. The tension this creates is obvious. Too much policy space impairs the value of international obligations. Too stringent obligations overly constrain national policy space. Finding a development-oriented balance is the challenge—for the objectives, structure, implementation and content of IIAs.

... when negotiating the objectives, structure and implementation of IIAs...

Many IIAs incorporate the objective of development among their basic purposes or principles, as a part of their preambular statements or as specific declaratory clauses articulating general principles. The main advantage of such provisions is that they may assist in the interpretation of substantive obligations, permitting the most development friendly interpretation. This promotes flexibility and the right to regulate by ensuring that the objective of development is implied in all obligations and exceptions thereto—and that it

informs the standard for assessing the legitimacy of governmental action under an agreement.

The structure of agreements may reflect development concerns through special and differential treatment for developing country parties. This entails differences in the extent of obligations of developed and developing country parties, with the latter assuming, either temporarily or permanently, less onerous obligations that are also non-reciprocal. Particularly important is the approach to determine the scope of commitments.

- Under a “negative list” approach, countries agree on a series of general commitments and then list, individually, all the areas these commitments do not apply to. This approach tends to produce an inventory of non-conforming measures. It also increases predictability because it locks in the status quo.
- Under a (GATS-type) “positive list” approach, countries list commitments they agree to make and the conditions they attach to them. This approach has the advantage that countries can make commitments at their own pace and determine the conditions for doing this. For these reasons the positive list approach is generally regarded as more development friendly than the negative list approach.

In theory, both approaches should arrive at the same result, if countries had the capacity to make proper judgments about individual activities—or, more broadly, about making commitments—when concluding an agreement. In practice, it is unlikely that developing countries would have all the information necessary to make the necessary judgments at the time of concluding agreements. As a result, the negative list approach might involve greater liberalization than countries may wish to commit themselves to start with. But even a positive list approach can lead to significant liberalization—because in

practice, negotiations generate pressures on countries to assume higher and broader commitments. And once a commitment has been made, it is difficult to reverse it.

The implementation of IIAs can also be designed with flexibility for development as the organizing principle. Two approaches are particularly relevant here: first, the legal character, mechanisms and effects of an agreement, and second, promotional measures and technical assistance:

- Whether an agreement is legally binding or voluntary affects the intensity of particular obligations. Indeed, it is possible to have a mix of binding commitments and non-binding “best effort” provisions in one agreement. So, development-oriented provisions could be either legally binding or hortatory, depending on how much the parties are willing to undertake commitments.
- The asymmetries between developed and developing country parties to IIAs can be tackled by commitments of the developed country parties to provide assistance to the developing parties, especially LDCs. An example is the TRIPS Agreement, in which developed countries have made commitments to facilitate technology transfer to LDCs. Also relevant here is the wider issue of home country commitments to promote the flow of FDI to developing countries, perhaps complemented by provisions for technical assistance through relevant international organizations. These are important, given the complexity of the subject matter and the limited capacity of many developing countries, especially LDCs, to fund FDI-related policy analysis and development and for human and institutional development. Institutional development also involves assistance to developing countries to attract FDI and benefit more from it.

... and especially their content ...

The quest for a development friendly balance plays itself out most importantly in the negotiations of the content of IIAs. Central here is the resolution of issues that are particularly important for the ability of countries to pursue development-oriented national FDI policies—and that are particularly sensitive in international investment negotiations, because countries have diverging views about them.

From a development perspective, these issues are:

- The definition of investment, because it determines the scope and reach of the substantive provisions of an agreement.
- The scope of national treatment (especially as it relates to the right of establishment), because it determines how much and in what ways preferences can be given to domestic enterprises.
- The circumstances under which government policies should be regarded as regulatory takings, because it involves testing the boundary line between the legitimate right to regulate and the rights of private property owners.
- The scope of dispute settlement, because this raises the question of the involvement of non-State actors and the extent to which the settlement of investment disputes is self-contained.
- The use of performance requirements, incentives, transfer-of-technology policies and competition policy, because they can advance development objectives.

Other important matters also arise in negotiations for IIAs, especially most-favoured-nation treatment, fair and equitable treatment and transparency. But these appear to be less controversial.

For each of these issues, more development friendly and less development friendly solutions exist. From the perspective of many developing countries, the preferable approach is a broad GATS-type positive list approach that allows each country to determine for itself for which of these issues to commit itself to in IIAs, under what conditions, and at what pace, commensurate with its individual needs and circumstances.

In pursuit of an overall balance, furthermore, future IIAs need to pay more attention to commitments by home countries. All developed countries (the main home countries) already have various measures to encourage FDI flows to developing countries in place. And a number of bilateral and regional agreements contain such commitments. Developing countries would benefit from making home country measures more transparent, stable and predictable in future IIAs.

TNCs, too, can contribute more to advancing the development impact of their investments in developing countries, as part of good corporate citizenship responsibilities, whether through voluntary action or more legally-based processes. Areas particularly important from a development perspective are contributing fully to public revenues of host countries, creating and upgrading linkages with local enterprises, creating employment opportunities, raising local skill levels and transferring technology.

... by making development objectives an integral part of international investment agreements.

These issues are all complex. Because the potential implications of some provisions in IIAs are not fully known, it is not easy for individual countries to make the right choices. The complexities and sensitivities are illustrated by the experience of NAFTA for the regional level, that of the MAI negotiations for the interregional level and that of the GATS and the TRIMs Agreement for the multilateral level. Given the evolving nature of IIAs, other complexities tend to arise in

applying and interpreting agreements. Indeed, disputes may arise from these processes, and their outcome is often hard to predict.

That is why governments need to ensure that such difficulties are kept to a minimum. How? By including appropriate safeguards at the outset to clarify the range of special and differential rights and qualifications of obligations that developing country parties might enjoy. Moreover, the administrative burden arising from new commitments at the international level is likely to weigh disproportionately on developing countries, especially the least developed, because they often lack the human and financial resources needed to implement agreements. This underlines the importance of capacity-building technical cooperation—to help developing countries assess better various policy options before entering new agreements and in implementing the commitments made.

The overriding challenge for countries is to find a development-oriented balance when negotiating the objectives, content, structure and implementation of future IIAs at whatever level and in whatever context. In short: the development dimension has to be an integral part of international investment agreements—in support of policies to attract more FDI and to benefit more from it. ■

BOOK REVIEWS

Globalization and the Quality of Foreign Direct Investment

Nagesh Kumar

(Oxford and New York, Oxford University Press, 2002),
257 pages

In the globalizing world economy, transnational corporations (TNCs) and their foreign direct investment (FDI) play a key role. By now, almost all countries in the world acknowledge the potential benefits from inward FDI, but there is still limited understanding of what is required to realize the benefits. This is the starting point for Nagesh Kumar in *Globalization and the Quality of Foreign Direct Investment*. He underlines that developing countries need to refine their FDI strategies if they want not only to maximize investment inflows but also to maximize their developmental impact.

The publication marks the completion of a major research undertaking that was initiated at the United Nations University in 1994 in Maastricht and is divided into three main parts. The analysis draws on operations data on foreign affiliates of United States as well as Japanese TNCs up to the year of 1994. This allows the author to go beyond simple FDI data and look at factors related to sales, value added, exports, research and development (R&D) and other aspects of international production.

The quality dimension of FDI, according to Kumar, can be judged by looking at the extent of localization (value added) of the output of foreign affiliates; the industrial composition of foreign production, with more technology-intensive industries ranking the highest; the export-orientation of affiliates; and the R&D intensity of production by foreign affiliates.

In the first section, Kumar paints a broad picture with regard to the distribution of foreign affiliate sales, in general and by different industries. His analysis confirms previous studies in that host country factors attracting market-seeking FDI tend to dominate. Country size, income level and extent of urbanization all influence positively the level of foreign affiliate activity. It is also noted that export-oriented FDI generally tends to have a lower level of value added than market-seeking investment. Kumar concludes that greater openness of a country to imports attracts more export-oriented investment, but sometimes at a cost in terms of the “depth” of the FDI received.

In the analysis of the industrial distribution of foreign sales, the author explores whether the allocation of FDI tends to be more uneven in industries that are more desirable from the point of the industrialization of host countries. The underlying assumption here is that FDI in more knowledge-intensive industries generate more spillovers and other development benefits than FDI in less knowledge-intensive industries. Kumar concludes that FDI in the former type of industries is more concentrated and that the benefits of such investment has therefore benefited fewer countries. Unfortunately, the author does not clearly define what industries should be regarded as more knowledge-intensive, nor why the knowledge-intensity of the *industry* should be a defining factor. It is, for example, well known that, within all industries, there are more or less knowledge-intensive *activities*. Moreover, even if one accepts the premise that knowledge-intensive industries are desirable, his conclusion is still not straight-forward. For example, the chemicals and the electrical and electronics equipment industries – which are likely to be regarded as knowledge-intensive industries – display a relatively low level of concentration.

Kumar draws the important conclusion that countries need a certain level of technological capabilities to attract more sophisticated FDI. It is unrealistic to expect foreign companies to develop modern industries unless a threshold level of technological activity and absorptive capacity is present in a country. But once the process has started, TNCs may contribute to further it.

The second section of the book is devoted specifically to the export behaviour of foreign affiliates. An interesting and perhaps somewhat surprising finding is the diverging developments of United States and Japanese affiliates' export behaviour. Whereas the export propensity of foreign affiliates of United States TNCs declined significantly between 1977 and 1994, that of Japanese-owned affiliates rose markedly, mainly due to growing exports back to the home market. This may indicate that efficiency-seeking motives predominated in the Japanese case, whereas market-seeking reasons lay behind most of United States outward investment between 1977 and 1994, a finding that would support earlier research e.g. by Lael Brainard (1997). Interestingly, Kumar concludes that cheap labour is an important factor explaining production for exports to the home market, but not for exports the rest of the world. This finding may reflect that much of foreign affiliate exports to third countries actually takes place among developed countries participating in regional trading blocks, notably the European Community. The fact that third country exports are related to the quality of infrastructure and low levels of trade barriers lends additional support to this hypothesis.

The final part of the book deals with innovatory activities of foreign affiliates and related policy implications. Kumar documents the dominance of TNCs in the area of technology development and discusses the allocation of R&D. He finds that very few developing countries have offered the kind of environment that attracts R&D-related FDI. Using econometric analysis, he also notes that foreign affiliates in host countries with relatively large domestic markets or that are part of customs unions are more likely to undertake in-house R&D. In the model used, neither patent regimes nor the openness of the country are found to exert a significant impact on the R&D intensity of affiliates, however.

In synthesizing his findings, the author describes the dilemma facing developing countries wishing to attract and benefit from FDI. First, without a sizeable domestic market, a threshold level of technological capabilities and decent

infrastructure it is difficult to attract FDI in the first place. Second, to encourage foreign affiliates to deepen their activities in a country, Kumar argues that an element of protectionism is required. Third, however, such protectionism tends to discourage the influx of much desired export-oriented FDI. Fourth, restrictions and performance requirements may deter the inflow of desirable kinds of FDI, but have sometimes been found to improve certain “quality parameters” of inward FDI. Thus, defining the best policy is a difficult task involving sensitive trade-offs.

Finally, Kumar considers the role of the international community, especially with regard to the future treatment of performance requirements and incentives. Kumar makes the point that developing countries should have greater freedom in applying performance requirements to foster their development objectives related to inward FDI, and therefore advocates that the poorest countries should be allowed to apply local content and other performance requirements currently prohibited the Agreement on Trade-Related Investment Measures (“TRIMs Agreement”) of the World Trade Organization. On the issue of incentives, by contrast, the author favours more multilateral intervention. According to Kumar, developing countries should seek to strengthen the international disciplines on the use of investment incentives. Such an approach, he argues, is the only way to address the “prisoners dilemma” inherent in incentives-based competition.

This volume offers a wealth of data and represents a useful contribution to the debate on the development impact of FDI. One advantage is its use of operational data for foreign affiliates from two of the world’s most important home countries. The comparison between the United States and Japanese cases offers interesting insights, although the quality of data in the latter case can sometimes put the reliability of the results into question.

There is undoubtedly a need for additional analysis on how best to leverage the international investment by TNCs for development. For the poorest countries in the world, the message conveyed is that FDI is not likely offer a “quick fix” but can

contribute to their growth and development once a process of industrialization has begun. Moreover, locational advantages are not created through excessive use of fiscal and financial incentives but through deliberate efforts by governments and other domestic actors to strengthen local capabilities and technological assets.

In some parts, conclusions drawn appear to have relatively fragile support in the data used. For example, analyzing the export propensities of affiliates, Kumar argues that China, Indonesia, Malaysia and Thailand by 1993-1994 had replaced Hong Kong (China), Taiwan Province of China, the Republic of Korea and Singapore as the most important hosts for export-oriented FDI in Asia. Had he considered the absolute values of affiliate exports, he would most likely have reached a different conclusion. In 1994, for example, the four Asian Tigers accounted for \$39 billion of exports from United States-owned affiliates as compared to \$13 billion from the other four countries mentioned.

The analysis would also have gained from more emphasis on the role of FDI in services. The econometric models used deal entirely with foreign affiliates in manufacturing, despite the fact that in the mid 1990s manufacturing accounted for less than a third of the total sales of Japanese foreign affiliates and less than half of those of United States-owned foreign affiliates. The emphasis of manufacturing is a common feature of FDI-related research and there is a need to expand our understanding of the role and development implications of FDI in the services sector. The *World Investment Report 2004* will seek to contribute in this regard.

It would furthermore have been interesting to see more analysis related to the underlying motives of foreign investors. For example, a characterization of industries not only on the basis of knowledge-intensity but also related to the predominance of market-seeking vs. efficiency-seeking investments or between vertical and horizontal integration of TNCs in these industries would have helped the reader to interpret the findings.

Kumar provides, sometimes a bit provocatively, useful information to researchers and policy-makers that should help improve our understanding of the role of TNCs in the development process. It also sheds new light on the difficult trade-offs countries face when designing their policies to attract quality FDI.

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The Multinational Firm: Organizing Across Institutional and National Divides

Glenn Morgan, Peer Hull Kristensen and Richard Whitley
(Oxford and New York, Oxford University Press, 2001),
321 pages

The book endeavours to enhance our understanding of transnational corporations (TNCs), more specifically the internationalization of firms in the age of globalization. It contrasts TNCs with “non-international firms” in an effort to understand the complex decision-making processes in the former. The focus is on the organizational aspects of international operations and activities. The most valuable perspective is perhaps that the editors do not believe in a single model for global firms but emphasize that there are several divergent models of managing TNCs in different parts of the world due to different national/market environments and contexts.

Part I, entitled “Convergence and Divergence in the Visible Hand of International Management”, sets the scene. In chapter two, Richard Whitley identifies the challenges of coordination and management TNCs face as opposed to those of non-international firms. The challenges for TNCs arise from the fact that TNCs, by definition, comprise foreign affiliates with different national characteristics. He stresses that even a strongly cohesive and integrated firm may become complex and diversified due to its international operations. Chapter three by Christel Lane provides an excellent account of German TNCs and presents empirical evidence to show how they have become increasingly global and how this globalization is influencing German managers and their perspectives. It explains the impact of the experience and knowledge German TNCs are gaining from their international operations on their business practices. The author concludes that this process of learning will result in “hybridization” of German firms and predicts that in time this

will change the pattern of German business systems. In chapter four, Eli Moen and Kari Lilja explain how national management systems in the Nordic countries are changing towards global systems. Although new “global” managerial practices are spreading among Nordic TNCs, the authors argue that more traditional Nordic management systems can still be traced in those TNCs that are apparently converging towards a global norm. The authors cite examples from the forest industry in Finland and conclude that, although TNCs dominate European paper and pulp industry, strategic positioning still depends on the country of their origin.

Part II of the book is entitled “Constructing and Deconstructing the Visible Hand”. This part brings together examples from different industries: electric engineering (chapter five), capital markets (chapter six), engineering firms from the United Kingdom operating abroad (chapter seven), and finally, Japanese firms operating in the United Kingdom (chapter eight). These chapters provide convincing evidence that local conditions in different markets are influencing the management system of these TNCs.

Part III is entitled “Changing National and International Economic Orders: Constructing and Reconstructing Systems of Economic Organization and Regulation”. Chapter nine analyses how emerging transnational regulatory standards and regulations are influencing management systems of TNCs. In chapter ten, Marie-Laure Djelic and Jabril Bensedrine describe how globalization is influencing TNCs and thus complicating the making of international regulations. Chapter eleven by Dieter Plehwe identifies three main factors that are shaping the business environment in Europe today: national trajectories, international competition and transnational governance. The author discusses the interaction of these three factors and the way they are influencing company strategies.

This is a very valuable volume for those who wish to understand globalization and TNCs. It has a clear message to those who believe that markets and firms are converging towards

a single “global” form of markets or firms; evidence is contrary to such a proposition. This volume differs from other books on this topic in that it focuses on the organizational aspects of international operations and contrasts “national” versus “global” management systems. The book is a must read for all scholars and researchers on international management as well as for those who are interested in understanding the impact of globalization on company strategies.

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Manchester School of Management
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United Kingdom

JUST PUBLISHED

Foreign Direct Investment and Performance Requirements: New Evidence from Selected Countries

(Sales No. E.03.II.D.32)(\$35)

The continuous globalization of the world economy poses new challenges for the governance of economic activities. Investment and trade liberalization have provided greater freedom to TNCs to organize their production activities across borders in accordance with their own corporate strategies and the competitive advantages of host-countries. Countries today view inward FDI as an important means of integrating their economies with international markets and expect it to contribute to their economic development. Nonetheless, openness alone is not always sufficient for the expected benefits to materialize. In order to narrow the gap between the objectives of host countries and TNCs, governments use a variety of policy measures. Performance requirements can be an important policy tool in this context, to enhance the benefits of, and address concerns related to, inward FDI. Their role in policy-making is still controversial, however. Many developing countries seek to preserve their right to utilize them, arguing that they should have the right to use tools that were available to developed countries when they were industrializing their economies. Developed countries, on the other hand, tend to associate performance requirements with interventionist strategies of the past and question their effectiveness. The present volume is meant to contribute to the debate on performance requirements by bringing new empirical evidence to bear on the subject. To this end, the volume presents four developing country case studies and a review of the experience of developed countries. The focus of the analysis is on performance requirements that are not prohibited by the WTO Agreement on Trade-Related Investment Measures, but may be addressed in various agreements at the bilateral or regional levels.

***An Investment Guide to Cambodia:
Opportunities and Conditions***

Co-published with the International Chamber of Commerce

(UNCTAD/IIA/2003/6), free of charge

An Investment Guide to Cambodia provides an objective overview of investment opportunities and conditions in Cambodia to potential foreign investors. After an executive summary, the *Guide* contains a chapter on the operating environment (which deals with such matters as infrastructure, human resources and taxation), one on opportunities (which highlight, among other things, those in agriculture and fisheries, tourism and export-oriented industries) and one on the FDI regulatory framework. It also includes a brief chapter summarizing the perceptions of investors, both foreign and domestic, already in the country. The appendices provide pointers to sources of further information, including a list of 60 major foreign investors. Wherever possible, the guide provides comparative indicators for the South-East Asian region: income, education, wages in certain industries etc. *An Investment Guide to Cambodia* is the sixth concrete product of a collaborative venture between UNCTAD and the International Chamber of Commerce (ICC), aimed at bringing together two parties with complementary interests: firms that seek new locations and countries that seek new investors. This *Guide* is a particularly useful tool for all potential investors looking for both basic and more advanced information on Cambodia.

FDI in Landlocked Developing Countries at Glance

(UNCTAD/ITE/IIA/2003/5)

The 30 developing countries classified landlocked by the United Nations perform poorly as hosts of FDI. Their combined inward FDI flows in 2001 amounted to just \$6 billion, accounting for

less than 1% of the total world flows that years. This booklet aims to contribute towards supporting them in developing and implementing appropriate FDI strategies and policy frameworks by providing enhanced information on favourable investment opportunities and thus encouraging increased FDI flows to landlocked developing countries. The booklet is divided into two parts. The first one describes recent trends in FDI to landlocked developing countries, and the changes that have taken place in relevant areas of the regulatory framework. The second part presents the 30 country profiles to provide the reader – at a glance – with a general picture of the role of FDI in these countries. A limited number of copies are available free of charge upon request.

Examen de la politique de l'investissement de l'Algérie
(Forthcoming)

Over the past few years, FDI flows to Algeria have increased, benefiting from macroeconomic stabilization and economic liberalization. The investment code of 1993 – updated in 2001 by the *Ordonnance 2001* – and the creation of an investment promotion agency improved the national investment environment. As a result, by 2002 Algeria became the third largest host country in Africa. However, FDI is highly concentrated in a handful of industries such as oil, steel, chemicals, pharmaceuticals and telecommunications. Moreover, the downstream effects of FDI in terms of job creation and technology transfer have been limited. This *Investment Policy Review of Algeria*, published in French (to be translated later on into English), identifies industries such as agro-business, information technologies and electronics in which additional FDI could be attracted. It also provides recommendations on how to modernize the legal and institutional framework for investment. It suggests proactive investment strategies (both at the national and industry level) and the strengthening of the local private sector, especially small and medium-sized enterprises. It also advocates a reinforced dialogue between the private and the public sectors and the creation of linkages between foreign affiliates and local suppliers.

Incentives

UNCTAD Series on Issues in International Investment Agreements

(Forthcoming)

Incentives are frequently used as a policy instrument to attract FDI and to benefit more from it. They can be classified as financial, fiscal or other (including regulatory) incentives. The issue of incentives is a relatively new phenomenon in international investment agreements. The only multilateral agreement to control certain incentives is the World Trade Organization's Agreement on Subsidies and Countervailing Measures, covering trade-related subsidies and trade-distorting investment subsidies including investment incentives. Issues that most frequently arise in the context of international agreements are the definition of "incentives", the application of the non-discrimination principle to regulate incentives (including the conditioning of incentives to performance requirements), transparency in relation to incentives policies, addressing incentives competition by limiting the lowering of regulatory standards or by establishing international control and consultation mechanisms with regard to the granting of incentives, and the encouragement of development-oriented incentives both on the part of host and home countries.

Transparency

UNCTAD Series on Issues in International Investment Agreements

(Forthcoming)

The aim of this study is to examine how transparency issues have been addressed in international investment agreements and other relevant instruments dealing with international investment. It identifies, in section I, some of the main issues that influence State and corporate approaches to the question of transparency

in international investment relations. The study takes a novel approach and addresses the nature and extent of transparency obligations as they apply to all three participants in the investment relationship – the home country, the host country and the foreign investor. Section II reviews the various ways in which transparency requirements are addressed in international investment agreements, focussing on the key issues identified in section I. Section III highlights points of interaction between transparency, on the one hand, and other general issues addressed in international investment agreements (i.e. those covered in other papers of this Series), on the other. Finally, in the conclusion, the paper briefly examines the significance of different approaches to transparency for economic development in individual countries and considers the various options open to negotiators when drafting transparency provisions, the most basic choice being whether to include or to exclude provisions on this subject.

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Books on FDI and TNCs received since August 2003

Dutta, Soumitra, Bruno Lanvin and Fiona Paua, eds., *The Global Information Technology Report 2003-2004: Towards an Equitable Information Society* (New York and Oxford: Oxford University Press, 2004), 308 pages.

Invest in Sweden Agency, *Med utländska flaggor i top och konjunkturen i botten: Hur gar det för Sverige? [With Foreign Flags Up and the Business Cycle Down, What Is Up for Sweden?]* (Stockholm: Invest in Sweden Agency, 2003), 152 pages.

Musat and Asociatii, *Doing Business in Romania 2003* (Bucharest: Musat and Asociatii, 2003), 5th edition, 279 pages.

Shenkar, Oded and Yadong Luo, *International Business* (New York: John Wiley & Sons, 2004), 748 pages + GeoDiscoveries CD-ROM.

Tiits, Marek, Rainer Kattel, Tarmo Kalvet and Rein Kaarli, *Competitiveness and Future Outlooks of the Estonian Economy: R&D and Innovation Policy Review* (Tallinn: Research and Development Council, 2003), 72 pages.



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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.

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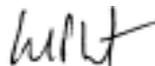
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