UNCTAD/UNDP
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNITED NATIONS DEVELOPMENT PROGRAMME

OCCASIONAL PAPER

FOREIGN DIRECT INVESTMENT (FDI) AND THE PROMOTION OF SUSTAINABLE HUMAN DEVELOPMENT

A contribution by
United Nations Economic Commission for
Latin American and the Caribbean (UNECLAC)

UNCTAD/EDM/Misc.74
3-5 February 1999

This background paper was prepared for the the first meeting of experts on "Conceptual and Operational Framework for the analysis of the integration of developing countries into the global economy in a manner supportive of Sustainable Human Development", held in Geneva from February 3 to 5, 1999.

This meeting was organized under UNCTAD/UNDP Global Programme on "Globalization, Liberalization and Sustainable Human Development".

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I. THE CHARACTERISTICS OF FDI IN LATIN AMERICA

1. As the 20th century nears its end, foreign direct investment (FDI), which reflects the international expansion of transnational firms, has become one of the most important components in the globalization process of the international economy. During the 1990s, FDI flows around the world have grown substantially, rising from an annual average of 245 billion dollars between 1991 and 1996 to around 400 billion in 1997 (UNCTAD, 1998). Thus, transnational companies have steadily increased their presence in most national economies, in both developed and developing countries.

2. A significant development in recent years has been the growing proportion of FDI going to developing countries, with their share of total flows standing at 38% in 1997. In that year, the greatest changes were seen in the distribution of world FDI flows between developing countries. Latin America and the Caribbean experienced strong growth, increasing their share of these flows to 44%, whereas the developing countries of Asia, although they retained their leading position （53% of developing country FDI receipts） were stagnant in relative terms, while Africa saw a sharp fall. The information available for 1998, although incomplete, shows that this trend has continued (ECLAC, 1998a). Thus, it would appear that the acute financial crisis that has arisen in Asia has helped the position of Latin America as a recipient of FDI flows. Recent events in Brazil, however, could have an adverse effect on the expectations that foreign investors have about the region.

3. In recent years, the growth seen in FDI flows into Latin America and the Caribbean has been very substantial, with a rise from 33 billion to 65 billion dollars between 1995 and 1998. This extraordinary growth means that 55% of the FDI stock existing in 1998 had accrued within the previous eight years. Thus, the stock of FDI in Latin America has largely come into being during the 1990s, which suggests there is a need to interpret the characteristics of this phenomenon afresh.

- FDI flows into the region have been **largely confined to a small group of countries**, basically Brazil, Mexico, Argentina, Chile, Colombia and Venezuela. These six economies, together with Peru, received 97% of flows going to the LAIA countries, which account for 90% of the total. The countries of Central America and the Caribbean, for their part, receive between them around 10% of total regional FDI flows.

- In 1996 **Brazil** overtook Mexico to recover its position as the **main recipient of FDI** in Latin America and the Caribbean. It has since retained this position, and in 1998 it was the country of destination for more than 40% of the FDI going to LAIA countries.

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Historically, foreign investment in the region has concentrated on manufacturing activities to supply highly protected domestic markets. As regional economies hae been opened up and liberalized, **non-tradable service activities** (telecommunications, energy, transport, banking, etc.) have taken on greater importance within the massive FDI flows now being seen. Also of growing significance are activities relating to the **exploitation of natural resources** that were formerly under State control (mining and hydrocarbons). In the case of **manufacturing**, FDI has been mainly confined to countries with large domestic markets (Brazil, Mexico and Argentina) or countries that serve as export platforms (Mexico and the countries of the Caribbean Basin).

- The **United States** is the main source of FDI flows into Latin America (ECLAC, 1998a). Recently, however, investment from **Europe**, chiefly Spain and the United Kingdom, has grown strongly. European investors have been particularly active as participants in privatizations of State enterprises in the energy and telecommunications sectors, and as buyers of local private banks (Calderón and Vodusek, 1998). Finally, the dearth of Asian investors in the region, and particularly of **Japanese** ones, is striking.

- The **purchase of existing assets** has been the method most commonly used by foreign investors in the region. At the beginning of the 1990s this mainly took place through the **privatization** of State enterprises, while more recently there has been an upsurge in **acquisitions** of private local companies. In 1997, FDI associated with the purchase of fixed assets in the private sector slightly exceeded purchases of State assets; the latter, however, saw greater relative growth, particularly in Brazil and Colombia, whose privatization programmes are at their height. The result was that, in that year, the three main forms of FDI in the region (acquisitions of private assets, privatizations and investments in new assets) stood at similar levels (ECLAC, 1998a).

- Between 1994 and 1997, **foreign companies increased their relative weight among the 500 largest companies in the region**, with their share in the total sales of this group rising from 29% to 33%. In 1997 they were largely confined to just three countries (88%), Brazil, Mexico and Argentina, and to just six areas of economic activity (84%): the motor industry (26%), foods, drinks and tobacco (19%), trading (11%), electronics (10%), petroleum (9%) and the chemicals industry (9%). Around 50% of these foreign firms are of United States origin, while 38% are from member countries of the European Union (ECLAC, 1998a).

1. DETERMINANTS OF FDI AND BUSINESS STRATEGIES

4. In interpreting the FDI phenomenon, ECLAC has sought to look beyond the determinants that are traditionally focused on (market size, output growth, regulatory framework, macroeconomic situation, patterns of competition, etc.) in order to take better account of the profound changes that have been occurring in the international economy[1]. At present, FDI flows, and thus the strategies of transnational companies, are the outcome of a combination of three sets of factors: the international environment, national policies (of both FDI recipient countries and countries of origin) and the strategies of business concerns (ECLAC, 1998a).

- As the globalization process has advanced, it has altered the structure of the international market, the nature of those competing in it, technological requirements, and international rules and regulations in the areas of trade, investment and intellectual property. Thus, companies doing business in the region, as well as new entrants, have found themselves faced with a new competition situation which has altered the structure, quality and scale of investments in Latin America and the Caribbean.

- The new national policies, and the results of these (macroeconomic stabilization, the opening up of trade and finance, economic deregulation, large-scale privatization programmes, the liberalization of regulations applying to private investments and the regional integration processes) have substantially changed the business environment in Latin America and the Caribbean, providing an incentive for investment decisions both by companies already operating in the region (whether domestic or international) and by new entrants.

- Transnational companies have adapted to this changed environment and have implemented new strategies in order to take advantage of trends in the international market and in national policies. Thus, to a greater or lesser degree, these companies have begun to establish production systems that are integrated at the international, regional and subregional levels, into which they have gradually been incorporating some Latin American and Caribbean economies.

5. The new patterns of competition produced by financial and trade liberalization have awoken the interest of new entrants and obliged transnational companies already operating in the region to rethink their strategies. Of **companies with an existing presence in Latin America**, some have ***withdrawn*** (opting to supply local markets through exports) or sought to defend or increase their market share by ***rationalizing*** their operations (mainly by using strategies of a defensive nature to protect themselves against imports) or ***restructuring*** their activities by making new investments that take into account the changed national, subregional (in the case of NAFTA and Mercosur) and international environment. It is thus possible to identify two strategies, basically in manufacturing activities, which relate to:

- the **quest for efficiency** in the integrated international production systems of transnational companies, and
- the quest for national and subregional **market access**.

6. As a result of deregulation in Latin American economies, new investment opportunities have opened up in sectors where private enterprise in general, and foreign companies in particular, were formerly subject to restrictions; so much so that there has been a large influx of **new entrants** in extraction activities (mining and hydrocarbons) and services (finance, energy and telecommunications). Thus, we can identify another two basic strategies adopted by foreign investors in the region:

- the quest for **raw materials**, and
- the quest for **access to domestic markets** in **services** sectors.

7. **The first of these stylized strategies** has been implemented most forcefully in the case of **Mexico**, chiefly in the motor vehicle, vehicle components, computer, electronics and garment subsectors. This is because, in response to the "Asian challenge" in the United States market, the three largest vehicle makers in the United States (General Motors, Ford and Chrysler, as it was before being bought by the German company Daimler-Benz), and some from elsewhere (Volkswagen and Nissan), have taken steps to improve their production efficiency, investing in Mexico in new plants with leading edge machinery and technology. In the same way, foreign companies (from the United States and, to a lesser extent, from Asia) have capitalized on the advantages of NAFTA and the inbond assembly plant programme by investing in Mexico in order to export to the North American market, concentrating particularly on the production of electronic goods (televisions, computers, sound systems and telecommunications equipment, etc.) and garments.

8. Just as in the case of Mexico, many U.S. companies have capitalized on the advantages offered by export processing zones (inbond assembly plants), low wages and U.S. tariff preferences by investing or forming partnerships with local businesses in **Caribbean Basin countries** (Costa Rica, the Dominican Republic, El Salvador, Honduras and Guatemala) with the aim of improving their competitiveness in the North American market. In the case of the Central American and

Caribbean countries, the response to the "Asian challenge" has centred chiefly upon the garment and electrical and electronic equipment sectors.

9. Of particular importance in the **second approach**, where manufacturing activities are concerned, are rationalization and modernization strategies whose aim is to penetrate, defend or secure a greater share in a national, or perhaps subregional, market. In the case of **Argentina** and **Brazil**, and by extension **Mercosur**, foreign companies with a presence in these markets have been obliged to reformulate their strategies in the face of the new patterns of competition resulting from the opening up of these economies. In general, such companies have sought to maintain and expand their presence in these countries by producing essentially for local markets, but in sufficient quantities to compete with imports. Thus, there have been major investments in the motor vehicle and food subsectors and in the chemical and machinery industries. In the case of the motor industry in Mercosur, the companies with a large presence (Fiat, Volkswagen, Ford and General Motors) are investing to defend their market position and meet growing demand, especially for compact or "popular" cars. Again, a large number of firms are looking to enter (or return to) the subregion (Chrysler, Renault, Peugeot, BMW, Mercedes Benz, Honda, Asia Motors and Hyundai), in search of new "market niches" (ECLAC, 1998a).

10. Meanwhile, a large group of transnational firms with a long history in the region have adopted a different strategy for achieving better positioning in revitalized regional markets. Especially in the countries of Mercosur and other important markets such as Mexico and Venezuela, the biggest foreign companies in the food, drinks and tobacco sectors have been trying to eliminate competition and consolidate their position in these markets by buying local assets on a massive scale.

11. **The third strategy** identified has emerged as a result of reforms enabling foreign capital to participate in prospecting for, extracting and processing natural resources. The first country to attract strong interest from the biggest transnational companies was **Chile**, after it had provided extensive guarantees and unrestricted access to **mining resources**. Since then, during the 1990s, other countries such as Argentina, Bolivia and Peru have adopted similar policies, and major new investments have been made in mining. Another important development is the progressive liberalization of the **hydrocarbons** subsector (under State control until a few years ago) which has enabled international investors to establish a growing presence in activities linked to prospecting, extraction, processing, distribution and marketing of petroleum, natural gas and derivatives of these, liberalization being achieved by auctioning off secondary reserves, creating joint ventures in certain key activities and, in some cases, completely privatizing the subsector. The most noteworthy cases in the region are **Venezuela, Colombia,** Argentina, Peru and Bolivia.

12. **Finally**, far-reaching liberalization of the **services sectors** in Latin America and the Caribbean has led to these activities accounting for a more and more substantial proportion of FDI receipts in most of the countries. Foreign investors, many of them newcomers, have secured substantial and growing shares of the finance, energy (electricity generation and distribution and

natural gas distribution) and telecommunications subsectors. In the case of the **financial subsector**, particular mention should be made of the vigorous acquisition strategy being pursued by certain Spanish (Santander and BBV), British (HSBC) and Canadian (Nova Scotia) banks. As a result of the privatization of public **electricity** generation and distribution companies, a new set of foreign investors have positioned themselves in the Latin American energy sector, the most prominent firms being Chilean (Enersis) and Spanish (Endesa), together with a number of pioneering companies of United States origin (AES Corp)[1] (ECLAC, 1998a). **Telecommunications** firms are among the companies most prized by foreign investors. Since the end of the 1980s the main State telecommunications firms in Argentina, Bolivia, Chile, Mexico, Peru, Venezuela and, recently, Brazil (Telebras), have passed into private hands, and cellular telephony has been put out to franchise. The most active companies in this new environment have been Telefónica of Spain in fixed telephony (local and long distance calls) and BellSouth of the United States in mobile telephony.

FOCAL POINTS FOR FDI IN LATIN AMERICA AND THE CARIBBEAN

Corporate strategy / **Sector**	**Quest for efficiency**	**Quest for raw materials**	**Quest for market access (national or regional)**
Primary		**Petroleum/gas:** Venezuela, Colombia and Argentina **Minerals:** Chile, Argentina and Peru	
Manufactures	**Motor vehicles:** Mexico **Electronics:** Mexico and Caribbean Basin **Garments:** Caribbean Basin and Mexico		**Motor vehicles:** Mercosur **Agribusiness:** Argentina, Brazil and Mexico **Chemicals:** Brazil **Cement:** Colombia, Dominican Rep. and Venezuela
Services			**Finance:** Brazil, Mexico, Chile, Argentina, Venezuela, Colombia and Peru **Telecommunications:** Brazil, Argentina, Chile and Peru **Electricity:** Colombia, Brazil, Argentina and Central America **Gas distribution:** Argentina, Brazil, Chile and Colombia

Source: ECLAC, on the basis of official information.

13. To sum up, by way of four basic strategies transnational firms have furthered the integration of Latin American and Caribbean countries into the international economy, overcoming the

1 The main target of this ambitious purchasing strategy and these large-scale investment plans is the Brazilian market, which has an energy deficit. A strong link is emerging between transport and natural gas distribution megaprojects and electrical power generation in Brazil.

difficulties raised by internal transformations and the repercussions of external upheavals. Thus, a number of Latin American countries are beginning to form part of the integrated production systems of the biggest transnational companies which, under the stimulus of the new regional situation, are implementing new investments or restructuring old ones.

2. CONTRIBUTION OF FDI TO GROWTH, COMPETITIVENESS AND EMPLOYMENT IN THE RECIPIENT COUNTRY

14. While the biggest countries in the region are also the largest recipients of FDI, when FDI receipts are measured in relation to the size of the economy (stock of FDI in relation to GDP) the situation looks rather different. The contribution of FDI to **growth** in an economy appears to be more decisive in certain smaller countries. From this point of view, Chile heads the list with a stock of FDI equivalent to almost 27% of its GDP, followed by Mexico with some 21%, while for Peru, Brazil, Colombia and Venezuela this percentage stands at around 14% (Calderón and Vodusek, 1998).

15. Again, for many of the region's smaller economies FDI can have substantial effects, even if what they receive on this basis is modest in comparison with other countries. In fact, during the first half of the decade the scale of FDI increased in several of these countries, suggesting that the level of FDI dispersal in the region has increased in relative terms.

- Between 1992 and 1996 FDI flows were of great importance for gross fixed capital formation in a number of countries, particularly Trinidad and Tobago (45%), Bolivia (23%), Costa Rica (19%) and Peru (16%) (UNCTAD, 1998).

- In 1995, the stock of FDI as a percentage of GDP was substantial in Trinidad and Tobago (77%), Costa Rica (36%), Jamaica (35%), Bolivia (29%) and Chile (27%) (UNCTAD, 1998).

- In per capita terms, the largest stock of FDI in the region is that of Trinidad and Tobago, followed by Chile and Costa Rica (Calderón and Vodusek, 1998).

16. Thus, for medium-sized and small countries （Chile, Costa Rica and Trinidad and Tobago） the presence of foreign capital has a major impact on economic performance. A pronounced feature of these cases is that FDI is confined almost exclusively to a few activities and companies, most of them involving the export of natural resources. In Costa Rica, especially in recent years, this situation has changed as a result of the strong impetus provided by export processing zones.

17. The recent massive inflow of FDI into Latin America and the Caribbean （especially to the larger economies） has helped **relieve the severe balance of payments pressures** experienced by many of the region's economies at the beginning of this decade. In most cases, the economic authorities have looked to FDI as a relatively stable source of financing to cover external deficits and as a mechanism for modernizing the goods and services production system, thereby improving

productivity and international competitiveness.

18. In the first case, the privatization programmes implemented in most of the economies of the region have provided governments with additional revenue that has helped to finance the structural reform process by reducing external tensions. In the first half of the 1990s, it was mainly through privatization of State assets that FDI came into the countries. This has proved to be the case in Argentina, Peru, Venezuela and, more recently, Colombia and Brazil. FDI through privatizations, although it does not increase the production capacity of the recipient country, at least in the first instance, has led to improvements in the quality of services (mainly power generation and distribution, transportation and telecommunications), which has had a positive effect on the systemic competitiveness of recipient countries.

19. In terms of **international competitiveness** (essentially in manufacturing) at least three very different situations have arisen:

i) The industries that have had the best export performance in the region are generally to be found in **Mexico**. The leading exporters are the motor vehicle and electronics industries, which were created under the import substitution industrialization model, and have since undergone far-reaching restructuring that has considerably improved their international competitiveness. Although the percentage of local content has fallen, which makes them import-intensive, the introduction of leading edge technology, the creation of some incipient technological clusters and the remarkable growth of exports seem to provide strong justification for these changes.

ii) The export processing zones of the **Caribbean Basin and Mexico** have also performed well, especially in terms of exports. However, "incentive wars" and low wages must make the overall verdict a more cautious one.

iii) Finally, the large investments that have gone into restructuring many of the foreign companies with a long-established presence in the **Mercosur** countries (Argentina and Brazil) and the arrival of new entrants as a result of the changed competition situation (due to the opening up of these economies) have considerably increased the export potential of these industries. Although the companies concerned are mainly interested in supplying domestic markets, the need to compete with imports has led to their becoming much more competitive producers in international terms.

20. Generally speaking, the contribution of FDI to the creation of **employment** has been modest. On the one hand, new investments in manufacturing production are highly capital-intensive. This is true both of investments made to produce goods for export (Mexico) and those whose purpose is to supply large domestic markets (Brazil and Argentina). Although investments made in the inbond assembly plants of Mexico and the Caribbean Basin generate a lot of jobs, their performance is unsatisfactory as far as wages are concerned. Low wages are, in fact, one of the main competitive

advantages of the countries that carry out this type of production for export. In the case of services, most of which were formerly provided by the State, restructuring and modernization subsequent to privatization have had adverse effects on employment. In most cases, staffing levels have been reduced considerably.

3. Measures to promote FDI in the less developed countries of Latin America and the Caribbean

21. It is clear that the globalization process is playing a central role in attracting FDI. A process of international competition and transnationalization is going on, and for small economies this has manifested itself in the form of very substantial structural change. In their efforts to move away from the form of economic development associated for more than a century with **primary export enclaves** (sugar, bananas, coffee), many of them have attempted to implement import substitution industrialization (**ISI**), only to come up quite quickly against internal and external limitations. This has led to new forms of economic organization arising, the most important being the **inbond assembly industry** (assembly of products in export processing zones) and tourism. Foreign companies have played a very important role at the enclave economy and ISI stages, and in the process of opening up economies to capitalize on these "new" comparative advantages.

22. Despite the greater diversification now being seen, most of the small economies in the region still have poor linkage and are very vulnerable. Contrary to the situation in medium-sized and large economies, **ISI has not proved to be an effective way** of improving sectoral linkage or reducing external vulnerability.

- the economies of the countries concerned are simply not big enough for them to function efficiently and competitively in the international market.
- the way transnational companies adapted to ISI policies was inefficient and their contribution in terms of international competitiveness was small.

23. Since the crisis of the 1980s, some of these economies have achieved a new and different kind of industrial dynamism through **export processing zones**. There has been a high degree of specialization in the assembly of garments for the United States market, and this has manifested itself in the form of substantial increases in export values and volumes and in the market share achieved in that country. In this way, great improvements have been brought about in the manufacturing export specialization and international competitiveness of countries such as the Dominican Republic and Costa Rica (Mortimore and Zamora, 1998; Vicens, Martínez and Mortimore, 1998).

24. FDI has played a major role in this new state of affairs, most of it being provided by new entrants. Rather than being the result of new national policies, generally speaking the rise of **inbond assembly schemes reflects a major change in the corporate strategies of United States firms** in sectors where there is intense competitive pressure in the domestic market because of imports from Asian countries. To compete better in their own market, many United States firms have established assembly activities, taking advantage of the incentives and low wages offered by the recipient countries and the facilities provided by the United States government (ECLAC, 1998a).

25. Within the new constraints on what can be achieved with national industrial policies, countries like the Dominican Republic and Costa Rica have had a degree of success in creating **clusters** of inter-related activities in the garment and other industries. They have also been able to stimulate some more technology-intensive activities. A key function of any industrial competitiveness policy at the present time is to guide foreign investors towards the creation of more and more sophisticated clusters. Notwithstanding the successes achieved by inbond assembly plant schemes in some countries, these are faced with a number of **challenges and dangers.**

26. These styles of industrialization are **uninclusive** and have few knock-on effects in the economy of the recipient country as a whole. The counterpart of higher exports is often lower value added in the country.

27. Some analysts maintain that the price paid by way of incentives has been too high and that the **"incentive war"** has benefited transnational companies without necessarily carrying forward the industrialization process (Mortimore and Peres, 1998). Furthermore, there are limits on the amount of incentives that small countries can give, after which it is impossible for them to carry on competing as they do not have the financial resources to match the subsidies of developed countries or larger economies. Again, as international trade rules come to be applied more evenly, and as progress is made with regional integration, countries become less able to attract investments by offering special preferences.

28. **Industrial success has proved fragile**, with countries such as the Dominican Republic and Costa Rica losing international competitiveness to Mexico (due to the advantages of NAFTA) and other Central American countries (because of their lower wages).

29. Once the time limits of the Multifibre Arrangement have expired, **the market will be opened up to greater competition**, which will force Latin American producers to diversify their exports and stop concentrating on those markets where they enjoy temporary preferences.

30. At present, there is increasing convergence between most Latin American and Caribbean countries in the way foreign investment is regulated, and as a result the advantages provided by favourable legislation are being rapidly eroded. The countries of the region have responded to this situation by resorting to other instruments whereby they can differentiate themselves and cope better with strong international competition for investment. This is what underlies efforts by the countries to improve and promote their "image", basically by creating factors favourable to production (level of education, infrastructure and certain incentives). Thus, in the long run the only way of sustaining investment flows is to ensure that the right factors are in place. In view of this, we can suggest some policy approaches for smaller recipient countries in the region.

30. In the **short and medium terms**, these countries should **take maximum advantage of benefits and preferences** while these still apply, and particularly the Multifibre Arrangement. At the same time, however, they should not discard the option of lobbying the United States

government to try and secure the same conditions as have been obtained by Mexico under NAFTA.

31. To sustain **long-term** policies for attracting FDI, foreign investment policies need to be **combined in an effective way** with competitiveness policies.

32. Small open economies should not waste resources on incentive wars. Policy should be focused on **promoting clusters**, which might even mean **identifying and attracting specific transnational firms**. To achieve this, it is vital to have more knowledge and a better appreciation of what is happening with specific agents. A particularly successful example of this is provided by the case of Costa Rica and the microprocessor company Intel.

33. Finally, and especially where small economies are concerned, it will always be beneficial to carry on **improving** the regulatory regime applying **internationally**, or at least within integration groups, to competition for investment. To this end, ECLAC is working with the Investment Negotiating Group of the Free Trade Area of the Americas (FTAA), to ensure that these issues are included in discussions.

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1... According to some econometric studies, these factors, which are essentially macroeconomic, account for around 50% of FDI flows into the region. The supposition must be, then, that the other 50% can be attributed to additional factors of a meso- and microeconomic kind which, being essentially of a qualitative nature （as the strategies of transnational companies are, for example） merit research. This research is currently being carried out by the Unit on Investment and Corporate Strategies of ECLAC (ECLAC, 1998b).