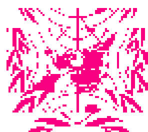
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

FOREIGN DIRECT INVESTMENT AND DEVELOPMENT

UNCTAD Series
on issues in international investment agreements



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NOTE

UNCTAD serves as the focal point within the United Nations Secretariat for all matters related to foreign direct investment and transnational corporations. In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975-1992) and the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992-1993). In 1993, the Programme was transferred to the United Nations Conference on Trade and Development. UNCTAD seeks to further the understanding of the nature of transnational corporations and their contribution to development and to create an enabling environment for international investment and enterprise development. UNCTAD's work is carried out through intergovernmental deliberations, research and analysis, technical assistance activities, seminars, workshops and conferences.

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The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

A blank in a table indicates that the item is not applicable;

A slash (/) between dates representing years, e.g. 1994/95, indicates a financial year;

Use of a hyphen (-) between dates representing years, e.g. 1994-1995, signifies the full period involved, including the beginning and end years.

Reference to "dollars" ($) means United States dollars, unless otherwise indicated.

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Details and percentages in tables do not necessarily add to totals because of rounding.

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IIA Issues Paper Series

The main purpose of the UNCTAD Series on issues in international investment agreements is to address key concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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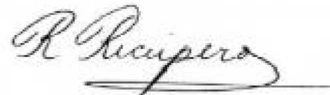
Preface

The United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on a possible multilateral framework on investment, with a view towards assisting developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces capacity-building seminars, regional symposia, training courses, dialogues between negotiators and groups of civil society and the preparation of a series of issues papers.

This paper is part of this series. It is addressed to government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The series is produced by a team led by Karl P. Sauvant and Pedro Roffe, and including Victoria Aranda, Anna Joubin-Bret, John Gara, Assad Omer, Jörg Weber and Ruvan de Alwis, under the overall direction of Lynn K. Mytelka; its principal advisors are Arghyrios A. Fatouros, Thomas L. Brewer and Sanjaya Lall. The present paper benefitted from inputs by Manuel R. Agosin. It also reflects comments received from John H. Dunning, Persa Economou, Dieter Ernst, Fabio Fiallo, Padma Mallampally and Zbigniew Zimny. The production of the paper was carried out by Hélène Dufays. It was desktop published by Teresita Sabico.

Funds for UNCTAD's work programme on a possible multilateral framework on investment have so far been received from Australia, Brazil, Canada, the Netherlands, Norway, Switzerland, the United Kingdom and the European Commission. Countries such as India, Morocco and Peru have also contributed to the work programme by hosting regional symposia. All of these contributions are gratefully acknowledged.



Rubens Ricupero
Secretary-General of UNCTAD

Geneva, December 1998

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Executive summary

This paper considers the role of foreign direct investment (FDI) in development. It is meant to give an overview in respect of this topic. At the same time, it provides the broader economic underpinnings for the specific issues relating to international discussions or negotiations on investment which are addressed in other papers of the series.

The paper starts with a discussion of the effects of FDI on development through trade, one third of which takes place within corporate production systems. The reason for starting with the trade effects of FDI are twofold. *Primo*, trade has traditionally been the principal mechanism linking national economies. FDI does have a similar linking function and, therefore, it is interesting to ascertain whether, and to what extent, the two linking functions reinforce each other. *Secundo*, and perhaps more importantly, the close, and growing, interrelationship that exists between trade and investment implies that trade policy issues and investment policy issues increasingly cannot be adequately addressed in isolation from one another. Further progress in the field of trade liberalization, therefore, is likely to necessitate an in-depth assessment of the trade implications of investment; and, conversely, effective action on FDI issues cannot be carried out without paying due attention to the interconnections that exist between trade and investment.

The trade effects of FDI depend on whether it is undertaken to gain access to natural resources or to consumer markets, or whether FDI is aimed at exploiting locational comparative advantage and/or other strategic assets such as research-and-development capabilities. Such trade effects are the result of the package of tangible and intangible assets that transnational corporations (TNCs) can bring to a host country through FDI or such other relationships as subcontracting, and which, in an increasingly liberalizing and globalizing world economy, acquire considerable importance, particularly as regards developing countries, for competing successfully in world markets.

The impact of FDI on development goes well beyond its linkages with trade. By its very nature, FDI brings into the recipient economy resources that are only imperfectly tradable on markets, especially technology, management know-how, skilled labour, access to international production networks, access to major markets and established brand names. These assets can play an important role in the modernization of the national economy and in the acceleration of economic growth. In addition, FDI can make a contribution to growth in a more traditional manner, by raising the investment rate and expanding the stock of capital in the host economy.

It has thus been widely recognized by governments -- as reflected in paragraph 36 of "A Partnership for Growth and Development" adopted by UNCTAD IX in 1996 -- that "foreign direct investment (FDI) can play a key role in the economic growth and development process. The importance of FDI for development has dramatically increased in recent years. FDI is now considered to be an instrument through which economies are being integrated at the level of production into the globalizing world economy by bringing a package of assets, including capital, technology, managerial capacities and skills, and access to foreign markets. It also stimulates technological capacity-building for production, innovation and entrepreneurship within the larger domestic economy through catalysing backward and forward linkages" (UNCTAD, 1996a).

There are areas, however, in which the impact of FDI can be negative, e.g. in cases where competition is stifled, restrictive business practices are used or transfer prices are manipulated. Small economies, furthermore, may need to guard against too much FDI too quickly: flows of FDI that are too large for the absorptive capacity of the host economy are likely to bring about negative side effects such as the appreciation of the exchange rate, which in turn has a negative impact both on export development and import substitution. The impact can also be suboptimal; this is the case where FDI leads merely to the exploitation of static comparative advantage and to a continuing reliance on existing local endowments. Finally, the impact of FDI can be optimized by appropriate policies aimed at encouraging the full exploitation of dynamic competitive advantages through the upgrading and strengthening of the domestic productive and technological base.

To conclude, the effects of FDI on development often depend on the initial conditions prevailing in the recipient countries, on the investment strategies of TNCs and on host government policies. Governments, therefore, cannot be passive. The contribution that FDI makes to development can be enhanced by policies that do not remain confined to the mere liberalization of FDI regimes and the granting of legal protection and guarantees to foreign investors. There does indeed exist a wide array of policies that can be used to stimulate greater learning, innovation and linkage effects as well as to promote trade and employment gains. Government action needs to aim at fostering, channelling and complementing FDI. Beyond these challenges to national policy, the growth of FDI and the emergence of integrated international production systems raise a number of new policy issues which, increasingly, require international attention. It is the purpose of this paper to assist both in the assessment of relevant issues by national policy makers and in discussions at international fora.

INTRODUCTION

TNCs are firms that control assets and engage in the production of goods and services in more than one country.[1] These activities cover the entire value-chain of investment and production, ranging from raising capital, establishing new production facilities or acquiring productive assets, and engaging directly in the manufacture of goods and services, to developing new technologies. TNCs engage in these activities in countries outside their home economies by means of FDI,[2] as well as of non-equity arrangements (such as licensing, franchising, original equipment manufacturing, or the subcontracting of components or finished goods) that may be closer to arm's-length arrangements (Buckley, 1993). International production by TNCs, based on resources and capabilities drawn from the different locations in which TNCs operate, has important implications for development, especially of host developing countries.

Firms invest abroad because of the existence of a conjunction of firm-specific assets from which they can derive rents (ownership advantages); difficulties or higher costs in exploiting these assets through arm's-length transactions (internalization advantages); and location-specific advantages of individual countries (Dunning, 1981, 1993a, 1993b). The location-specific advantages that are found to be the most appealing to TNCs are the size of the domestic market, the growth of the domestic economy, openness to international trade, and attractive combinations of cost and productivity, along with a base of capable suppliers (UNCTC, 1992a; UNCTAD, 1998a). FDI, non-equity arrangements and trade are all part and parcel of the overall strategies of TNCs. Given the importance of TNCs and FDI in the world economy, the manner in which these strategies are pursued has important effects on development. These effects are primarily related to the capital, technology, managerial capabilities, employment, skills and access to markets that TNCs can provide. The intangible assets with growth-promoting qualities that TNCs can provide are particularly important for developing countries.

The globalization of the world economy entails a growing interpenetration among economies (UNCTAD, 1994a, chapter III). The role of FDI in this process has become increasingly important; in recent years, world FDI has grown more rapidly than world exports, and sales of foreign affiliates exceed world exports in value (UNCTAD, 1996b). FDI, moreover, involves a linking of production systems and, thus, represents "deep" integration, as it involves relationships at the level of production that bring factors of production together, as compared with "shallow" integration through trade, which generally involves arm's-length relationships (UNCTAD, 1993a). Integration through FDI itself is becoming deeper as an increasing number of TNCs pursue complex integration strategies that create closely integrated production and distribution networks rather than stand-alone or simple integration strategies with limited linkages within the overall networks of TNCs. Under complex integration strategies, firms engage in considerable cross-border specialization through a vertical and horizontal intra-firm division of labour across borders, including increasingly at the functional level (UNCTAD, 1993a, chapter V).

From the viewpoint of TNCs, complex integration strategies allow firms to reap gains associated with economies of scale and scope for the production of an intermediate product or a production-related function. Such strategies also permit firms to locate each production activity or corporate function where the cost-productivity combination is the most favourable from the viewpoint of achieving maximum profitability for the TNC as a whole. One implication is that countries, regardless of their level of development, may be in a position to host a specific TNC activity that matches their locational advantages. Not having to attract the full range of production activities of a TNC gives countries the ability to specialize in "niche" production.

This paper examines the role of TNCs in host developing countries' growth and development.[3] It is organized as follows. Section I reviews briefly the recent changes in developing countries' attitudes and policy regimes towards TNCs and the surge of FDI to developing countries during the 1990s. Section II looks at the relationships between, and impacts of, FDI and other forms of TNC activity on trade, and, through trade, on growth and development. Section III examines channels through which FDI affects directly growth and development in host developing countries;

these include, in the main, effects on savings and capital formation, technology transfer and domestic innovation, local entrepreneurship, and employment, training and human capital formation. Section IV draws the discussions of trade effects and development effects together, and considers some policy implications for host and home countries.

Notes

1 TNCs are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is a firm that controls assets used in production abroad. A (majority or minority-owned) foreign affiliate is an incorporated or unincorporated enterprise in a (host) country in which a firm resident in another (home) country has a stake that permits a lasting interest in the management of that enterprise.

2 "Foreign direct investment" is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity (the foreign direct investor or parent enterprise) of one country in an enterprise (foreign affiliate) resident in a country other than that of the foreign direct investor. It includes equity investments as well as non-equity arrangements that give rise to the control of assets used in production abroad. (See UNCTAD, 1997a, annex B, for a fuller definition and a description of FDI as it is usually measured.)

3 For a comprehensive review of the role of TNCs in development, see UNCTC (1988), Lall (1993), Dunning (1993a) and Caves (1996, chapter 9), as well as the individual volumes of the *World Investment Report* series (UNCTC, 1991; UN-TCMD, 1992; UNCTAD, 1993a, 1994a, 1995a, 1996b, 1997a and 1998a) and the volumes of the *United Nations Library on Transnational Corporations*.

Section I

TRENDS IN POLICIES AND INVESTMENT FLOWS TO DEVELOPING COUNTRIES

During the past 15 years or so, there has been a sea-change in the attitudes of developing country governments towards FDI. Until the mid-1980s, many governments viewed TNCs with suspicion and tended to curtail their freedom of action through outright prohibitions, limitations on the industries in which they were allowed to operate, restrictions on profit remittances and capital repatriation, or the imposition of stringent performance requirements (albeit often in exchange for tax breaks or subsidies). By contrast, all developing countries now welcome FDI and have liberalized considerably their rules and regulations in this respect (UNCTAD, 1995a, chapter VI; UNCTAD and the World Bank, 1994): over the period 1991-1997, some 94 per cent of a total of 750 changes in the FDI regimes of countries were in the direction of a more favourable environment for TNCs (UNCTAD, 1998a).

The liberalization trend entails a reduction of obstacles to the operation of TNCs; a strengthening of the standards of treatment of foreign affiliates; and efforts to ensure the proper functioning of markets, especially through the use of competition policies. For example, in most developing countries, TNCs are now allowed to operate in most industries of the economy. In addition, limitations on profit remittances, the repatriation of capital and other transfers of funds have been generally dropped or relaxed significantly. The practice of imposing performance requirements (UNCTC and UNCTAD, 1991), often as a counterpart for tax incentives, is also becoming less important.[1] Access to incentives available to domestic firms has been granted in most of the reformed FDI regimes. In fact, some countries are granting foreign affiliates better than national

treatment, in the sense that they are the beneficiaries of incentives that are not available to domestic producers. It was often the case in the past that foreign affiliates were denied access to domestic capital markets, on the ground that this restriction forced TNCs to finance their investments in the host country by bringing in scarce foreign exchange; in many countries these limitations have either been dropped or are simply no longer operative. Similarly, there is now a much more widespread acceptance of the principles of national treatment and fair and equitable treatment of foreign investors (Fatouros, 1993). The liberalization trend has also meant a dramatic decline -- even virtual disappearance -- of nationalizations of foreign affiliates since the peak reached in the mid 1970s; indeed, there is a widespread trend towards privatization (including of erstwhile nationalized foreign affiliates). Finally, an increasing number of countries are revising their intellectual property regimes and adopting new competition laws.

These numerous and diverse changes in policies at the national level in respect to all aspects of policies related to FDI and TNC activities are a significant part of the context of discussions about a possible multilateral framework on investment. This is also the case because the liberalization trend is strong in all regions of the developing world and in the economies in transition, having gone furthest in Latin America, in part because policies in that region used to be very restrictive before the recent changes.

The liberalization of FDI regimes has been complemented with the signing of an increasing number of bilateral investment treaties. Of the 1,513 treaties in existence as of 31 December 1997, about two-thirds date from the 1990s (153 in 1997 alone) (UNCTAD, 1998a). Increasingly, these treaties are no longer between developed and developing countries alone, but also between developing countries and between these countries and countries with economies in transition (UNCTAD, 1996b, pp. 134-148). At the regional and multilateral levels, too, an increasing number of agreements deal with investment issues.

Indeed, and more generally, the situation is now one of competition over FDI, with incentives to attract such investment becoming more widespread and generous (UNCTAD, 1996c). Developing countries now perceive FDI as making a positive contribution to their development. Generally, changes in FDI regimes have been part and parcel of a broader set of reforms

that include the opening up of the economy to foreign trade, greater emphasis in development strategies on attaining international competitiveness, and deregulation.

The swing in attitudes has been such that expectations may have become too high in terms of what TNCs can do. While they can, indeed, contribute to the development effort in many ways, the performance of the domestic sector is typically much more important. Moreover, the quantity and quality of FDI and the role of TNCs in development depend also on the policy environment in host countries and, equally importantly, on the productive assets available locally. On the policy side, this goes well beyond the mere liberalization of FDI regimes to include policies related to trade, exchange rates and, generally, macroeconomic stability. Deliberate efforts to improve human capital and the physical and social infrastructure can also be valuable ways to enhance the quality of FDI that countries can attract.

As the regulatory frameworks of developing countries have evolved, TNCs are engaged in a process of stock adjustment which has led to successively higher FDI inflows into developing countries since about the mid-1980s: from an average of $20 billion annually during 1983-1988 to an average of $93 billion in 1994-1995, reaching $149 billion in 1997. The share of all developing countries in total FDI flows has grown significantly since the mid-1980s, from one-fifth to nearly two-fifths (annex table 1). Asia alone is now receiving nearly a quarter of world FDI inflows, compared with one-tenth during the 1983-1988 period. Countries in Latin America and the Caribbean, on the other hand, saw their share of total FDI inflows decline sharply in the 1980s, owing to the protracted economic crisis in much of the region; during the 1990s, however, FDI inflows have returned substantially to that region. In Africa, FDI flows have moved up only slowly and stagnated around $5 billion since 1994, implying a declining share in world flows. Reflecting the overall rise in FDI flows to developing countries, the ratio of FDI inflows to gross fixed capital formation in developing countries is now about one-and-a-half times that of developed countries -- 8.7 per cent as compared with 5.6 per cent in 1996 (UNCTAD, 1998a).

The flows of FDI have tended to concentrate in a few Asian and Latin American countries. In Asia, inflows into China loom large: its huge market and the availability of skilled and low-wage

labour have been very attractive to TNCs. Since the opening up of the Chinese economy to inward investment, FDI inflows have surged, and the country now receives around 11 per cent of world inflows. These flows have also increased relative to the size of the Chinese economy, having risen from 0.6 per cent of gross domestic product (GDP) in 1983-1988 to about 5 per cent in the mid-1990s.

Investment in other Asian countries has also been large, representing, in the case of some East and South-East Asian countries, an intensification of trends that started in the early 1980s. During the 1990s, there have been sharp increases in FDI flows to India, Indonesia, Malaysia, Pakistan, Philippines, Republic of Korea and Singapore. Very recently, FDI inflows have been rising significantly in other countries as well (e.g. Viet Nam and Sri Lanka). The region's economies have received investments not only from TNCs based in traditional home countries (especially Japan), but also from TNCs from the region itself, in particular from the Republic of Korea, Taiwan Province of China, Hong Kong, Special Administrative Region of China (hereinafter: Hong Kong, China), and Singapore. While the full effects of the financial turmoil of 1997-1998 remain to be seen, the underlying fundamentals suggest that Asia will remain an attractive investment location in the future as well.

In Latin America,[2] the countries receiving the largest inflows have been Argentina, Mexico, Brazil (since 1994), Chile, Peru (also since 1994) and Colombia. However, several smaller recipients (e.g. Bolivia, Ecuador, Paraguay and Costa Rica) have also had sharp increases in inflows of FDI (ECLAC, 1998, p. 17). FDI has responded favourably to improved macroeconomic conditions. First in Argentina and more recently in Brazil, inflation has been brought under control and growth has resumed, albeit with some fluctuations. In addition, privatizations of public utilities and other state-owned firms have attracted large inflows of FDI. In Brazil, privatization has begun and can be expected to induce larger inflows of FDI.

The creation of the North American Free Trade Agreement (NAFTA) has been an important factor influencing FDI in Mexico. Several TNCs have established or upgraded production there in order to take advantage of the enlarged market provided by Mexico's membership in NAFTA. Investment inflows into Argentina have

also responded to the pull of the larger market provided by the country's membership in the Southern Common Market (MERCOSUR) (together with Brazil, Uruguay and Paraguay). In Chile, there has been a long upswing in FDI, mainly in mining and other natural resource-related industries, dating back to 1987. A debt-equity swap programme that operated between 1985 and 1990 started the upsurge and attracted the attention of investors. The country's recent association with MERCOSUR is likely to encourage investment in manufacturing for that market.

Finally, concentration also characterises FDI inflows to Africa. The largest recipients are Nigeria, Egypt and Morocco, accounting together for about two thirds of FDI flows to the continent. Of the total, North Africa attracts more than a third, sub-Saharan Africa the balance.

Taking the developing world as a whole, FDI inflows are heavily concentrated in a few host developing countries: 18 economies (annex table 1) accounted for over four-fifths of total FDI inflows into developing countries in 1997 (i.e. 32 per cent of total world inflows). However, it is also the case that many small countries are able to attract large and growing FDI inflows relative to the size of their economies. For example, inflows into Africa as a whole, relative to African GDP, are of about the same relative order of magnitude as flows to developed countries. In some countries where the absolute magnitudes of FDI are small -- such as Angola, Gambia, Ghana, and Zambia -- the ratio of FDI to gross fixed capital formation is between 15 and 90 per cent (UNCTAD, 1998a, annex table B.5). Nonetheless, the fact remains that African countries have been unable to attract FDI in the amounts that would be warranted by their natural resources base and potential market size. The problems that make these economies less attractive to foreign investors are manifold, including political, economic, legal and institutional factors. Governments in Africa are acutely aware of them, and are making efforts to overcome them (UNCTAD, 1995b).

An important aspect of the surge in FDI during the 1990s is the impressive increase in outward investment by TNCs based in developing countries themselves, mostly (but not exclusively) to other developing countries (UNCTAD, 1993b; 1997b). Whereas only 2-3 per cent of all FDI outflows originated in developing

countries at the beginning of the 1980s, this share was more than 14 per cent in 1996-1997 (annex table 2).

South, East and South-East Asian firms account for the bulk of these outflows. In these countries, export-oriented growth has led to the emergence of TNCs that invest in other countries of the region and in final markets in developed countries (UNCTAD, 1997b). As firms from the region improve their own competitive and technological capabilities, they have also begun to assume a leadership role. The most important feature of this pattern is that it is oriented towards the exploitation of new comparative advantages on world markets. This has required high rates of investment relative to GDP, as well as access to international markets (UNCTAD, 1995a, chapters IV and V); TNCs have had a role in this respect in several of the countries of the region. The growing degree of economic integration achieved within the region and the pattern of growth that has emerged (the so-called "flying geese formation") owes much to TNC activity (UNCTAD, 1995a, chapter V; Ozawa, 1992). In fact, for some of these countries, FDI outflows are now relatively more important than for the major home countries of TNCs. The ratio of outward FDI to gross fixed capital formation in the 1990s has averaged over 9 per cent in Singapore and about 5 per cent in Taiwan Province of China. This ratio is higher than the one for developed countries, which has remained at about 5 per cent (UNCTAD, 1997a). Some of these patterns and trends in the region, however, may change as a result of the financial turbulence of 1997-1998.

Some Latin American firms have also begun to make large investments abroad, mainly in other countries in the region. Companies that have developed firm-specific assets have led the process. There have also been instances of investment in final markets to support the exports of the investing firms, and an embryonic trend can be observed towards integrated production for regional markets, particularly in the context of MERCOSUR. These trends in outward investment have contributed to the changes in attitudes towards FDI and TNCs in the countries concerned.

Notes

1 Certain performance requirements that affect trade (trade-related investment measures, or TRIMs) are prohibited under World Trade Organization (WTO) rules. These include local content and trade-balancing requirements (UNCTAD, 1996b, p. 151). There are other performance requirements that are not prohibited by WTO. Nonetheless, developing countries have tended to rely less and less on them, partly in hope of attracting additional FDI inflows.

2 For an in-depth analysis of FDI trends in Latin America and the Caribbean, see ECLAC (1998).

Section II

EFFECTS ON DEVELOPMENT THROUGH TRADE

This section discusses the relationship between FDI and trade and also the effect of TNCs on growth and development through trade. FDI has conventionally been regarded as a substitute or alternative to trade. Thus the first question that needs to be addressed relates to the relationships that exist between FDI and trade. In the manufacturing sector, the sequence that firms have usually followed in their internationalization is that they first export a product to overseas markets and, at a later stage, begin producing it in those markets (UNCTAD, 1996b, chapter III). This is because trade is less risky than FDI, partly because it involves less sunk costs. As a foreign market becomes consolidated, FDI may become desirable, first in small amounts and in ancillary activities (trading services, storage, repair, after-sales servicing), and later for the full production of the product. If the sequence holds, the direct effects of FDI are trade-replacing as far as any given product is concerned. This is of some concern for home countries and for their labour unions, who sometimes tend to oppose outward FDI on the grounds that it leads to job losses. However, even in this case, FDI may have positive indirect effects on trade and further investment flows, as it may give rise to a stream of exports of inputs, intermediate goods, machinery, and services. As a result, even in the manufacturing sector, the net effect of FDI on trade may well be positive and beneficial to the economies of host and home countries.

In the case of export-oriented investment, and as trade and investment barriers fall, such investments become increasingly important compared to those that are made just to service the domestic markets of the host country, increasing the likelihood of positive effects of FDI on trade. More generally, with the rise of integrated international production, trade and investment are now linked in complex ways and are increasingly jointly determined

by the locational decisions of firms (UNCTAD, 1996b, chapter IV).

In the case of natural resources, FDI has always led to the expansion of trade. In fact, FDI has often been a precondition for trade on a large scale by many resource-based countries and is clearly trade creating. On the other hand, in the services sector, there are technical barriers to cross-border trade, as many services can be delivered to foreign markets only through FDI. However, investment in such services often creates new flows of imports of goods and tradable services into the host economy and, at the same time, strengthens the infrastructure of the production of tradable products.

The presumption of this section is that, for most developing countries, trade has positive effects on long-term growth.[1] There are two important reasons for this. The first is related to market size; most developing countries have relatively small domestic markets, because of low *per capita* income and/or small populations. The second reason is that, in most developing countries, investment and productivity growth are highly dependent on imported capital goods and technology. This means that investment and technology acquisition depend ultimately on the capacity to generate foreign exchange. In order to ensure a sustained rise in the investment rate and high productivity growth, a steady expansion in exports is required. Given the characteristics of developing country exports, which tend to be concentrated in one or a few commodities with low price and income elasticities of demand in world markets, the only way to achieve high and sustained rates of export growth without deteriorating terms of trade is through export diversification.

A. Direct effects

What do TNCs have to do with all this? The activities of TNCs, both of the FDI variety and also more arm's-length relationships between TNCs and firms in developing countries, have significant effects on trade flows. In order to understand the ways in which TNCs and FDI affect trade, one must distinguish between different types of FDI (and other TNC activity) according to the different objectives of TNC involvement in developing countries. Broadly speaking, one can distinguish between natural-resource-seeking

investment, market-seeking investment, efficiency-seeking investment, and strategic-asset-seeking investment.[2]

Natural-resource-seeking FDI is the oldest form of TNC involvement in developing countries. It is undoubtedly trade-creating on the production (or output) side: FDI is often a precondition for the production of primary commodities for foreign markets, especially in developing countries, and generates a stream of exports of natural resources that would not have otherwise occurred. From the side of inputs used and consumption generated, there are also positive trade effects, since natural-resource-oriented FDI is usually accompanied by a flow of imports of capital goods, specialized intermediate inputs, and consumer goods.[3] Additional gains can be derived by host countries through the processing of natural resources; trade policies prevailing in importing countries, however, particularly those leading to tariff escalation, tend to discourage local processing in developing countries.

Market-seeking FDI became the predominant motive for investing in the manufacturing sector of developing countries in the 1960s and 1970s during the heyday of import-substitution industrialization. This motivation also was paramount in the wave of United States investments in Europe in the early postwar period and in Japanese investment in the United States since the early 1980s. Generally, market-seeking investment in manufacturing is a gross substitute for exporting from the home country, and its existence is often due to import barriers in host countries. It has trade-reducing effects on the production side, but trade-creating effects in so far as inputs used in production are concerned, since import substitution leads to a change in the *composition* of imports towards intermediate inputs and capital equipment. Any market-seeking investment will also normally have multiplier effects on domestic demand and production, which could lead to significant indirect increases in imports. Thus, investment-related trade measures (IRTMs) are of interest in discussions about a possible multilateral framework on investment.

There are causes other than trade barriers for market-seeking investment. In some cases, significant transport costs may make investment in a host country an efficient alternative to exporting to it. Differences in consumer tastes and the need to adapt a product to local conditions and inputs may also recommend catering to the domestic market through investment rather than exporting.

In these cases, market-seeking FDI has no trade effects in production (since it does not replace exports) and positive effects in consumption. Indirect effects on trade are also positive.

Recently, the formation or strengthening of regional groupings has given rise to significant investments to serve the enlarged markets.[4] This has been most evident in the case of NAFTA, where there have been large investments in Mexico for the United States markets (both by United States-based TNCs and by TNCs from other home countries, especially Japan), and in Europe, where the Single Market programme (officially completed in 1992) gave rise to a wave of FDI inflows in the late 1980s and the early 1990s (UN-TCMD, 1993). It has also been in evidence with investments by European TNCs (and others) in Central and Eastern Europe, countries with which the European Union has signed trade agreements, and in Argentina after the establishment of MERCOSUR in the late 1980s. While these investments have an element of investment diversion and may have taken place elsewhere in the absence of the integration schemes, the large markets to which they are directed ensure economies of scale often absent in earlier market-seeking FDI.

This means that the probability that market-seeking investments may reduce the recipient country's welfare is much lower in these cases than in the tariff-hopping investments made during the import-substitution period. To the extent that they lead to efficient production and to the spread of such production, they may turn out to be welfare-improving when the world economy is considered as a whole. They undoubtedly raise the rate of growth of recipient countries when they increase their capital stock. In these cases, investment is trade-creating in both production and consumption: it generates a new stream of exports from host countries and a stream of imports of components, inputs, capital equipment, and services from home countries.

Much of FDI in services is market-seeking. Since many services can only be delivered to foreign markets through FDI, in such cases FDI has no adverse trade effects on production and may have positive trade effects on consumption by inducing new exports of machinery and other services (consultancy and design, for example) from the home country of the investing TNC (UNCTC, 1989; Sauvant and Mallampally, 1993; UNCTAD and the World Bank, 1994). It may have indirect, longer-term positive effects on the exports of goods (or services) from host countries. For example, FDI in

banking, telecommunications, or public utilities may lower the costs of these non-traded inputs and render host country producers internationally competitive in several sectors where no exports had taken place prior to the foreign investments. This situation may change as services become more tradable (Sauvant, 1990; UNCTAD, 1994b).

Efficiency-seeking FDI occurs when TNCs locate part of their value-added chain abroad in order to improve the profitability of their overall operations. The oldest such investments have been labour-seeking investments. As wages rose in home countries, TNCs sought to obtain access to low-cost labour in developing countries by locating in them the labour-intensive segments of their production processes. This has been a characteristic of some Japanese investment in Asia; United States investment in Mexico, Central America and Asia; and European investment in Central and Eastern Europe. More recently, as real wages have risen over time in some of the Asian countries that were first to industrialize with an outward-oriented strategy, labour-seeking investment has moved on to other, lower-wage Asian countries.

Labour-seeking investments are generally trade-creating, since they give rise to exports from host countries. In many cases, they also lead to a diversification in the composition of host-country exports towards manufactures. On the consumption side, such investments also tend to be trade creating, since a large share of the raw materials used in production (and a certain proportion of wage goods) are imported.

Of course, labour-seeking operations of TNCs in developing countries can take forms other than FDI. Labour-intensive processes can be shifted to developing countries through various contractual arrangements between domestic firms and TNCs or foreign buyers (and even large firms from home countries that are not, strictly speaking, TNCs). All of these forms of relationships with international firms are trade creating. The benefits of FDI and other forms of involvement by TNCs in labour-intensive industries in developing countries are closely related to assisting host countries in overcoming informational disadvantages related to accessing markets. In the absence of TNC involvement, it may be very costly for firms in developing countries to penetrate the markets of developed countries. Information is opaque and costly to obtain. TNCs and buying groups in developed countries provide several kinds of information that

are crucial to success in these markets: they have ready-made marketing channels and contacts with clients and distributors, and they often supply product design, technology, and key inputs.

The shifting of labour-intensive processes to developing countries has probably been the most important factor behind the growth of their manufactured exports in the past three decades, and TNCs have been among the most important agents of their comparative advantage. However, local firms have also played an important role, especially in East Asia. Elsewhere, TNCs (including those from other developing countries) have been more significant, but the benefits have been highly concentrated in a few countries. Furthermore, the fact that export activity has been driven by a static set of advantages (cheap labour) has sometimes meant that the benefit to countries diminishes once this is exhausted (when wages rise). TNCs can and do upgrade their export activity from host countries, but this is sometimes in response to government policies to raise the quality of factor inputs and to induce investors to move into more complex activities. It is not always because TNC investment is raising the basic competitive capabilities of host countries: TNCs respond to opportunities presented by growing skills and supply efficiency that arise from other sources.

The location of labour-seeking operations abroad has often been criticized in home countries of TNC parent firms, in particular by trade unions, on the grounds that they cause unemployment. This need not be the case, since, as pointed out earlier, they create a flow of exports of components, inputs and machinery; in addition, they create employment in highly-skilled services (e.g. design or marketing). More than reducing employment at home, labour-seeking investments change its composition towards higher-wage employment, which causes unemployment at the lower end of the wage scale but raises the demand for highly skilled and high-wage labour.

Labour-seeking investments also occur in the services sector. For example, a growing part of data processing, which is very labour-intensive, can and does takes place in developing countries, where labour costs are lower than in the home country of the investing TNC (e.g. software development in India or data-processing in Barbados). These services can be undertaken on behalf of a services or manufacturing TNC, either by an affiliate or by a subcontractor in a developing country.

There are other, more complex, forms of efficiency-seeking investments that are closely related to the emergence of integrated international production. One increasingly important form for developing countries is *component outsourcing* (UNCTAD, 1995a, chapter IV). The main driving force of this has been the increase in wages in the developed countries, particularly in Japan and Europe. A secular appreciation of the yen and European currencies *vis-à-vis* the United States dollar can be a strong incentive for this kind of FDI by Japanese and European TNCs wishing to remain globally competitive. It has also been extensively used by TNCs from the United States in certain industries, such as automobiles, electronics and personal computers. The main locational advantage of some developing countries is low unit labour costs (related not only to relatively low wages, but high labour productivity as well). These operations require greater skills than is typical of labour-seeking FDI. Therefore, they tend to be concentrated in the outward-oriented and relatively industrialized developing countries.

The extreme form of component outsourcing is original equipment manufacturing, wherein a firm in a developing country undertakes to supply a TNC with a fully made manufacturing product that will bear the brand name of the TNC. This is one of the forms that inter-firm agreements have taken so far between TNCs and firms in developing countries. Several firms from the Republic of Korea began their penetration of markets of developed countries through original-equipment-manufacturing products, which they later partly replaced with their own brand names. Besides advantages related to knowledge of the market and to technology, TNCs possess service and distribution systems, which developing country firms would have to set up from scratch. For this type of relationship to be possible, the level of managerial, entrepreneurial and technological capabilities of the developing country firm must be fairly advanced (Ernst, Ganiatsos and Mytelka, 1998).

Component outsourcing generates trade and represents a step up the "quality ladder" from simple labour-seeking relationships. Not only does it expand exports (and imports), but it also leads to a diversification of exports in the direction of more complex products.

In both labour-seeking and component-outsourcing activities, access to markets plays a key role as regards the contribution of TNCs to development, be it through FDI or through other contractual

relationships. Besides the informational advantages of TNCs, when a product is traded within the network of a TNC, it may be less likely to be subject to protectionist threats than when the exporter is an independent developing country firm. There are, in fact, laws in developed countries that favour the processing abroad of inputs originating in the importing country (in the United States, the Tariff Schedule 806/7 rules of origin). This processing is normally undertaken by a foreign affiliate of the originating company or by a subcontractor. There is evidence, however, that rules of origin can make it more difficult for exporting countries to diversify their markets since, in order to qualify for the duty-free entry of their processed products, they must import higher cost components from the country/ies applying the rules of origin than are available from third parties.

Still another form of efficiency-seeking FDI is *horizontal FDI* in differentiated products; this is less common in developing countries and tends to be associated largely with investment flows among developed countries (for example, in automobiles, computers, chemicals, consumer goods). It occurs because of the need to adapt products to the tastes or quality requirements of a particular market. These investments require a relatively large market, as they are related to the demand for different brands of a similar product in industries that are characterized by significant economies of scale. As the markets of developing countries are enlarged through regional trading arrangements, these investments are likely to become more common in those countries as well (Robson, 1993). In fact, there are growing cross-border investments in these industries in NAFTA and MERCOSUR. They are trade-creating and welfare-enhancing. The recipient country ends up exporting some brands of the product and importing others, at lower cost to the consumer. Welfare increases, not only because of lower costs of production, but also because of the availability of greater variety.

Strategic-asset-seeking FDI usually takes place at an advanced stage of the globalization of a firm's activities when firms, including a few from developing countries, invest abroad in order to acquire research-and-development capabilities (e.g. Japanese or Korean investment in microelectronics in the United States). As already noted, integrated international production involves the location of *any* component in the value-added chain where it contributes most to a TNC's profitability. Thus it may be efficient for a firm to relocate design, research and development (or other high value-

added activities) from its home base to a foreign affiliate. Some developing countries are, or can make themselves, able to attract this kind of FDI through investment in human resources and infrastructure; for example, the availability of skilled personnel and the requisite telecommunications infrastructure have contributed to the location of research-and-development centres and headquarters' services by TNCs in Singapore, software development in India, and service centres for airline reservations in the Caribbean. These investments are trade-creating in production and consumption. For the developing countries involved, this kind of FDI is tantamount to exporting high-skill labour services. And it usually gives rise to exports of services and equipment from home countries.

B. Indirect effects

The trade effects of FDI do not stop here. There are also indirect effects through the exchange rate and the availability of foreign exchange. Balance-of-payments effects figured prominently in the literature on FDI in the 1970s (for example, Lall and Streeten, 1977; see also Gray, 1993; and UNCTAD, 1997a, chapter II, for a summary of empirical findings); at the same time, most developing countries faced a binding foreign exchange constraint on growth. Therefore, countries were interested in FDI not only for its more direct contribution to development, including through the trade effects discussed above, but also for the additional imports that it made possible through the relaxation of the foreign exchange constraint. However, since FDI inflows eventually give rise to outflows of profits, associated with repayments of loans from parent firms to foreign affiliates as well as payments for licences and technical assistance, outflows could eventually exceed inflows. More precisely, the issue revolves around the comparison between the inflow of foreign exchange associated with an investment project and the present value of future outflows of profits, using as the discount factor the international interest rate at which the country can borrow. Normally, one can expect that discounted future outflows will be larger than the capital originally invested, since profit rates, particularly in developing countries, tend to be well above international interest rates.

However, an investment project may have other balance-of-payments effects that must be taken into account: it may generate net exports or it may save foreign exchange by substituting domestic

production for imports. By contrast, investments in non-export oriented firms in general and in non-tradable products in particular (most services, construction), usually have negative direct balance-of-payments effects, since most such projects require imported inputs and neither generate nor save foreign exchange on the output side.[5] This provides a rationale for the preference of developing countries for FDI in export sectors.

The evaluation of the balance-of-payments effects of FDI depends crucially on the most likely counterfactual: what would have happened in the absence of the FDI (Lall and Streeten, 1977)? Would the activity have been undertaken by a domestic firm, perhaps under license of a TNC, or in a subcontractual relationship, or not at all? This is, of course, a matter of conjecture. The issue is now less pressing, as, in the present times of much higher international capital mobility, growth in developing countries is not as constrained by foreign exchange availability as it was in the 1970s and 1980s. This is not to say that balance-of-payments effects are unimportant for all countries or that they could not become important again in the future (UNCTAD, 1997a, chapter II, pp. 85-94).

FDI may also be expected to have an impact on the real exchange rate and, through this channel, on future trade flows. Normally, all increases in capital inflows, irrespective of their type and of the place where they are invested, are likely to lead to an appreciation of the exchange rate,[6] simply because it raises the supply of foreign exchange and thereby lowers its real price. In other words, capital inflows imply an increase in absorption and a rise in domestic demand, which bid up the prices of non-tradables, while (in small countries) the prices of tradables remain constant.[7]

It is important to distinguish between the short-term (or "impact") effect and long-run effects of FDI on the real exchange rate. The total effect can be obtained by adding both effects. As already noted, the impact effect of all capital inflows is to appreciate the exchange rate. However, FDI has less of an impact effect on the exchange rate than other purely financial types of foreign capital inflows, since a significant share of FDI takes the form of imported capital goods. Over time, the long-run effect on the real exchange rate will depend on the sectoral allocation of FDI. If foreign capital is invested primarily in tradables, the additional

generation or saving of foreign exchange will appreciate the exchange rate further. This is particularly the case when the investment projects involved raise productivity. On the other hand, FDI into non-tradables increases their supply (and often productivity) and lowers their relative price, thereby counteracting the impact effect of capital inflows towards appreciating the real exchange rate. Experience has shown, however, that, in practice, the impact effect dominates long-term effects and the exchange rate tends to appreciate when there is a surge in FDI, regardless of the sector to which it goes.

These considerations are particularly important for small countries that suddenly become attractive as investment sites to TNCs. When locational advantages are perceived to have improved, the capital stocks desired by TNCs in a particular country may experience a dramatic increase, leading to very large inflows of FDI for a period that can be quite protracted. This may cause a significant real appreciation of the currency and discourage exports -- the disadvantage of being small in a large international capital market.

C. Transfer pricing

Transfer pricing of transactions conducted within TNCs -- between parent companies and their foreign affiliates and among the latter -- was a serious concern of host developing countries in the 1970s (Plasschaert, 1993). At that time, profit remittances were often restricted, and profit tax rates in host countries were often higher than those applied in home countries. It is of less concern now as foreign affiliates can remit profits with greater ease and as income-tax rates on foreign company profits have tended to decline in most developing countries, which now usually apply national treatment to TNCs on tax matters.

Nonetheless, the issue is still important. If foreign companies are able to extract their profits from host countries via intra-company transactions at artificial prices, the benefits of FDI to host economies are accordingly reduced. Incentives may still remain for doing so, especially in countries that have not signed double taxation treaties with home countries of TNCs. Also, in some developing countries, corporate taxes are higher than in the home countries of investing TNCs. The more complex the relationships between parent firms and foreign affiliates, the greater are the opportunities

for abusive transfer pricing. Such relationships can include loans from parent firms to their affiliates, management and consultancy contracts, technology-licensing arrangements, purchases of inputs, and sales (or purchases) of components to (from) parent firms or from affiliates in third countries.

The signing of double taxation treaties goes a long way towards solving the problem, because it removes much of the incentive for abusive transfer pricing. This is especially so in the case of host countries whose corporate income tax rates are lower than the tax rates of home countries: with a double taxation treaty, profit taxes paid in the host country are credited against the tax liability of the parent company at home. However, in some developing countries corporate tax rates are higher than in the home countries of TNCs, in which case double taxation treaties may not be enough to dissuade affiliates from transferring profits to their parent firms through abusive transfer-pricing practices. Moreover, some TNCs channel part of their profits through tax havens, in which case double taxation treaties are useful for neither host nor home country. The basic dilemma is that TNC activities are global and taxing authorities are national or sub-national. Therefore, the adoption of clear accounting rules can be an added advantage in this respect.

In short, transfer pricing and other tax issues associated with FDI require international cooperation among governments so that the interests of governments as well as TNCs are addressed effectively. International cooperation, however, has so far focused mainly on the bilateral level.

D. Summary

FDI and TNC activity increasingly tend to concentrate on production for regional or global markets. FDI in services is also very important, and is likely to be trade-creating and to enhance the competitiveness of developing country exports in the long run. The transition from shallow to deep integration and the emergence of integrated international production in some industries has tightened the relationship between trade creation and FDI.

However, a passive reliance on TNCs to lead export development may lead to the exploitation of static comparative advantages, and a continuing reliance on existing endowments,

unless the country itself plays an active role in upgrading its productive base. Moreover, much of the export dynamism in export oriented countries of East Asia has come from local firms subcontracting to foreign buyers rather than through FDI. Specific actions by governments, in particular with a view towards improving the physical, financial and technical infrastructure, are essential for the enhancement of competitive advantages.

Countries with small economies, especially, may need to guard against too much FDI too quickly. As has been remarked: "the rest of the world's pockets are very deep relative to a small economy's ... absorptive capacity" (Dornbusch and Edwards, 1994, p. 103). Flows of FDI that are too large for the absorptive capacity of a host economy appreciate the exchange rate and run the risk of retarding outward-oriented development. Policies to smooth out FDI stock adjustment over time can be used, especially in countries that suddenly become very attractive as sites for FDI.

The dangers of transfer pricing have diminished as foreign exchange constraints in developing countries have eased and corporate tax rates have fallen. But they have not disappeared altogether, and the issue needs to be followed closely at the national and international levels, including through the signing of double taxation treaties. In the meantime, it is important that developing countries adopt clear accounting rules regarding transfer pricing.

In any case, the closer linkages between trade and FDI mean that trade policy issues and investment policy issues cannot be understood and assessed in isolation from one another. Thus, trade-related investment measures (TRIMs) and investment-related trade measures (IRTMs) are both becoming more frequent issues of interest to countries.

Notes

1 This is a fairly recent notion. Advocates of import substitution have argued in favour of limiting trade flows in order to develop domestic industries (Bruton, 1988). As modern economic history has shown, this view, however unpopular today, has had support in developed as well as developing countries: practically all currently industrialized countries of significant economic size went through an import-substituting phase that allowed them to reap economies of scale and greater degrees of technical efficiency through learning by doing which

eventually transformed them into exporters of manufactures. This is the classical argument for temporary infant industry protection. (For a modern version of this argument, see Rodrik (1992).) Most developing countries, however, are too dependent on international trade to benefit from protection.

2 See, for instance, Dunning (1993b, Introduction) and Ozawa (1992).

3 Newly hired workers will normally consume part of their wages on imports, although, given the capital intensity of TNC activities in many natural resources, this effect may be small.

4 These investments reflect not only the desire of TNCs to position themselves in specific enlarged markets but also, in some cases, to take advantage of the locational advantages offered by low-wage sites within those markets.

5 As already noted, some FDI in services may have indirect positive effects on future production of tradables by improving the host economy's competitiveness.

6 The nominal exchange rate is defined as the price in domestic currency of one unit of foreign currency; the real exchange rate, as the ratio of the prices of tradables to non-tradables.

7 In one extreme case, the real exchange rate remains unchanged: when the Central Bank fixes the exchange rate in nominal terms and succeeds in sterilizing completely the effects of capital inflows on the money supply. In practice, most, if not all, episodes of capital inflow have led to exchange-rate appreciation.

Section III

DIRECT EFFECTS ON DEVELOPMENT

The impact of TNCs and FDI on development of course does not stop at their linkages with trade. On the one hand, by their very nature, TNCs possess valuable resources that are only very imperfectly tradable on markets. These resources usually have growth-enhancing characteristics: technology, management know-how, skilled labour, international production networks, access to markets and established brand names. In addition, TNCs can make a contribution to growth in a more traditional manner, through raising the investment rate and expanding the stock of capital located in a host country. On the other hand, TNC activity can have adverse effects on development, precisely for the same reasons: the entry of large firms with efficient internal markets and considerable size and market power may deter the full development of the imperfect markets and factors in host developing countries, or may prove more costly than alternative means of acquiring the assets that TNCs provide. Thus, when a country is in effect able to develop indigenous resources, there is a need to articulate properly the contribution that TNCs can make to the enhancement of local capabilities. Their potential negative effect in inhibiting their emergence was, indeed, a traditional argument in favour of restricting FDI to those activities that cannot be developed by domestic entrepreneurship. Like the infant-industry argument for import substitution, this position can be labelled the "infant entrepreneurship argument" (for an argument along these lines, see Bruton, 1988).

A. Savings and investment

There has been an unsettled controversy about the effects of capital inflows on savings and investment that has raged since the early 1970s (Weisskopf, 1972) and that has been revived recently.

In the 1990s, large capital inflows into several developing countries have not generally led to increases in total investment. In fact, in many countries that have experienced surges of foreign capital, investment has remained unchanged and domestic saving has fallen (Agosin and French-Davis, 1996). If foreign savings merely crowd out domestic savings with no change in the investment rate, the usefulness of foreign capital for capital formation, a key factor in development, can be questioned.

Clearly, however, FDI is a distinctive form of foreign capital. The channels through which capital inflow can discourage domestic saving are as follows: if the exchange-rate appreciates, it encourages consumption and may also relax liquidity constraints to the consumption of durables, since an important portion of capital inflow is intermediated by the banking system. If, in addition, capital inflow causes stock market and real-estate booms, the wealth effects on consumption can be quite significant. However, FDI is less likely than other kinds of capital inflows to have these effects because it is associated with *real* investment. As already noted, FDI puts less downward pressure on the real exchange rate than do other forms of capital inflow. Indeed, it has been observed that countries in which FDI dominates capital inflows have experienced more significant increases in investment than countries in which capital inflows have been mostly of the financial variety.

The argument has frequently been made that FDI is likely to have more favourable effects on capital formation when it takes the form of greenfield investments rather than that of mergers and acquisitions, which play an important role in world FDI flows (UNCTAD, 1998a). This depends to a large extent on the counterfactual situation and also on domestic economic policy more than on whether the foreign investment represents an immediate addition to the country's capital stock. Firms often prefer mergers and acquisitions when entering a foreign country because, through the purchase of an existing firm, the foreign company buys into an ongoing concern and does not have to start *de novo*. However, the purchase is more often than not followed by *sequential FDI* (i.e. by investments in modernization and capacity expansion) and *associated* FDI (e.g. by FDI undertaken by suppliers) which can be larger than the original purchase (UNCTAD, 1995a).[1]

The capital contribution of FDI may be particularly important in privatizations, which usually also require significant sequential

investment in order to make privatized firms profitable. Privatized firms are often very large, and sufficient capital resources are usually not available to domestic groups. Even the latter's borrowing capacities on international capital markets may not be large enough for the amounts normally involved. This is also the case with investments in mining. Domestic firms (even state-owned) having the know-how to operate mining concerns may not have access to the large amounts of capital required by this very capital-intensive activity. That is why some countries have sought the participation of consortia of TNCs in the expansion of their mining investments.

It is sometimes claimed that FDI leads to home country investment levels that are lower than those that would have occurred in its absence, and that this is tantamount to exporting jobs abroad. The issue at hand is about the counterfactual to FDI: if investment abroad had not taken place, would the firm have invested the same amounts at home? The answer to this question is not straightforward. If the foreign investment proves not to be profitable, it might not have been profitable to invest at home either. And FDI can stimulate upstream or downstream investments in the home country. The same considerations apply to FDI outflows from developing countries, adjusted for, among other things, the conditions prevailing in individual countries and industries.

B. Technology transfer and innovation

Perhaps the most important contribution that host developing countries desire from TNCs is in the area of technology.[2] Almost by definition, developing countries lag behind developed countries as regards the generation and application of technology. The same goods are produced in developing countries with technologies that are outdated in developed countries; and some goods are not produced at all, because the technological know-how is not available in developing countries. Even where similar technologies are used, developing country enterprises tend to use them less efficiently because they lack the requisite skills and capabilities. Since technology is a non-rival good (in the sense that its use or consumption does not diminish its value for another agent) and is sometimes presumed to be transferable without cost across countries, the technological gap between developed and developing countries needs to be explained. Contrary to what neoclassical growth models postulate (e.g. Mankiw, 1995), technology is not a free good that

is clearly specified and readily available for use by any firm anywhere. Moreover, some technology is not accessible if its owners decide not to licence it. In important respects, technological assets contain a tacit element that is not easily transmittable or replicable in another environment, and their effective use entails considerable investments in learning and skill upgrading.

In addition, technology cannot be traded like a physical product: technology markets are opaque and often subject to informational failures. Buyers and sellers have different sets of information. If buyers knew exactly what they were buying, they would not need to make the purchase, since they would already know the technology. On the other hand, sellers have strong incentives to withhold information from buyers. Firms tend to guard carefully their technological assets, since they can be copied and used by others who have not invested in their development. This is all the more so in countries with poorly developed intellectual property protection regimes. The utilization of ideas also requires human capital that is capable of doing so, and this is a particularly scarce resource in developing countries.

A large proportion of all innovation takes place within TNCs (UNCTAD, 1995a, chapter III.B). There are several reasons for this. In the first place, research and development involves large sunk costs and therefore requires large markets to be profitable. Research and development is thus concentrated in large firms, and -- in such areas as biotechnology -- in strategic partnerships and alliances among large firms (Mytelka, 1998). Transnationality and research-and-development expenditures are also highly correlated, with causal links running in both directions. Proprietary technology figures prominently among the intangible assets that impel firms to invest abroad through equity participation as well as non-equity arrangements (e.g. licensing, franchising, turnkey operations). At the same time, transnationality enlarges the market over which a firm can exploit technological assets, and it is a strong incentive to undertake research and development. Since, as already mentioned, ideas are non-rival goods with essentially zero marginal costs of production, monopoly rents generated by them -- and, therefore, the incentive to produce them -- are strongly correlated with the size of the market over which they can be deployed (Romer, 1993).

FDI can, under these conditions, make an important contribution to technology transfer and to the effective use of technology. More specifically, FDI can make three sorts of technological contributions to host countries (Romer, 1993):

- It can introduce a new technology not previously in use in the domestic economy and, therefore, lead to the production and consumption of a new good.
- Foreign investment with a technological component usually requires the introduction and/or development of new skills needed to operate the technology (with the attendant externalities).
- Domestic innovation depends on the number of ideas that are available in the economy; thus the introduction of a new idea increases the stock of ideas and stimulates domestic innovation.

These considerations have a great deal of force, but they rest on simplifying assumptions. They equate technology with knowledge in the abstract sense, and ignore the costs and difficulties involved in mastering new technologies, particularly in a developing country. More important, they ignore the difference between learning operational technology and the creation of new technology: FDI may be a very effective way of transferring new operating know-how but not necessarily of the innovation process that underlies the generation and upgrading of that technology. It is widely accepted that TNCs tend to transfer the *results* of innovation but not innovative capabilities themselves, at least to most developing countries: the relocation of their research functions abroad is overwhelmingly to other developed countries. This can lead to a "truncating" of the process of technology transfer and to a relegation of developing host countries to lower levels of technological activity (even when their industrial capabilities have reached a level at which, as in many newly industrializing economies, they are able efficiently to undertake advanced research-and-development work). It is the case that developing countries that have been able to build up powerful autonomous innovative bases (like the Republic of Korea or Taiwan Province of China) have restricted internalised technology transfer via TNCs, precisely in order to allow national enterprises to develop their "infant" innovative capabilities. Moreover, TNCs

may transfer the technology that is appropriate to the static factor endowments of host economies and not their dynamic endowments. Thus, they may start with simple assembly technologies and move to lower cost locations when wages rise; it is not in their economic interest to invest in the creation of the high level skills that would make more complex technologies viable. How widespread this is cannot be judged from the available evidence, since it is possible to find examples of both types.

Furthermore, it has not been unusual for TNCs in the past to continue to derive rents from outdated technologies in developing country operations. At the same time, domestic policy can influence the extent to which FDI makes a technological contribution. Pure import-substitution policies may encourage TNCs to undertake market-seeking investments that fail to incorporate state-of-the-art technologies. Export-oriented policies, on the other hand, are likely to encourage the introduction of technology that would make products more competitive in international markets.

The degree of diffusion to a host economy is important when evaluating the contribution of FDI to technological upgrading. "Diffusion" refers to an important (though not the only) form of externality connected with technology. If there were no diffusion at all, the developmental effects of FDI, even when introducing new technologies, might be small, since a significant proportion of the additional output made possible by an investment project would be captured by the TNC in the form of monopoly rents. Some technologies may be more susceptible to diffusion to domestic firms than others. This is the case of technologies that, in order to operate them, do not require highly specialized human resources unavailable in the host country and available only within TNCs.

The question arises as to whether it is preferable to obtain technology through FDI or in more unpackaged forms (even though these forms may well involve elements of control by parent firms), such as licensing; installation and training related to the supply of machinery and equipment; advice by suppliers to clients on quality control, new materials and other important technological changes; and technology alliances that are at arm's length and enable firms in developing countries to window on a wide number of technological developments and leverage their own work in this area. Japan and the Republic of Korea have relied heavily on licensing and other forms of acquisition of technology from

TNCs, while Singapore mainly relied on FDI, attracting it into specific industries. Taiwan Province of China has made active use of both vehicles. There is no ready-made recipe in this respect. Much depends on the expected gains with respect to technological capacity-building and movement towards higher value-added production through one rather than the other. Two considerations are important in making the decision. The first one is whether the technology is available in unpackaged form. Firms are more likely to license older technologies from which they have already derived significant rents than newer technologies that are at the heart of the companies' business interests.[3] The second consideration is the availability in the host country of entrepreneurial and technical skills to operate new technologies and earn profits doing so; the position of countries in this respect is bound to change over time, as human resources and technological capabilities improve. Indeed, TNCs are entering into collaborative relationships with firms and institutions for technology generation and development in some developing countries (UNCTAD, 1995a).

One aspect of technology concerns organizational and management practices, including, among others, strategic marketing capabilities. Management may be considered as a sort of "soft" technology. Management technologies are diffused through various channels (UNCTAD, 1995a, chapter III.C), including joint ventures between domestic firms and TNCs or through the migration of executive personnel from foreign affiliates to domestic companies (Ernst, Ganiatsos and Mytelka, 1998). TNCs can therefore contribute to the spread of modern management techniques to host countries. And such soft technologies may be diffused more easily than hard technologies that are embodied in capital equipment and that require highly skilled complementary human resources. An example is just-in-time management of inventories. Pioneered in Japan, it has been emulated widely by United States and European TNCs. Innovations such as these have a great potential for improving the productivity and competitiveness of developing country firms.

There have been concerns that FDI and non-equity TNC activities could lead to an accentuation of the dualistic nature of the economies in some developing countries, with foreign affiliates or large domestic firms with strong links to TNCs increasing their technological lead over small and medium-sized domestic enterprises. The latter suffer from acute disadvantages with regard to technological or foreign market information and to access to capital markets

(UNCTAD, 1993b, 1998c). In some cases, FDI may have led to a widening of the gap between foreign firms and small and medium-size enterprises; in other cases, small firms have been able to participate in sophisticated original equipment manufacturing and even higher-end original design manufacturing. Clearly, it all depends on the initial degree of dualism in the economy and on active government policies to overcome the relative backwardness of small and medium-sized enterprises.

C. Entrepreneurship and linkages

It is sometimes claimed that FDI may have adverse impacts on the indigenous development of entrepreneurial talents by pre-empting business opportunities and crowding out domestic entrepreneurs. This was one of the rationales for the effort that governments of developing countries made in the 1970s in the form of operational measures to "unpackage" FDI and to attempt to obtain for domestic firms some of the assets associated with TNCs. In some countries (e.g. the Republic of Korea), such policies paid off in terms of the development of domestic enterprises. In others, results were mixed: domestic entrepreneurship did not fare as well even though FDI was discouraged. The debt crisis also weakened the capacity of developing countries to unpackage, since foreign borrowing was no longer available to them. Nowadays, the bottleneck is mostly on the side of domestically available human resources and entrepreneurial talents.

FDI may have crowding out effects on domestic firms if large foreign firms borrow on domestic financial markets: domestic interest rates tend to rise, thus reducing the viability of investment projects for small and medium-sized domestic firms without access to international capital markets; and local bankers -- for both risk and profitability reasons -- may have a greater interest in lending to larger firms (such as TNCs) rather than to the vast majority of local firms which are small. It may be argued that, if financial markets are integrated, domestic interest rates will tend to move towards levels prevailing in international markets. If this were the case, the problem would lie not with the potential crowding out effects of FDI but with the unwillingness of the authorities to open up domestic financial markets to international trade in financial assets. However, even in developing countries with a substantial degree of financial openness, domestic interest rates tend to be

higher than international rates, basically because domestic assets are imperfect substitutes for foreign assets. There is, therefore, some rationale for monitoring the domestic borrowing of large foreign firms and for putting in place lending mechanisms that ensure a sufficient flow of working and investment capital to the small and medium-size enterprises sector should local finance become accessible to TNCs.

On the other hand, FDI projects could promote domestic entrepreneurship in downstream and upstream activities. This issue is closely related to the extent to which FDI generates backward or forward linkages within a host economy. The greater the demand by a foreign affiliate for domestically produced inputs or services, the more favourable will be its impact on entrepreneurial development. Likewise, there will be similar favourable effects if a good or service produced by a foreign affiliate lowers the domestic price of an input that is used further upstream in the production process. Domestic purchases of foreign affiliates tend to increase as companies gain experience in host environments (see studies cited by Caves, 1996, p. 232). Subcontracting relationships often become important over time, with the consequent transfer of technology and managerial skills. In developing countries in which TNCs have invested heavily in the manufacturing sector, there is evidence that subcontracting has been very brisk. In Mexico, for example, 37 out of the 67 affiliates examined in a survey utilized local subcontracting (UNCTC, 1992b). Similarly, in Argentina, the privatization of telecommunications and public utilities has led to the development of equipment and input supplying firms (Chudnovsky, López and Porta, 1996). In the natural resources sector, FDI has traditionally not had strong linkages with the domestic economy; FDI in Chilean natural resource industries, for example, has been observed to have had much less impact on domestic firms through backward or forward linkages than that observed in manufacturing (Riveros, Vatter and Agosin, 1996). Generally, it would appear that forward and backward linkages are more likely to be generated when FDI is in the manufacturing or services sectors than in natural resources where foreign affiliates often have few interactions with the domestic economy. This, of course, does not mean that FDI in mining or petroleum is *per se* undesirable, since it may confer benefits that are unrelated to linkages.

TNCs may be able to raise the capabilities and quality of domestic suppliers and subcontractors to international levels more

effectively than domestic firms by transmitting technical information, skills, finance and other forms of assistance. Under import-substitution regimes, many countries sought to force the pace of local content by imposing time-bound rules, often not very efficiently. Performance requirements have increasingly been questioned (and some are not permitted under the WTO TRIMs agreement), although some Asian economies (e.g. the Republic of Korea and Taiwan Province of China) used them effectively by ensuring that supplier capabilities were able to match world levels (Lall, 1996). The increase of TNC linkages is increasingly driven by pure cost and efficiency considerations; as a result, TNCs are changing their sourcing patterns and raising local content in countries that have capable supply clusters while lowering them elsewhere. They are also often rationalising regional patterns of sourcing to get fewer types of components from particular countries but often on much larger scales.

TNCs will tend to have powerful (but possibly very uneven) effects on the development of local suppliers in developing host countries. As with FDI flows themselves, there appears to be growing concentration in locations that are industrially advanced and able to meet the rigours of world competition without substantial additional cost and effort. Other activities may well receive FDI but may not gain much by way of local depth and linkages. There also appear to be differences by home country of the investor; Japanese investors tend to stick with traditional suppliers (though this seems to be changing with greater international experience and under local pressure), while United States investors are more amenable to developing local suppliers in developing countries (though they are more likely to retain majority or full ownership of their own affiliates).

D. Employment and skill development

There was considerable concern in the 1970s that FDI did not generate enough employment, basically because foreign affiliates tended to transplant the capital-intensive technologies of their parent firms to developing country settings, with little effort to adapt them to local conditions where labour was abundant and capital scarce. In fact, foreign affiliates tend to use more capital-intensive technologies than domestic firms in the same industry, after controlling for other variables such as size. In host countries

whose main attraction for TNCs is the high quality of their mineral resources, TNCs create very little employment indeed. Mining is by its very nature a capital intensive activity, and possibilities for technology adaptation are small. However, the relevant question is, again, the counterfactual: would investment by national firms have taken place in the absence of a TNC? In some cases in which technologies are known in host countries, the answer could be affirmative. In industries in which new technologies are needed, it is unlikely that domestic firms would have invested.

Perhaps more importantly, TNCs have generated significant employment through their investment in export-oriented, labour-intensive activities, primarily in manufacturing but also in certain services, in developing countries. This includes the establishment of affiliates in export-processing zones, as well as the subcontracting of labour-intensive tasks to independent suppliers. Although it is limited in both the kind of jobs generated and their long-term sustainability, such employment generation has proved to be a useful strategy for several countries (UNCTAD, 1994a, chapter IV).

FDI can make a positive contribution to human resource development through the training and transfer of skills that are either unavailable or scarce in host developing countries (Enderwick, 1993; UNCTAD, 1994a, chapter V). It is well known that on-the-job training has strong externalities, and, for this reason, market forces tend to provide less than socially desirable levels of it. The technological superiority of TNCs is also a potential source of human capital formation. Managerial skills have already been mentioned. Even when not required to do so, TNCs typically utilize host country personnel in middle (and top) management. The reason is obvious: local managers are better acquainted than expatriates with the ways of doing business, tastes and customs of the host country. Training may also take place at more technical levels or on the shop floor. These activities confer an externality on domestic firms through staff turnover and can, therefore, be encouraged through appropriate policies that are economically justifiable.

At the same time, however, host countries cannot rely on foreign investors to meet their broader or emerging skill needs. TNCs use the technologies that are appropriate to local education levels and train mainly to create efficient operators of such technologies (for instance, simple assembly). They do not generally invest in

the more difficult and long-term process of creating new skills needed for more advanced technological tasks. The upgrading of the general skill level and the provision of high level specialised technical manpower is something that host countries need to do themselves. Indeed, such upgrading itself can be used, as in Singapore, to attract higher inward FDI and to induce existing investors to move into more complex activities. Moreover, TNCs from the developed world tend to concentrate on industries with more advanced technologies, leaving a wide range of simpler activities in which skill creation has to depend on local firms. TNCs from other developing countries do also enter into simple labour-intensive activities, but these tend not to involve large amounts of training. Most important, no industry, however attuned to training, can replace the provision of education and basic skills by the national education system, which thus remains a vital area of host government policy.

E. Other effects

FDI may also *encourage competition and promote gains in technical efficiency* in host countries. This is the case when TNCs enter the domestic markets of developing countries in industries in which domestic firms are already operating. Even in the largest developing countries, domestic markets tend to be small, and oligopoly or monopoly conditions often prevail. Under such conditions, the entry of firms with state-of-the-art technology may prompt domestic firms to make greater efforts to improve their technical efficiency (UNCTAD, 1997a, chapter IV). The entry of TNCs into an industry has been found to have a positive effect on the productivity of domestic firms in a number of countries (Frischtak and Newfarmer, 1993; UNCTAD, 1995a, chapter III; and UNCTAD, 1997a, chapter IV).

On the other hand, in certain cases, the entry of TNCs into some industries of host developing economies has been known to lead to greater market concentration. By their very nature, TNCs typically operate in concentrated industries. In addition, they may wind up displacing smaller and less efficient domestic firms, rather than prodding them to increase their efficiency.[4] As in the case of developed countries, an increasing share of FDI consists of takeovers through privatization of small and medium-size enterprises or local private firms. It is feared that TNCs, with their large size, deep

pockets, competitive advantages and perhaps aggressive entry tactics, may lead to growing market concentration and the stifling of local entrepreneurship. However, it is difficult to derive welfare conclusions simply from changes in the levels of industry concentration. If concentration rises as a result of TNC entry, it may reflect the realisation of scale economies (especially in small host countries) or the introduction of modern technologies, rather than predatory behaviour by TNCs. Moreover, concentrated domestic market structures in a world with liberal import competition and the possibility of new foreign entry have a very different economic significance from similar structures in relatively closed economies: markets are far more "contestable" in the former than in the latter. While the possibility of predatory conduct always remains, the solution seems to be effective competition policy in general rather than any specific policies related to FDI (UNCTAD, 1997a).

Income distribution in most developing countries is more unequal than it is in developed countries. Little is known about the distributional impact of FDI and other TNC activities. One can, however, speculate that, if TNC activities lead to the introduction of new skills or to the training of human resources not previously available or undertaken in host countries, it is likely that they will make income distribution less unequal, since the accumulation of human capital has an equalizing impact on income distribution. If FDI is in labour-intensive industries, wages will be bid up and the impact on income distribution will be, again, positive. On the other hand, FDI in sectors such as mining, which are very capital-intensive and geographically isolated, may employ little labour and generate dual wage structures that contribute to income inequality. However, except in countries where FDI is large relative to the size of the domestic economy (e.g. as in Singapore or Malaysia), its effect on income distribution will probably be of secondary importance.

Notes

1 For the cases of Argentina and Chile, see Chudnovsky, López and Porta (1996) and Riveros, Vatter and Agosin (1996), respectively.

2 This subject has been dealt with in several studies. See, for example, UNCTC (1987), UNCTC (1990a), UNCTC (1990b), Cantwell (1993) and Chen (1993).

3 Firms are also prone to license technologies in industries characterized by rapid obsolescence, but they usually do so to other TNCs and in exchange for cross-licensing.

4 Of course, that is the nature of competition, the other side of the coin of technological progress in Schumpeterian "creative destruction". In the case of relations with foreign firms, however, there are several more complicated issues involved. One has to do with the fact that displaced domestic firms may eventually have become competitive, given appropriate policies in host countries. Another relates to international income-distribution considerations: to the extent that TNCs drive domestic firms out of the market, income distribution at the international level may become more concentrated.

Section IV

FOREIGN DIRECT INVESTMENT, TRADE AND DEVELOPMENT: POLICY ISSUES

Since the onset of the debt crisis in the early 1980s, FDI has come to be perceived in a much more favourable light than in the past by developing country governments. While debt repayments tend to be fixed and can create serious balance-of-payments problems regardless of the use to which the borrowing is put (especially when they are not devoted to investment in tradables), FDI projects generate outflows of profits only when they are successful.

There are good reasons for this reassessment of the potential role of FDI in development. Under current conditions -- and if the policy framework is adequate -- FDI and other forms of TNC involvement in developing countries have the potential for making a contribution to their development. In an increasingly liberalized and globalized world, the current need of developing countries is to strengthen their competitiveness in world markets, while accumulating capital, both physical and human. Policies to ensure the deployment of assets associated with TNCs -- in particular, technology, advanced skills and market access -- are a component of an industrial strategy that promotes this goal (UNCTAD, 1995a). FDI in service industries, prominent in recent FDI inflows into developing countries, may assist in improving the systemic competitiveness of host developing countries and, thereby, may eventually encourage new exports by lowering the costs of doing business.

FDI is not a zero sum game. Outflows of FDI to developing countries are likely to have positive effects on home countries as well. They usually lead to an increased flow of exports from

the home country. Cheaper imports into the home country may create adjustment problems, but they also involve significant welfare gains for consumers. In some cases, there may be losses in employment in some labour-intensive industries, but there should be gains in employment in others, which often pay higher wages than the industries affected by FDI outflows to developing countries. FDI in services in developing countries should have strong benefits for employment and exports from home countries, since it often leads to the export of machinery and highly-skilled services from the home country.

At the same time that the positive economic effects of FDI in both host and home countries have come to be more fully appreciated, there has been increased interest in the broader role of FDI in sustainable development (Jun and Brewer, 1997). FDI is thus viewed increasingly in relation to environmental and income-distribution issues, as well as issues of civic life, such as transparency and illicit payments. Although an extensive discussion of these issues would be beyond the scope of this paper, it should be noted that these issues are on the agenda in many host and home countries and therefore increasingly on the international economic policy making agenda as well.

A. Attracting foreign direct investment

Given the importance of FDI as a package of internationally mobile assets for growth and development, it is not surprising that all countries are competing to attract it. Policy efforts to attract FDI take place in many cases not only at the national level but also, and independently so, at various sub-national levels. Typically, these efforts focus on the following areas (UNCTAD, 1998a):

- *Improving the regulatory framework for FDI*. Reference has already been made (section I) to the world-wide liberalization trend and to the fact that unilateral national efforts at liberalization are increasingly being complemented by facilitation and protection efforts at the bilateral, regional and multilateral levels. The principal purpose of these efforts is precisely to create regulatory frameworks that are conducive to FDI. In a highly competitive world market for FDI, "best

practices" in this respect by *one* government rapidly become "benchmarks" for *all* governments. And benchmarking among governments is particularly important in a regional context. At the same time, however, countries need to guard themselves against a "race to the bottom" in their policy competition, as this would, ultimately, harm their longer-term development efforts.

Important in this respect is also the fact that countries seek to improve their capabilities to face the challenges of a more interdependent and competitive world (Dunning, 1992, 1993b). Efforts to ensure greater policy coherence, especially between FDI and trade policies, are part of these efforts to obtain greater systemic competitiveness, as are, of course, the more basic efforts to ensure macroeconomic, social and political stability and predictability.

- *Facilitating business*. Beyond the liberalization of regulatory frameworks (a more passive policy approach), more and more countries also give more attention to pro-active policies to attract FDI. Reference has already been made to the growing incentives competition for FDI. Typically, incentives are only one of the tools that governments use to attract FDI (UNCTAD, 1995a, 1996c). Most countries have established investment promotion agencies[1] whose purpose is precisely to attract FDI and look after foreign affiliates once they are established (by providing a range of after-investment services). Investment promotion agencies also search out, more than in the past, non-traditional investors and non-traditional home countries. Among the former, small and medium-size enterprises are particularly noteworthy (UNCTAD, 1998c); among the latter, TNCs from Asia and Latin America deserve special attention. In addition, many countries are engaged in a continuing process of regulatory reform, in the framework of which they seek to reduce the "hassle costs" of doing business, including through more efficient administrations.

- *Improving the economic determinants*. While the preceding sets of factors are important in terms of creating an appropriate enabling framework for FDI and, more generally, a good investment climate, in the end it is the economic determinants that are most important for the locational decisions of TNCs. Traditionally, the principal economic determinants were market size and market growth, dependent in turn on the income and income growth of a country or region. They certainly continue to be valid, and some of them even play a role in the creation of regional free trade agreements which, increasingly, are also free investment agreements. With markets becoming more open and technology and competitive pressures fostering the formation of integrated international production systems, the skill levels and adaptiveness of human resources, the quality of the physical infrastructure (including telecommunications and transportation) and various created assets (including innovatory capacity) are becoming more important, as is the existence of a vibrant domestic entrepreneurial sector and, in particular, the capacity of local suppliers to provide world-standard inputs. Government policies aimed at attracting FDI -- and, even more importantly, seeking to promote the growth of domestic enterprises -- increasingly pay attention to upgrading these determinants of locational decisions, be they decisions taken by foreign or domestic firms.

In brief, governments increasingly seek to create an environment in which firms -- be they domestic or foreign -- can prosper.

B. Increasing the benefits from inward foreign direct investment

The ultimate objective of governments in attracting FDI is, of course, to promote growth and development. FDI can play a role in this respect, but there is no simple and single description of what this role should be. For many countries, the objective is largely achieved when they have, on their territories, vibrant

enterprise sectors, regardless of whether enterprises are domestic or foreign owned. Many others, however, and especially governments of developing countries with strong administrative capabilities, seek to play an active role to help the firms located on their territories become internationally competitive; and FDI can play a particular role in this respect. This can perhaps best be illustrated with reference to East and South-East Asia, where it is possible to distinguish four different types of FDI strategies among the fast-growing economies in that region (Lall, 1996; Ernst, Ganiatsos and Mytelka, 1998; Wade, 1990). In brief, these are:

- Passive open-door policies to both FDI and trade, with no intervention to promote industrial development selectively (e.g. Hong Kong, China).

- Active industrial policies and promotion of local enterprises in certain activities, but effective open-door, non-interventionist policies in most export-oriented industries (e.g. Malaysia and Thailand).

- Active intervention in promoting strong TNC participation in manufacturing; no discriminating treatment in favour of local industry, but pervasive and selective guidance and inducement of foreign investors to upgrade their capabilities, including by increasing local technological activity (e.g. Singapore).

- Restriction of FDI and maximization of reliance on "external" forms of technology transfer in the context of a comprehensive set of industrial policies to deepen the indigenous manufacturing sector, promote local linkages and increase local innovative capabilities (e.g. Republic of Korea, Taiwan Province of China and, previously, Japan).

Each of these strategies above reflects the economic position, beliefs and capabilities of the governments concerned. Their experiences suggest that FDI can be treated in many ways, and that it can play very different roles in industrial and technological development. Countries that have wished to promote *indigenous*

technological deepening may have chosen to intervene to restrict the entry of TNCs, or to guide TNC activities and maximise their spillovers through operational measures such as performance requirements. Those that have chosen to rely on TNCs have often intervened in the FDI process to target investors, guide their resource allocation and induce them to undertake more complex value-added activities than they would perhaps otherwise have done. The different approaches to FDI partly reflect resource endowments, as well as differing political beliefs and administrative and productive capabilities. The options applicable to the larger developing economies, with greater scope for internal specialisation and local content, as well as better established indigenous enterprises, have been different from those open to smaller economies with limited internal markets.

What the discussion above suggests more generally is that FDI may have uneven effects on development. Effects are determined to a large extent by the conditions prevailing in host countries, by the investment strategies of TNCs and by the policies of host governments. Host governments do indeed retain a role in influencing the benefits that their economies gain from inward FDI. TNCs can be powerful agents of dynamic comparative advantage if a proactive and efficient government takes their efficiency needs into account and offers the right set of incentives and support measures for upgrading and transferring technology skills.

With the growing liberalization of FDI and trade policies, and with competitive bidding for FDI among all countries, many of the policy elements adopted in the past by countries such as the Republic of Korea and Taiwan Province of China are increasingly difficult to pursue. However, proactive strategies of the sort used by Singapore are available, and are sometimes regarded as "best practice" in FDI promotion and management. More host countries and sub-national authorities may be moving in this direction, away from passive open door approaches that were often considered optimal a few years ago.

C. Dealing with outward foreign direct investment

There is another aspect of the liberalization trend that has received far less attention, namely the liberalization of policy regimes governing outward FDI. Developed countries have traditionally

had a liberal regime in this respect, and developing countries are beginning to follow suit (UNCTAD, 1995a, chapter VII). Home countries can also facilitate outward FDI towards developing countries through a variety of policies (UNCTAD, 1995a, chapter VII). Indeed, most developed countries already pursue policies with this objective in mind, and developing countries whose firms are becoming internationally competitive are beginning to adopt them as well. Governments provide information on foreign markets and investment opportunities, as well as on legal and administrative frameworks abroad, to their foreign investors. Some governments also supply finance through specialized public banks. Most home governments have instituted investment-insurance programmes for foreign investors. Some of these forms of assistance have been multilateralized: the World Bank Group's International Finance Corporation provides both equity and loan financing to foreign investors; and the Multilateral Investment Guarantee Agency (MIGA), also of the World Bank Group, insures foreign investors against political risks in countries that have become MIGA signatories.

D. International issues

The policy issues addressed so far all concern national policies. By their very nature, however, FDI, TNC activities and the internationalization of production touch upon the policies, rules and regulations of more than one country. And given the nature of international production -- representing, as it does, a deeper integration of national economies than trade -- more and more issues are becoming potentially subject to international concern. Indeed, in principle, all issues related to the production process -- the essence of a country's economic activity -- contain an international dimension. By necessity, this leads, at least in the longer run, to an internationalization of the domestic policy agenda (Ostry, 1992). The growth of FDI and international production -- the productive core of the globalizing world economy -- creates therefore a range of new challenges that need international responses.

It is not surprising, therefore, that FDI issues are being increasingly addressed at the bilateral, regional, plurilateral and multilateral levels (UNCTAD, 1996b, 1996d, 1997a, 1998a, 1998d). The role of TNCs and FDI in economic growth and development, as reviewed briefly in its multifaceted impact in this issues paper, is central to these discussions, in particular for developing countries.

In international fora at all levels, therefore, the topics that are addressed in this paper and in other papers in this series will be on the agenda for many years into the future.

Note

1 The World Association of Investment Promotion Agencies (supported by UNCTAD, UNIDO and MIGA) has some 100 members.

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