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Developing countries and a possible multilateral framework on investment: strategic options

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The question of the establishment of a comprehensive and legally binding multilateral agreement for the treatment and protection of foreign direct investment has now come to occupy a prominent place on the international economic policy agenda. Two recent developments have brought this issue to the fore: first, in September 1995 negotiations began in the OECD to establish a Multilateral Agreement on Investment, meant to be a free-standing international treaty open to all OECD members and the European Communities, and to accession by non-OECD member countries as well; and second, the Singapore Ministerial Declaration of December 1996 of the World Trade Organization. Although the Declaration has for the present established only a working group to examine the relationship between trade and investment, it is widely regarded as having sown the seeds for the negotiation of a multilateral framework on investment (MFI) under the domain of the World Trade Organization. Against this background, there are two basic options open to the developing countries in responding to the demand for an MFI: to allow the current trends and arrangements to evolve and gather further strength and momentum and to move towards an MFI on the basis of the experience gained and consensus generated on important issues over time, or to prepare for negotiation of a comprehensive MFI and try to ensure that the resulting framework takes adequate care of their developmental (as well as their political and social) needs and concerns. Should the developing countries decide to take the multilateral route, the World Trade Organization forum may be a better option for them.

* Former Commerce Secretary to Government of India, Chennai, India. The manuscript was completed in April 1998, reflecting the status of international discussions and negotiations at that time. This article will be subsequently reproduced in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Volume 10 (UNCTAD, forthcoming).

Background

There are several reasons why a multilateral framework on investment (MFI) has become an important issue for industrialized countries now. First, the main home and host countries for the flows and stock of foreign direct investment (FDI), as well as for large transnational corporations (TNCs) whose strategies and operations are increasingly becoming globalized are for the most industrialized countries. The developed countries still account for over four fifths of the global FDI outflows and two thirds of the global FDI inflows. Secondly, the outward flows of FDI from the developed countries are rising, and, more importantly, the share of developing countries in the receipt of those flows is rising too, as many developing countries are increasingly becoming attractive destinations for FDI. The involvement of developing countries in an MFI, instead of its being confined only to industrialized countries, has therefore become a matter of interest to developed countries.

However, the fundamental reason behind the demand of the developed countries for a multilateral treaty on FDI is that they see FDI as playing a crucial role in the strategies of their enterprises to gain and consolidate market access around the world. FDI, trade and technology are increasingly intertwined and are becoming complementary or alternative modes of accessing foreign markets. FDI in particular is becoming more important than trade for delivering goods and services to foreign markets and, in addition, it is becoming a powerful vehicle for TNCs to organize production internationally, thereby enhancing their competitive edge. With an estimated $7 trillion in global sales in 1995 (the value of goods and services produced by some 280,000 foreign affiliates of TNCs), international production outweighed exports of goods and services (roughly $6 trillion) as the dominant mode for TNCs to service foreign markets (UNCTAD, 1997).[1] Furthermore, while FDI flows were $350 billion in 1996, the total investment generated by them in foreign affiliates -- the true measure of the investment component of international production -- was an estimated $1.4 trillion, or four times the volume of the FDI flows alone. In short, developed countries are now taking

[1] As far as developing countries are concerned, however, exports continue to be the principal mode of delivering goods and services to foreign markets.

a holistic and integrated view of trade (in goods as well as services), investment and technology and are therefore pressing for binding multilateral disciplines in all these areas, with a view towards enlarging and ensuring market-access opportunities for their enterprises around the world.

This holistic approach has received an impetus from a few other factors as well. First of all, the successful conclusion of the Uruguay Round not only extended the multilateral trade regime to the new areas of services and intellectual property rights, but also integrated trade in goods, services and technology and established a strong enforcement mechanism, including the possibility of cross-sectoral retaliation to penalize non-compliance. In addition to the General Agreement on Trade in Services (GATS)[2] and on Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement dealing with some investment issues, the Agreement on Trade-Related Investment Measures (TRIMs) has a built-in agenda that, among other things, follows for the discussion of investment policies. The World Trade Organization (WTO) is thus a convenient forum for bringing new issues on the multilateral trade agenda and establishing rules and disciplines for them. A second factor providing impetus to the new holistic approach to trade is the ongoing unilateral liberalization of FDI policies by developing countries and the spurt in bilateral treaties for the protection of FDI. A third factor is the growing number of regional arrangements on investment, such as the North American Free Trade Agreement (NAFTA), the ASEAN Free Trade Agreement (AFTA), the Asia-Pacific Economic Cooperation (APEC) Non-binding Investment Principles and the Southern Common Market (MERCOSUR) Protocols. These seem to have generated an impression in the industrialised countries that the distance to be travelled to reach an MFI with developing-country participation has narrowed and the time is now ripe to begin a process in WTO. The Singapore Ministerial Declaration of December 1996 is their first but decisive step in this direction.

The current desire of the industrialized countries for a legally binding treaty on FDI contrasts with their attitude towards the

[2] Unless otherwise indicated, the instruments mentioned here are contained in UNCTAD, 1996a.

multilateral initiatives undertaken in the past within the United Nations system to lay down standards for the conduct of foreign investors, especially TNCs. The industrialized countries were insistent then that the three multilateral instruments negotiated under the auspices of the United Nations system -- the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (negotiated in UNCTAD and adopted by a United Nations General Assembly resolution in 1980), the Draft United Nations Code of Conduct on Transnational Corporations (negotiated in the United Nations, but not adopted) -- and the Draft International Code of Conduct on the Transfer of Technology (negotiated in UNCTAD, but not adopted) -- should all be non-binding and voluntary codes. This reflected the different poliltical contexts within which these negotiations had taken place, as well as their different motivations and goals.

Within the Organisation for Economic Co-operation and Development (OECD), although the Code of Liberalisation of Capital Movements was adopted as a legally binding code in 1961 when the OECD itself came into being, it was only in 1984 that the national treatment principle for the establishment stage was incorporated in it. The OECD Declaration on International Investment and Multinational Enterprises, adopted in 1976, which includes, *inter alia*, a "national treatment" instrument (establishing national treatment in the operational stage) and Guidelines for Multinational Enterprises (establishing voluntary standards for the behaviour of such enterprises), is legally non-binding. The Recommendation of the Council on Bribery in International Transactions, adopted by the OECD in 1994, is also not binding.

It is thus clear that, as the focus of the industrialized world shifts from the obligations of the owners of capital to the obligations of host countries, the instruments envisaged, such as the MFI, are sought to be made legally binding. The underlying philosophy behind this approach would seem to be that the obligations of investors/ enterprises should be left to be addressed by national laws and regulations (applicable alike to domestic and foreign investors, and consistent with the country's international obligations), while intergovernmental agreements should be confined to the obligations and commitments of the signatory Governments. The implications

for developing countries of this dual approach are twofold: first, obligations on investors/enterprises that may contribute to the developmental objectives of the host countries will be avoided, or at best addressed only through recommendations for voluntary compliance in a multilateral agreement; and second, developing countries need to ensure that they have sufficient freedom and flexibility in the agreement to pursue their own policies for achieving their developmental (as well as political and social) objectives.

The apprehensions of developing countries over a legally binding MFI stem from the fact that they are net importers of capital and technology and that there is a large competitive gap between their enterprises, particularly small and medium-sized enterprises, and the large TNCs of the industrialized world. There can be little doubt that developing countries recognize the importance and value of FDI and foreign technology to their growth and development; the unilateral liberalization of their FDI and trade regimes and their increasing shift towards a market- and outward-oriented approach in economic policy-making bear ample witness to this. However, their experience shows that the building up of domestic entrepreneurial, industrial and technological capabilities is essential if they not only want to cope with but also to realize the full benefits of FDI and foreign technology. Without sufficient domestic capabilities, FDI and foreign technology seldom permeate the productive system of the national economy and spread their beneficial effects throughout it. Selective and judicious government intervention is therefore widely considered necessary to support or protect domestic industry and technology creation, sometimes even to ensure a level playing field for domestic enterprises. It also becomes necessary for developing countries to employ an appropriate mix of incentives and performance requirements for FDI to achieve specific developmental objectives. Besides economic objectives, regulation of FDI is also seen as necessary by developing countries, the more so because they are overwhelmingly net importers of capital, in order to realize certain political and social objectives as well. Even in the case of the developed countries, it is noteworthy that their attitude toward inward FDI changed only after they became large exporters of capital and technology (e.g. Canada, Japan). Adequate freedom and flexibility to pursue their own policies towards FDI and foreign technology is therefore regarded by developing countries as a matter

of fundamental importance, although it is debatable whether regulation of FDI is the only or the best way for ensuring that FDI contributes to the developmental and social objectives of host countries.

Issues related to options open to developing countries

Against this background, what are the strategic options open to developing countries in responding to the demand for a strong, legally binding and effectively enforceable MFI? This is a complex question, considering its socio-political and economic implications. But before the options are analyzed, it may be pertinent to take note of some related issues.

The first is the expected impact of such a multilateral treaty on FDI flows to developing countries. The question is whether a multilateral treaty will enhance significantly the flows of FDI to developing countries in comparison with their own unilateral liberalization measures, coupled with the bilateral, regional or plurilateral agreements that they are already entering into of their own volition. The current pattern in FDI flows to developing countries throws some interesting light on this question. Its dominant feature is that the distribution of the flows is highly skewed. Taking the four-year period from 1993 to 1996, total FDI flows to developing countries were $388 billion. Of this, China alone accounted for $139 billion, or about 36 per cent of the total flows to all developing countries. The next five largest recipients -- Mexico, Singapore, Brazil, Malaysia and Indonesia -- each had a share varying between 4 per cent and 8 per cent; together, they accounted for about 28 per cent of total FDI flows. The next 14 largest recipients (each of which had a share varying between 0.8 per cent and 2.5 per cent) together accounted for about 24 per cent of total FDI flows.[3] These include,

[3] These 14 developing economies, in descending order of their individual shares, are Argentina; Peru; Hong Kong, China; Colombia; Thailand; Chile; Nigeria; India; Philippines; Republic of Korea; Viet Nam; Taiwan Province of China; Venezuela; and Egypt. It may be noted that Turkey and Bermuda have been excluded from these calculations, although the UNCTAD data include them also in the FDI flows to developing countries. It needs also to be noted that Mexico and the Republic of Korea, accounting for nearly 10 per cent of the total FDI flows to developing countries, are now members of the OECD and participate in the negotiations on an MAI.

inter alia, the newly industrialized economies of Hong Kong, China; Republic of Korea; and Taiwan Province of China. All the remaining developing countries, taken together, accounted for barely 10 per cent of total FDI flows to developing countries. Of these, the 48 least developed countries (as designated by the United Nations) accounted for a mere 1.3 per cent of the total FDI flows to developing countries (receiving $1.6 billion of a total FDI flow of $129 billion to developing countries in 1996).

It is difficult to argue that FDI flows to China, or the other leading developing countries, would be significantly influenced by their being or not being a party to an MFI. The driving force behind the FDI flows to these countries is the market and investment opportunities they offer, supported by their macroeconomic conditions, growth prospects and investment climate. Leading developing countries have shown that it is possible to maintain a sound investment climate and guarantee stability of policies and security of investment by their own autonomous measures. Conversely, despite providing a liberal investment climate and incentives for FDI, the poorer countries have been unable to attract FDI, primarily because of their lack of market and investment opportunities. There is no empirical evidence for the view that, if there were a multilateral treaty on FDI, the least developed and other developing countries, now on the fringe of FDI flows, would be able to compete more effectively for FDI and receive increased flows.

Two further interlinked questions in this context are: if developing countries can voluntarily enter into bilateral investment promotion and protection treaties (of which there has been an explosion in the 1990s), as well as regional and plurilateral arrangements, why should they hesitate to move on to the next higher level of a uniform and binding multilateral treaty? Would it not strengthen their investment climate much more than unilateral measures that are not irreversible or regional measures that discriminate against non-members? Secondly, if existing arrangements are conducive enough to promote and secure FDI flows, why should industrialized countries want an MFI?

It is true that there has been a dramatic increase during the 1990s in the number of bilateral investment treaties (BITs) for the

promotion and protection of FDI. As of 1 January 1997, there was a total of 1,330 such treaties in the world, involving 162 countries, compared with less than 400 at the beginning of the decade. More than two thirds of these treaties came into existence in the 1990s, around 180 in 1996 alone. Although the number of BITs between developing countries themselves is rising, over 60 per cent of all BITs at the end of 1996 involved developed countries. China leads developing countries in the number of BITs, having concluded 80 such treaties, of which 20 were with developed countries. The propensity of developed countries to conclude BITs varies widely, with Germany accounting for 111, the United Kingdom for 87, Switzerland for 81, France for 74, Netherlands for 58, the United States for 39 and Japan for 4 treaties. It must be stated that BITs have not been an important factor in influencing FDI flows to developing countries. In fact, according to a recent survey in the United Kingdom, most TNCs were not even aware of the existence of such treaties.

The main reason why BITs have found favour with developing countries is that they provide for national treatment to foreign investors in the post-establishment phase only (although some treaties -- e.g., those of the United States -- also stipulate national treatment as entry), and do not place restrictions on host countries in following their own FDI policies. This is because the aim of BITs is the protection and equitable treatment of FDI after the investment has taken place in consonance with the host countries' laws and regulations. As regards regional agreements, such as ASEAN or MERCOSUR, for one thing, such agreements are made among developing countries at similar levels of development and, for another, they do not restrict the autonomy of the participating countries in following their own FDI policies. The APEC Non-Binding Investment Principles (1994), besides being a voluntary code, also do not impinge on the freedom of host countries to pursue their own policies. NAFTA, however, signed between the United States, Canada and Mexico, marks a departure from BITs and other regional agreements inasmuch as it enshrines the national treatment principle from the pre-establishment phase onwards, although this has been tempered to a significant extent by exceptions allowed to Mexico. Furthermore, NAFTA does not prescribe any roll-back obligation, although of its own volition Mexico has undertaken certain roll-backs.

It is only the Multilateral Agreement on Investment (MAI) currently under negotiation in the OECD that aims at making the national treatment obligation legally binding in both the pre- and post-establishment stages of an investment at the plurilateral level.

On the other hand, the main purpose behind the multilateral treaty being contemplated by the industrialized countries is to gain market access for their enterprises under conditions of non-discrimination between domestic and foreign investors in regard to entry, establishment and operation. National treatment from the entry stage itself is crucial to the goal of gaining market access, and therefore, even if some country-specific exceptions are initially permissible under the treaty, they would be subject to stand-still and roll-back commitments.

The issue of national treatment at the pre-establishment stage (or the right of entry, right of establishment) is thus at the heart of the division between industrial and developing countries in their approach and attitude towards a legally binding multilateral treaty on investment. This issue is also closely linked to the objective of developing countries that any such treaty should take into account their developmental needs and concerns. While industrialized countries may argue that an investor-friendly agreement is *ipso facto* development-friendly as well, the experience of developing countries is that it takes more to advance the development dimension than mere statements of principles or exhortations in a treaty, or even negative lists of exceptions and transition periods. In their view, the pursuit of developmental objectives, in the light of each country's unique needs and circumstances, requires sufficient freedom and flexibility to pursue one's own policies which, in the context of a legally binding treaty on foreign investment, means the freedom to regulate the entry of foreign investment and to grant national treatment, subject to such qualifications as may be necessary, only in the post-establishment phase for investments conforming to the host country's policies, laws and regulations.

Lastly, socio-political and economic considerations interact rather closely in the realm of FDI. Foreign investment is much more politically sensitive than foreign trade. Concerns relating to national sovereignty or protection of social and cultural interests tend to figure

prominently in the case of foreign investment, arising at least in part from the fact that investment means long- term ownership and control over assets, resources and enterprises. For example, the domestic ownership requirements in many developing countries stem as much from political sensitivity as from economic considerations. This is also true, to a large extent, with respect to foreign ownership and control in the so-called "cultural industries" (e.g. media, publishing, films), or State ownership and control in some core industries. These concerns cannot be ignored or countered by purely economic arguments. The notion of non-discriminatory treatment between national and foreign investors therefore needs to be tempered by political realities as well, particularly against the background of the huge asymmetry in capital ownership between industrialized and developing countries.

The options

In the light of the issues discussed above, there are two basic options open to the developing countries in responding to the demand for an MFI (UNCTAD, 1996b):

- To allow the current trends and arrangements -- namely, autonomous liberalization of their FDI policies by host developing countries and bilateral and regional arrangements for the promotion and protection of FDI -- to evolve and gather further strength and momentum, and to move towards an MFI on the basis of the experience gained and consensus generated on important issues over time.

- To prepare for negotiation of a comprehensive MFI and try to ensure that the resulting framework takes adequate care of their developmental, as well as their political and social, needs and concerns.

It must be stressed at the outset that the first option does not in any way mean or imply that developing countries should go slow in the liberalization of their FDI regimes or dilute their standards of fair and equitable treatment and effective protection of FDI. In fact, their

current unilateral and extensive liberalization of FDI regimes stems from their recognition of the value of FDI in promoting their growth and development and in integrating their economies into the global economy. The fundamental issue in the choice of options is not the need for liberalization of FDI regimes or the standards to be followed for the treatment and protection of FDI, but how the liberalization and high standards of treatment of FDI can be maintained without eroding the capacity of host developing countries to pursue their own developmental, political and social objectives. The choice for developing countries, in other words, is between an evolutionary and a revolutionary approach.

First option: evolution of current arrangements[4]

Developing countries are not the countries which are seeing the need for, or demanding, an MFI at this juncture. They can therefore consider the option of continually improving their investment climate to attract FDI flows through unilateral measures to liberalize their FDI policies and regulatory frameworks, supported further by bilateral and regional agreements. As long as they keep their policies stable and transparent, and as long as foreign investors perceive their investment climate to be congenial in terms of fair and equitable treatment and other factors bearing upon the investment decisions of foreign investors, they will continue to receive FDI flows in tune with their market and investment opportunities. There is no *a priori* reason why a stable, predictable and hospitable investment climate for FDI cannot be maintained at as high a level under a combination of autonomous, unilateral and bilateral/regional measures as under a multilateral treaty. At the same time, developing countries will have the necessary freedom and flexibility to ensure that a liberal investment climate is in harmony with their own developmental as well as political and social needs and concerns. They will then be free to decide upon the nature and extent of national treatment to be accorded to foreign investors in the pre- and post-establishment phases of investment in the light of their own specific needs and circumstances. The surge in FDI flows to developing countries in the 1990s shows that investment climates and investment

[4] For a detailed discussion of this option, see UNCTAD, 1996b, pp. 161-166.

opportunities can be synchronized under the existing arrangements, as a major contributory factor behind the FDI upsurge has been the unilateral liberalization of FDI regimes by developing countries.

On the other hand, a legally binding multilateral treaty, in which the chief bone of contention is bound to be the issue of national treatment for FDI at the entry and establishment stages, may compel developing countries to minimize their commitments to as low a level as their negotiating strength will enable them to achieve. This may be attempted by keeping the "negative list" of exceptions as comprehensive as possible or the "positive list" of commitments as short as possible (or a mixture of both), resisting stand-still or roll-back obligations, or demanding long transition periods or special safeguards and derogations. Apart from the political and social sensitivities attached to FDI, this kind of minimalist approach may be considered necessary by developing countries in order to ensure adequate attention for the development dimension, which, as noted earlier, cannot be addressed merely by general statements in the preamble or exhortations and best-endeavour clauses in the body of the treaty. In the end, the scope for pursuit of national political, social and developmental objectives will depend upon host countries having sufficient freedom and flexibility to follow their own policies for building up their domestic industrial and technological capabilities.

Proponents of this option -- of allowing existing arrangements to evolve organically -- have therefore pointed out that the momentum for further liberalization of FDI policies is centred currently on the unilateral, bilateral and regional levels, and that it may be counter-productive if this momentum were disrupted by multilateral negotiations, which would bring the divisive issues, especially the issue of market access, to the fore. They have also pointed out that many developing countries have yet to adjust to the impact of the liberalization measures agreed in the Uruguay Round, and it may be too early for them to contemplate another multilateral undertaking for substantial liberalization of FDI, including the important issue of right of establishment.[5]

[5] See UNCTAD, 1996b, p. 165.

Developing countries therefore have adequate grounds to consider the options of allowing the existing arrangements to evolve, pursuing unilateral liberalization of their FDI regimes in accordance with their own needs and circumstances, enhancing their investment climate, and entering into bilateral, regional or plurilateral agreements to foster FDI. As these efforts gather more strength and momentum, those countries can use the experience gained to move closer towards a possible multilateral arrangement that is evolutionary in character. Being voluntary in nature, the existing arrangements have acquired a certain strength and durability, which, through further evolution, can provide a good basis for formulating a multilateral arrangement at an opportune time. Developing countries can therefore argue that the time is not yet ripe to begin negotiations on an MFI.

The option of continuing with the existing arrangements presupposes that developing countries have the collective will and strength to resist the pressure of the industrialized countries to begin negotiations on an MFI now. The experience of the Uruguay Round, and more recently of the Singapore Ministerial Declaration, suggest that this option may not really be feasible.

Second option: negotiating a multilateral agreement[6]

The proponents of an MFI have advanced several reasons for such an instrument. First, foreign investment and trade are inextricably intertwined, and the present international arrangements governing FDI do not adequately reflect or respond to the contemporary global economic reality. As with the multilateral trade rules ushered in by the Uruguay Round, a multilateral framework of rules for investment is needed as well in order to "catch up with the market" and cope with the dynamics of the ongoing integration of the world economy. In particular, this will enable firms to contest markets irrespective of the modality used to contest them. The underlying tenets of this argument are that FDI and trade are not substitutes but are complementary to one another, that FDI has become more important than trade in delivering goods and services to foreign markets, that FDI is becoming a key instrument in

[6] For a detailed description of this option, see UNCTAD, 1996b, pp. 166-168.

organizing production internationally, and that restrictions on trade or investment are indistinguishable from one another. Barriers to investment need therefore to be reduced under multilateral disciplines as barriers to trade have been reduced under GATT/WTO rules.

Secondly, the establishment of a multilateral framework of rules will help create a stable, predictable and transparent environment for investment, enhance business confidence and thereby promote the growth of FDI flows to developing countries. Conditions to help stimulate FDI are precisely those that are required to stimulate domestic investment as well. Bilateral investment treaties and unilateral measures, however strong and liberal, do not engender the same degree of business confidence, while regional agreements tend to discriminate against countries not belonging to a particular regional set-up. Furthermore, current bilateral and regional treaties, besides being limited to the signatory countries, do not adequately address certain vital issues of significance to foreign investors, especially non-discriminatory treatment of foreign investors at the entry stages of investment. In addition, the same investment issues are addressed in a variety of ways in bilateral and regional treaties, leading to complexity and inconsistency in the treatment of FDI. It is therefore in everyone's interest for the existing patchwork of bilateral and regional instruments to be superseded by a single multilateral instrument that lays down uniform rules for the treatment of investment worldwide. Those who argue for a multilateral framework raise two subsidiary arguments: first, small and medium-sized TNCs will be particularly enabled to invest abroad; and second, the least developed countries (LDCs) will be helped in competing for FDI which now flows predominantly into developing countries with large, lucrative and growing markets. According to WTO, if LDCs become signatories to a multilateral treaty on investment, it will substantially improve their investment climate and thereby enable them to attract much- needed FDI flows.[7]

However, as noted earlier, the fundamental motive behind the demand of industrialized countries for a strong and comprehensive MFI is the gaining and consolidation of market access for their business enterprises, particularly in developing countries with large

[7] See WTO, 1996, vol. I, pp.7 and 75.

or growing market and investment opportunities. A legally binding multilateral treaty, firmly enshrining the four elements of liberalization of the FDI regimes of host countries -- national treatment at the establishment and operational stages; fair and equitable standards for treatment of FDI; strong protection of FDI; and effective dispute-settlement procedures -- is key to achieving this objective. From their perspective, as trade, technology and investment become increasingly and inextricably integrated in the strategies and operations of business enterprises, and as multilateral frameworks have already been established for trade and intellectual property rights under WTO, it is time to establish the third pillar for a multilateral framework for investment.

In considering their response to an MFI, developing countries may perhaps need to avoid or discount extreme positions on a few issues. While it is valid for them to argue that the development dimension must be firmly built into any MFI; that there must be a balance between the rights and obligations of investors; and that such a framework must be cognizant of the asymmetry between industrial and developing countries in capital exports and imports, the case against an MFI cannot rest merely on the assertion that there is insufficient evidence as yet on the interlinkages between trade, investment and development. At the other extreme, the assertions of the advocates of a multilateral framework, to the effect that it will significantly augment the flows of FDI, reduce the cost of FDI (by reducing the risk perception) or improve the quality of FDI (because of the stability of investment rules) and benefit, the LDCs and small and medium-sized TNCs in particular need to be discounted to some extent as well. A multilaterally agreed framework of rules may contribute to the improvement of the investment climate (assuming that its provisions meet substantially, if not wholly, the expectations of the investors), but it will remain only one of several factors influencing the investment decisions of TNCs or investment flows into developing countries. Market opportunities and a host of other factors will continue to play a preponderant role in determining the destination of FDI flows.

The perceptions of the industrialized and developing countries on the need for, and value of, an MFI are bound to differ markedly

because of the fundamental differences in their situation as capital and technology exporters and importers. However, given the importance attached by industrialized countries to an MFI and given the past experience in new issues being brought to the agenda of the multilateral trade framework, it would be prudent from a practical standpoint for developing countries to be prepared for negotiations. As noted earlier, the industrialized countries are fairly clear in their negotiating objectives (they being the *demandeurs*), but the developing countries have yet to evince the same degree of clarity as to what they would wish to see in such a treaty. When the negotiations take place, the crux of the problem will lie in the scope and content of the treaty. If developing countries can evolve a common or collective stand on at least some of the key issues, it may still be possible for them to ensure that the treaty has the necessary balance to safeguard their interests.

Feasibility of the options

Some may be of the view that the first option outlined in this article (*viz.*, allowing existing arrangements to evolve organically) has little chance of being feasible, for two reasons. First, developing countries will not have a common stand on an MFI or the collective will and strength to oppose the establishment of an MFI in WTO. Secondly, and more importantly, if some developing countries decide to join an MAI (should one be adopted), others will be forced to follow suit, as otherwise they will be at a disadvantage in competing for FDI. Once an MAI comes into existence, BITs will become even more irrelevant, and unilateral liberalization will not be sufficient to compete effectively with the liberalization guaranteed by a multilateral treaty. Regardless of whether an MAI will or will not contribute to enhanced FDI flows to developing countries, the only feasible option available to those countires is the MFI route once an MAI gets established and some developing countries accede to it.

The validity of this viewpoint needs to be considered from different angles. First, the flows of FDI are predominantly determined by the market and investment opportunities offered by host countries whichopportunities, in turn, depend essentially on the size of the countries' economies and certain other advantages they may offer. As noted earlier, nearly 90 per cent of FDI flows are concentrated in

about 20 developing countries, with one country alone, China, accounting for more than one third of those flows. Therefore, competition between signatory and non-signatory MAI developing countries may at best be limited to this small number of countries. Furthermore, there is no reason to believe that an investment that otherwise would have been received by a country would be lost by it merely because it is not a party to an MAI. Conversely, if an investment would not have been made otherwise, the potential host country would still not receive it even if it was a signatory to an MAI. In other words, if through its own policies a country maintains a congenial investment climate, it can still compete effectively for FDI even if it is not a signatory to an MAI.

Even assuming that an MFI is the better or the only option for developing countries, the cost-benefit equation will depend heavily on the scope and forum of the MFI. In a way, these are interrelated. The aim of the OECD MAI will naturally be to set the highest possible standards for the liberalization of investment rules and for the widest possible coverage of investment, because it is being negotiated among countries at more or less the same level of development and with the same outlook. The ultimate elimination of the distinction between a domestic and foreign investor is the *summum bonum* of the OECD approach. This is understandable in the context of the OECD negotiations. For the vast majority of developing countries, however, adherence to such standards would involve costs substantially higher than whatever benefits they might receive. There will be some developing countries that may find it in their interests to join such a treaty; but this by itself is unlikely to weaken the competitive position of other developing countries not joining the treaty.

For pursuing the multilateral route, WTO offers the best forum for developing countries, for reasons explained later in this article. The negotiations can then take into account the interests of the capital exporters on the one hand and those of the capital importers on the other; the scope and content of the treaty would hopefully be influenced by this fundamental difference between the two sets of parties. Moreover, given the WTO decision-making process, if an MFI is negotiated in that organization, it will apply to all WTO members, and the risk of some developing countries losing their competitive edge for attracting FDI by remaining outside of the MFI

will therefore not arise. Negotiations in WTO would bring to the fore the need for a balanced and evolutionary approach in this matter and would reveal that, while developing countries may be able to offer national treatment to FDI in the post-establishment and operational stages, they have still a long way to go before they can take on the obligation of national treatment in the pre-establishment phase. Therefore, even if the first option outlined in this article is not considered feasible or desirable for any reason, developing countries need to consider seriously the forum for negotiating an MFI, as this will have a vital bearing on the scope, content and further progression of the MFI to which they may be a party.

Key issues in a multilateral framework from a developing-country perspective

Of the key issues to be considered by developing countries, the most crucial is **national treatment in the pre-establishment phase** (or "right of entry" or "right of establishment"). As observed earlier, the critical difference between most BITs being so readily entered into by developing countries and the proposed multilateral treaty lies in the issue of non-discriminatory treatment of foreign investment at the entry and establishment stages. All the other important elements of treatment of foreign investment -- such as national treatment in the post-establishment phase (i.e. after the investment has taken place in accordance with the host country's laws and regulations), most-favoured-nation (MFN) treatment at all stages, fair and equitable treatment of an established investment, freedom for repatriation of capital and remittance of profits and dividends, protection of foreign investment, and dispute settlement through international arbitration -- are more or less guaranteed in the bilateral treaties, and their transposition to a multilateral treaty, even in a more strengthened fashion, may not pose a serious problem for developing countries. But national or non-discriminatory treatment between domestic and foreign investors at the entry and establishment stages has consciously and deliberately been excluded from most BITs to give developing countries the freedom to pursue their own developmental and political objectives. It is this basic freedom that could be eliminated or curtailed substantially by the proposed multilateral treaty.

It may be argued that the concerns of developing countries over national treatment at the entry stage can be addressed through general exceptions (e.g. for security or cultural reasons) or country-specific reservations. But such an approach would imply very long "negative lists" to take care of current and future requirements, the more so if they are to be further subjected to stand-still and roll-back commitments. Besides industry- or activity-specific reservations (which mean exclusion or restriction of foreign investment in certain industries, subsectors or activities), the entry-stage national treatment exceptions will also need to address the important issue of the domestic ownership policies of developing countries. At present, such policies require, for example, minimum levels of domestic ownership *per se*, formation of joint ventures with minimum levels of domestic ownership by local partners, minimum volume of foreign investment in any foreign-owned enterprise and maximum level of foreign investment in small and medium-sized enterprises, and the like. Moreover, there has to be a mechanism to ensure that the negative lists are not frozen over time (i.e. their composition can be changed) and that their modification does not require tortuous renegotiations. On the other hand, a positive list approach, i.e. specifying the industries and activities which alone would be eligible for national treatment in the pre-establishment phase, would run the risk of the initial commitments being kept by countries at as low a level as possible. Thus, both the negative and positive list approaches will have their own deficiencies under a legally binding multilateral treaty, but both of them will tend to make the host country's policies appear more restrictive and less liberal towards FDI than what is actually followed by the country in practice. (An analogy would be the difference between bound tariffs and effective tariffs in the trade regime.)

Some possible ways for tackling the pre-establishment phase national treatment issue, from the standpoint of developing countries, are:

- exclusion of the whole issue from the treaty as far as developing countries are concerned, and its review, say, after a 10-year period;

- having neither a negative nor a positive list, but only a requirement for notification from time to time of the exceptions to national treatment;
- the inclusion of "developmental reasons" in the category of general exceptions, in addition to security, public order or cultural reasons;
- freedom for each country to apply only national treatment to larger projects only; and
- freedom from stand-still and roll-back obligations.

The World Bank's 1992 Guidelines on the Treatment of Foreign Direct Investment of 1992 provide another model for considering the question of regulation of FDI at the entry stage. They recommend free admission of FDI subject to a "restricted list" of investments, which are either prohibited, require screening and licensing, or are reserved for nationals on account of the host country's economic development objectives. They maintain the right of host countries to make regulations to govern the admission of FDI. According to the guidelines, FDI taking place in non-restricted list activities without prior approval would remain subject to the host country laws and regulations applicable to investment, which presumably could include domestic ownership requirements as well.

There may be other ways to address this issue, but unless the issue of national treatment at the entry and establishment stages (including domestic ownership requirements, and screening and approval of foreign investment) is carefully examined and mechanisms are found to address the needs and concerns of developing countries on this critical issue, the chasm between industrialized and developing countries on the scope of an MFI will remain unbridged. In this context, it is worth stressing that keeping uniform national treatment rules for developed and developing countries and only allowing a transition period for the latter to comply with the rules will not solve the problems of developing countries.

The second key issue for the consideration of developing countries is the **definition of investment** for the purposes of a legally binding multilateral treaty that seeks to eliminate the distinction between domestic and foreign investors. The scope and implications

of the treaty would rest heavily on the concept and definition of investment. The current (February 1998) draft of the OECD treaty adopts a broad definition of investment, *viz*., that "investment means every kind of asset owned or controlled, directly or indirectly, by an investor", including not only equity capital regardless of any threshold percentage, but also portfolio investment, debt capital, intellectual property rights and every form of tangible and intangible movable and immovable property. The term "investor" has been defined as any natural or legal person of a contracting party, the legal person being any kind of entity constituted or organized under the applicable law of a contracting party, including branch operations. Recognizing the wide coverage of the definition, a proposal was under consideration in the OECD to the effect that the definition of investment consists of an open (i.e., non-exhaustive) list of assets that are considered as investment, and a short closed list of items or operations that, except for purposes of investment protection, are not considered as investment. The latter list would include items like trade credits, traded goods and foreign exchange operations. Even with such safeguard provisions, it is clear that the definition of investment in the OECD treaty would go far beyond the traditional notion of FDI.

There has long been confusion and disagreement as to the appropriate definition of FDI, and different practices are in place in different countries and international institutions, although basically the definitions aim to exclude portfolio investments. For its annual *World Investment Reports,* UNCTAD follows the definition that FDI is "an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate). Foreign direct investment implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy" (UNCTAD, 1997, p. 295). Under this definition, FDI has three components, *viz*., the foreign investor's initial equity capital, subsequent reinvested earnings, and long-term intra-company debt transactions between parent and affiliate enterprises. In this context, it should be noted that the threshold of equity stake for determining control of an affiliate enterprise by a parent enterprise differs among

industrialized countries, with UNCTAD adopting a threshold equity stake of 10 per cent, while some countries, such as Germany and the United Kingdom, use a threshold of 20 per cent or more. For statistical purposes, the International Monetary Fund (IMF) defines foreign investment as direct (FDI) when the investor holds 10 per cent or more of the equity of an enterprise.

The broad definition of investment as envisaged in the OECD draft raises the issue of whether the proposed treaty is really for the treatment of (or a liberal regime for) TNCs and foreign investors rather than for the treatment of FDI *per se***.** To ensure that the obligations they undertake are within manageable limits, developing countries need to ensure that the definition of investment is kept within the narrow confines of "direct" investment as traditionally understood and that it does not get extended to portfolio investment, debt capital or financial transactions *per se*, or to intangible assets. The definition of investment has implications not only for the impact of the national treatment and other obligations of an MFI, but also for the potential need for further exceptions for balance-of-payment reasons under the obligation of free transfer of funds by foreign investors.

In this context, it is also relevant to note the struggle for jurisdiction over different kinds of capital movements among international institutions. The question of expanding the role of the IMF in the area of capital movements is currently receiving attention. According to the Interim Committee communiqué of 30 April 1997, accepted by developed and developing countries, "the Fund's Articles should be amended to make the promotion of capital movement liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements". The extension of the IMF's jurisdiction will naturally involve a discussion of the type of underlying transactions in the capital account that it should cover. Developing countries have cautioned that any extension of IMF jurisdiction beyond payments and transfers on the capital account should be confined to transactions that are directly relevant to the IMF's mandate as the overseer of the international monetary system and should be in harmony with the existing or prospective role of other institutions dealing with capital movements. Most developing countries have also considered it important to exclude "receipts" from

such jurisdiction in order to ensure that they maintain their discretion in managing capital inflows. Given the IMF's macroeconomic responsibilities, the extension of IMF jurisdiction in the area of capital movements will most likely exclude **inward** FDI, but it may well encompass outward FDI. Developing countries need to take a holistic view of the efforts under way to extend the jurisdiction of international institutions in regard to capital inflows and outflows (specifically in WTO and the IMF) and to ensure coherence in the obligations they undertake in different international fora.

The third major issue for the consideration of developing countries is **performance requirements** and **investment incentives.** The OECD treaty seeks to prohibit several performance requirements totally, and to prohibit a number of other performance requirements when they are not connected to the granting of subsidies and fiscal incentives. Three performance requirements falling within the totally prohibited category are the employment of a given level of nationals, establishment of a joint venture with nationals and a minimum level of local equity participation. Exceptions to total prohibition may be carved out for specific purposes, as, for example, export-promotion schemes, development aid, public procurement and environmental concerns. It is important that developing countries try to ensure that the obligations do not go beyond the existing TRIMs Agreement and that if they do, exceptions are carved out for development reasons as well.

Performance requirements are often linked explicitly or implicitly to investment incentives. Negotiations in the OECD thus far have remained ambivalent in disciplining the use of investment incentives. Views vary, from having no specific provision at all on investment incentives to constraining their use, including the prohibition of "positive discrimination" (i.e., more favourable treatment of foreign investors as compared to domestic investors) and caps on specific incentives. There has been some consensus so far on only three principles, namely, MFN, national treatment and transparency.

Empirical evidence suggests that incentives are less often used now to attract FDI flows **in general**, but are used more to achieve

specific purposes. However, international competition for FDI with fiscal, financial and other incentives is becoming pervasive, and is even more intense now than it was some 10 years ago (UNCTAD, 1996c). Competition with incentives is strong despite the evidence that incentives play a relatively minor role in the locational decisions of TNCs relative to other locational advantages. There is therefore a strong view that multilateral disciplines must be formulated to restrain investment incentives analogous to the disciplines on trade subsidies in WTO. Developing countries need to ensure that an MFI does not evade the issue of investment incentives while disciplining the use of performance requirements and that it allows for "negative discrimination" (i.e., domestic investors being given preference over foreign investors) in the matter of investment incentives.

Beyond these three key issues, there are some other important issues that require the special attention of developing countries. These are: **movement of natural persons, curbing of restrictive business practices, transfer of technology, and the obligations of investors**. Briefly stated, the imbalance between the treatment of the movement of capital and that of the movement of investment/trade-related human resources should be minimized under the proposed multilateral treaty. In the area of restrictive business practices, the regulation of the anti-competitive behaviour of TNCs cannot be left to be tackled solely by the domestic laws of host countries. A multilateral instrument seeking to liberalize investment regimes, beyond prohibiting restrictive business practices that are illegal *per se*, should aim at curbing such practices and thereby strengthen the efforts at the national level (Shahin, 1997). As regards transfer of technology, although the problem is complex and there may be no easy solutions, issues such as dissemination of information on, and transfer of, freely available technologies, assistance for transfer of environmentally friendly technologies, and concrete forms of technical assistance merit consideration even if it is found difficult to translate them into legally binding obligations. (In the case of proprietary technologies, the argument of industrialized countries has always been that they fall within the realm of the individual business decisions of enterprises.) Lastly, the obligations of the investors, legally binding where possible, and suggested good corporate practices where this may not be possible, must be spelt out so that there is a balance between the rights and obligations of investors under a multilateral treaty. In

respect of restrictive business practices, transfer of technology and investor obligations, the three multilateral instruments of the United Nations/UNCTAD referred to earlier provide valuable concepts and formulations for the advocacy of developing countries.

Lastly, there are two further important and complex policy issues that require serious thought in the context of FDI liberalization. These are **competition policy** and **environmental concerns**. As UNCTAD's *World Investment Report 1997* emphasizes, the reduction of barriers to FDI and the establishment of standards for the treatment of TNCs need to go hand in hand with the adoption of measures designed to ensure the proper functioning of markets, including measures to control the anti-competitive practices of firms. *WIR 97* stresses the need for taking an integrated view of trade, investment and competition policies and for establishing effective competition policy instruments at the international level. It further points out that UNCTAD's Set of Principles and Rules for the Control of Restrictive Business Practices (referred to earlier) remains at present the only multilateral instrument on this subject. The 1996 Singapore Ministerial Declaration of WTO resulted in the creation of a separate WTO working group to study the interrelationships between trade and competition policy. It is important that competition-policy issues are examined to identify the rules and disciplines that may be required at the multilateral level, taking into account the developmental needs and problems of developing countries (Shahin, 1997). Their linkage to the proposed MFI would also need particular consideration.

As regards environmental concerns, non-governmental organizations (NGOs) have voiced the apprehension that the increasing thrust towards the liberalization of foreign trade and investment regimes and unfettered freedom of TNCs to access markets and resources around the world could have an adverse impact on the preservation and protection of the environment. They feel that the "top-down" approach to liberalization of investment rules contained in the OECD's draft MAI could undermine the ability of national Governments to regulate access to, and use of, their natural and biological resources, and that it could put developing countries and transition economies in a particularly disadvantageous position. They have expressed the view that, if the MAI is to be made sustainable, negotiations should not proceed until a comprehensive review of its

potential impact on the environment and sustainable development has taken place.[8] In this context, developing countries need to keep in mind that it was with some struggle that they were able to establish the sovereign rights of States over their biological wealth and resources in the 1992 Rio de Janeiro Convention on Biological Diversity. As far back as 1962, they had achieved the adoption of a non-binding United Nations General Assembly resolution on Permanent Sovereignty over Natural Resources, which, besides establishing their sovereign rights, provided that "the exploration, development and disposition of such resources, as well as the import of foreign capital required for these purposes, should be in conformity with the rules and conditions with regard to the authorization, restriction or prohibition of such activities". It is important that developing countries do not overlook the rights already secured by them in such international instruments and not allow those rights to be diluted or whittled down by the national treatment obligations (such as right of entry, right of establishment and freedom of access to resources on a par with nationals) envisaged by the proposed MFI.

* * *

Before they choose the option of the multilateral treaty route, and regardless of whether they join the negotiations for such a treaty with conviction or under compulsion, it is important that developing countries formulate their negotiating objectives on the key issues in order to enhance the prospects of their political, developmental and social concerns being adequately reflected in the multilateral treaty. There can be little doubt that the interests and attitudes of individual developing countries will differ widely, depending on their macroeconomic policies, socio-political cultures, market size, domestic industrial and technological capabilities, skill advantages, and the regional arrangements to which they are, or want to be, a party. It may therefore be difficult for them to forge a common stand on many of the issues. Even so, there is scope and need for their collective thinking on the key issues enumerated above to ensure that their common or differing interests are addressed in a multilateral framework. Developing countries need to realize that, given the

[8] For a detailed analysis of this issue, see Werksman, 1997.

complexity and sensitivity of the issues to be tackled, and the divergence in the basic interests of industrialized and developing countries on these issues, the negotiation of an MFI will perhaps be the most difficult of the negotiations they may be called upon to undertake, with the long-term implications perhaps the most far-reaching. Their willingness to join the negotiations for an MFI should therefore be preceded by a strong and collective, as well as individual, application of their minds to their negotiating objectives.

Choice of forum

The OECD option

Should the developing countries decide to take the multilateral route, for the negotiations they would have the choice of the OECD forum, the WTO forum or both. Negotiations in the OECD on an MAI have been in progress since September 1995. As noted earlier, the MAI is meant to be a free-standing international treaty open to all OECD members and the European Communities, and to accession by non-OECD members as well. If developing countries choose to accede to the OECD treaty, they should take into account certain parameters applicable to an OECD MAI. First, the objective of the OECD countries is to establish the **highest standards** for the liberalization of investment regimes and investment protection, with as broad a definition of investment as possible. This is understandable because the OECD is a group of broadly like-minded countries at similar levels of economic development, in which liberalization is already well advanced. They are also among the largest exporters of capital, technology, goods and services. Secondly, national treatment from the pre-establishment stage onwards (including freedom of entry and right of establishment), subject only to very general exceptions (e.g. security exceptions and possibly cultural exceptions) and certain limited country-specific reservations, is the cornerstone of the treaty. The country-specific reservations are contingent upon each country offering adequate "upfront liberalization" so that there is a satisfactory balance of commitments on the part of all the signatories to the treaty. Thirdly, stand-still and roll-back commitments (the latter according to a pre-determined timetable or through future rounds of negotiations) are fundamental

parts of the treaty, as the goal is to lay down an irreversible initial minimum standard for liberalization and carry forward the process through future commitments. Fourthly, a wide range of performance requirements would be prohibited, excepting some requirements when they are connected to the granting of an advantage. Lastly, the OECD instrument, would be comprehensive in scope, covering all industries and activities.

Thus, the OECD treaty seeks to adopt a top-down approach to the liberalization of investment regimes, as the only reservations permitted are those listed for each country at the time of adherence to the agreement, and which are further subject to progressive liberalization. The ultimate aim of the treaty is to abolish the distinction between a domestic and foreign investor.[9]

It is obviously not the mandate of the OECD negotiators to take into account the developmental needs and concerns of developing countries. Moreover, although the treaty is open to accession by non-OECD member countries, they were only consulted as the negotiations progressed; they did not take part in the negotiations.[10] The OECD was carrying out this consultation process through its "Policy Dialogue Workshops" and "Out-reach" programmes. The purpose of these consultations was only to keep interested non-member countries informed of the progress of the MAI negotiations and to obtain their views on the various issues under negotiation.

Developing countries that are invited by the OECD for consultation can certainly take advantage of the opportunity made available to them in order to keep themselves informed about the progress of the OECD negotiations, to study the documents and statements made available to them and, more importantly, to make known their views on matters of concern to them. This does not, however, imply that they would accede to the OECD treaty. Some of the developing countries may take the view that the future thrust and direction of their own FDI policies would be in line with the high

[9] For a comprehensive analysis of the objectives and features of the OECD MAI, see Witherell, 1995, and Engering, 1996.

[10] In the later phases of the negotiations, however, some observers were admitted.

standards of liberalization adopted by the OECD treaty and that they may themselves become significant exporters of capital. Their own level of development and their current or possible future participation (or non-participation) in regional arrangements (e.g., NAFTA, Free Trade Area of the Americas (FTAA), APEC) may also influence their attitude towards the OECD treaty. They may therefore try to secure possible exceptions or safeguards and decide to join the treaty. For most of the developing countries, however, the consultation process may simply be a valuable educational experience. As the gap between the OECD standards and their own needs is substantial, they may not find it possible to join the treaty. Participation in the OECD's consultative process may also reveal disagreements among OECD members on key issues, and such disagreements could be used by developing countries to form alliances, to the extent possible, in the pursuit of their interests in an MFI or within WTO.

Even if some developing countries acceded to the OECD treaty, it would still only be a plurilateral agreement. The vast majority of the developing countries would most likely remain out of its purview. It has been suggested that if some of them join the OECD treaty, there may be pressure on other developing countries to follow suit, under the apprehension that they might otherwise be at a disadvantage in competing for FDI. Given the factors that influence the locational decisions of TNCs, such an apprehension is unwarranted and should not form the basis for a developing country's decision to join the OECD treaty.

It is a matter of conjecture at this point in time as to what the fate will be of the OECD negotiations, either be it because OECD members cannot agree among themselves on the MAI or because there are strong and definite indications that there will be an MFI within the framework of WTO. Will the OECD negotiations then go forward and culminate in a treaty? On the other hand, if a OECD treaty is concluded and it is followed by a WTO agreement, how will the issues of compatibility between the two be resolved? Also, how will the provisions of the OECD treaty be harmonized with the existing or future provisions of WTO's GATS, TRIMs and TRIPS Agreements? Furthermore, if there is an OECD treaty and it allows the country-specific reservations demanded by a developing country, would it not be better for that country to join the OECD treaty than to pursue

the WTO route, because the OECD treaty would be a stand-alone treaty and will not involve the risk of cross-retaliation? These are important questions, but they have not yet been examined or have not yet come up for consideration. However, it is fairly certain that an OECD treaty, whether in draft form or as adopted, as the case may be, would become the starting point for discussions in WTO. The industrialized countries would press hard for its adoption in WTO with as little dilution of the standards as possible. The developing countries must be prepared for this eventuality, which in essence means they must be ready to put forward alternative concepts and formulations on issues of importance to them.

The WTO option

If the multilateral route is to be pursued, the WTO forum may be the best option for developing countries. First, on the policy plane, the global economic reality is that trade, investment and technology are now increasingly intertwined, although the different facets of the interlinkages and their implications for the developing world undoubtedly need more research. The GATS, TRIMs and TRIPS agreements of WTO already address some of the issues related to investment, but the need for a comprehensive framework for investment within that organization will be felt in the coming years in order to ensure coherence and consistency between trade and investment policies. As noted earlier, furthermore, the chief message of UNCTAD's *World Investment Report 1997* is that competition policy needs to be addressed as well if the problems generated by the globalization of the world economy and the liberalization of the trade and FDI regimes are to be effectively tackled.

The harmonization of trade and investment rules in the WTO framework can open up some useful options for developing countries. For example, the question of FDI in the services sector could be left to be addressed by the GATS (especially with respect to issues such as MFN, transparency, national treatment and market access), the more so because the GATS envisages successive rounds of negotiations on the progressive liberalization of service activities, taking into account the interests of developing countries. The question of trade-related performance requirements, especially what is

prohibited or permissible, can similarly be left to be handled by the TRIMs Agreement. Some of the performance requirements (e.g., employment of nationals, joint ventures, and minimum level of local equity participation) which the OECD treaty seeks to prohibit are not banned by the TRIMS Agreement. The issue of national and MFN treatment for intellectual property rights can likewise be left to be covered by the TRIPS Agreement. An MFI under WTO can thus focus on matters that are not yet within the ambit of existing WTO agreements. This will not be the case with a treaty outside WTO, which is likely to involve obligations and commitments by developing countries over and above those accepted by them under the WTO agreements.

The second reason for preferring the WTO forum is that, although the principles of "special and differential treatment" for developing countries and "non-reciprocity" in concessions and commitments to be given by them have been dented by the Uruguay Round agreements, WTO still offers the best forum for developing countries to exercise their collective influence and to bring their developmental concerns to bear on the negotiating agenda. The philosophy that developing countries are at different levels of development as compared to the industrialized countries and that, therefore, there is a need for differentiated rules and disciplines for them is embedded in the WTO system, notwithstanding the deficiencies in their implementation. The numerical strength of the developing countries and the consensual approach to decision-making in WTO also make that organization an advantageous forum for them. To some extent, these advantages may offset the disadvantages arising from their weak bargaining power and their inability, unwillingness or unpreparedness to adopt a common stand in WTO negotiations.

Thirdly, and most importantly, unlike the negative list and top-down approach of the OECD, it is possible for developing countries to advocate a "bottom-up" approach in WTO through a positive listing of the agreed commitments. In this respect, the GATS offers a useful model of a hybrid approach, with a positive listing of sectors opened up and a negative listing of limitations on market access and national treatment. The MFN and transparency obligations, further rounds of negotiations for progressive liberalization, and special

consideration for developing countries will underpin the process of initial commitments and future liberalization under this hybrid approach. Alternatively, as suggested earlier, developing countries could insist that changes in their regime for pre-establishment national treatment should be notified only, with the question of its progressive liberalization to be reviewed after the multilateral agreement has been in force for, say, 10 years. These approaches will enable developing countries to have sufficient freedom to pursue the liberalization of their FDI policies of their own volition and to accept their commitments as legally binding at their own pace. Given the number of developing countries participating in WTO, the prospects of evolving an approach that is compatible with both the liberalization of FDI regimes and the developmental needs and concerns of developing countries are greater in WTO than in any other forum.

A serious disadvantage, it may be argued, in concluding an agreement within the WTO framework is that it will entail the risk of cross-retaliation across sectors under the WTO dispute-settlement mechanism. This may be a genuine concern, but this problem needs to be seen in perspective now that the cross-linkage of sectors has become an integral part of the WTO system. The extreme action of cross-retaliation in the WTO scheme is permissible only after all the previous layers of dispute resolution are exhausted, and thereafter only with the express sanction of the Dispute Settlement Body. So far, no plea for cross-retaliation has taken place in WTO, and only time will tell which types of disputes, and in what circumstances, reach the point of non-resolution so as to invite retaliation across sectors. Also, it is only State-to-State disputes that will fall within the ambit of WTO's dispute-settlement mechanism. State-to-investor disputes will continue to be resolved through their own mechanisms, e.g., through international arbitration (as in existing BITs). To avoid the contingency of cross-retaliation, developing countries may try to negotiate to have an MFI, although falling under WTO's definition of "multilateral trade agreements", treated as a distinct agreement (in an Annex other than Annexes 1, 2 and 3 of the Agreement Establishing WTO) and subject to the WTO dispute-settlement mechanism, barring the provisions applicable to cross-retaliation in that mechanism.

Heterogeneity of developing countries

In analyzing the implications of any international agreement for developing countries, there is often a tendency towards oversimplification. It is assumed that they are a homogeneous group with a similar outlook, problems and constraints. However, heterogeneity amongst them is a reality, and it comes to the surface nowhere more tellingly than when legally binding agreements in the economic field are negotiated. This is true -- as it was with the Uruguay Round Agreements -- for the proposed MFI as well. Newly industrializing economies and some ASEAN and Latin American countries may consider that the gap to be bridged between their own autonomous policies towards foreign investment and the obligations to be assumed under a multilateral treaty is not so large as to be insurmountable by them, especially in the light of the regional arrangements to which they are, or are contemplating to be, a party (such as APEC, NAFTA or FTAA). A multilateral treaty with high standards of liberalization could be seen by them as an instrument to attract more FDI, provided the treaty takes care of a limited number of their concerns, in particular the safeguards necessary for balance-of-payments reasons.

For developing countries with large and growing domestic markets -- such as China, India and Indonesia -- the size of the domestic market is a great advantage, as foreign investors are more likely to access their markets through local presence rather than direct exports. An autonomous and transparent liberalization of their FDI regimes (e.g., opening up of more industries to FDI, including infrastructure and services industries, liberalization of foreign ownership limits), coupled with national treatment in the post-establishment phase and adequate protection of investment, would still enable them to attract FDI. Their attitude to a multilateral treaty will essentially hinge upon how the issue of national treatment at the pre-establishment stage, which really means freedom and flexibility for them to follow their own policies at the admission stage, is resolved to their satisfaction. This may also be true for a number of other developing countries that have the potential to attract substantial FDI flows.

The oil-exporting developing countries in West Asia fall into a distinct category. Availability of capital is not a problem for them. As long as their domestic ownership policies and their system of differential taxation of enterprises based upon the level of domestic/foreign ownership are not altered by legally binding multilateral obligations, such other issues as liberalized and fair treatment of foreign investment or its effective protection may not come into conflict with their own autonomous policies. An MFI may be viewed by them from this limited perspective, as they know they do not need such a treaty *per se* to increase FDI flows.

At the other end of the spectrum are the large number of low-to-middle-income countries, including island economies, and, in particular, the 48 LDCs which are currently marginal receivers of FDI. Leaving aside those whose basic problem is political and social instability, the others are unable to attract FDI not because their investment policies are restrictive, but because their market and investment opportunities are meagre, their infrastructure weak, and their capacity to utilize FDI limited. The LDCs in particular are on the horns of a dilemma. They can claim longer transition periods and special exceptions under a multilateral agreement and they will most likely be granted favoured treatment, as was the case in the Uruguay Round Agreements. But the longer they remain under such exceptions and thereby outside the mainstream of rules and disciplines, the greater is the possibility that the competitive distance between them and other developing countries will widen. Although a multilateral investment treaty by itself may not alter dramatically their receipt of FDI flows, they may possibly gain by offering a strong national treatment privilege from the pre-establishment phase onwards, excepting only very small investments and the limited activities that may be within the capacity of their domestic investors. They may therefore wish to join an MFI on the consideration that it will give a boost to their investment climate. Even small incremental flows of FDI may be important to many of the LDCs in view of the small size of their economies.

The preceding broad analysis of the implications of an MFI for different categories of developing countries should not, however, mask the political dimensions of such a treaty for almost all those countries.

The political and social implications explain in substantial measure why so many developing countries are reluctant or unwilling to convert unilateral liberalization of FDI policies into legally binding multilateral commitments. The question of national and non-discriminatory treatment for foreign investors is closely linked to the issue of erosion of political and economic sovereignty, much more strongly than in the case of foreign trade. Besides this political sensitivity, the scope for utilizing FDI to serve their developmental objectives, in particular their need to develop and strengthen their own indigenous industrial and technological capabilities (or, in other words, ensuring sufficient "economic space" for their own enterprises to develop), rests crucially upon the freedom and flexibility they have in the admission and regulation of foreign investment. Thus, political and developmental considerations are intermeshed in the issue of national treatment at the entry stage, albeit with varying degrees of intensity, for almost all developing countries, regardless of the category into which they may fall.

Summary of options available to developing countries

The strategic options available to developing countries analyzed in this article can be briefly summarized as follows:

- Developing countries could allow the current trends and arrangements with regard to FDI (namely, pursuing their own autonomous liberalization of their FDI regimes together with bilateral and regional arrangements for the promotion, protection and fair and equitable treatment of FDI) to evolve and gather strength and momentum, and move towards a possible multilateral framework at an opportune point in the future on the basis of the experience gained and consensus generated on important issues.

- The above option is contingent, however, upon developing countries having the collective will and strength to resist the pressure of industrialized countries to begin negotiations on an MFI in WTO and/or to join the OECD treaty on investment currently under negotiation.

- The crux of the difference between existing bilateral treaties/ regional arrangements and the multilateral treaty advocated by industrialized countries lies in the issue of national treatment for foreign investors at the pre-establishment phase (i.e., freedom of entry, right of establishment, non-discriminatory treatment between domestic and foreign investors from the admission stage onward). This issue has vital implications for the political, social and economic objectives and concerns of developing countries.

- Before they choose the option of the multilateral treaty route, whether out of conviction or compulsion, it is essential that developing countries try to evolve a collective or common stand on certain key issues, such as national treatment in the pre-establishment phase, the definition of investment, performance requirements and investment incentives, movement of natural persons, restrictive business practices, transfer of technology and obligations of investors. In addition, the issues of competition policy and environmental concerns require examination from the perspective of developing countries. In the end, the critical question may not be why developing countries should join an MFI, but whether the scope, structure and content of the MFI adequately safeguard their legitimate interests and concerns. This will depend largely on the freedom and flexibility they have under an MFI to pursue their own policies.

- Developing countries invited by the OECD can take part in its consultation process. But in deciding or not whether they should accede to the OECD treaty (should it be concluded), they need to take into account the basic objectives and features of that treaty, especially its top-down approach to liberalizing investment regimes. Those developing countries whose judgement is that the gap between their own autonomous policies and the obligations imposed by the treaty is not substantial and can be managed by them may wish to join it. But the vast majority of developing countries may not find it possible to subscribe to the high standards set by the OECD treaty. There is, however, no ground for the apprehension that

developing countries not joining the OECD treaty will be at a disadvantage when competing for FDI.

- If developing countries decide to choose the multilateral route, the best forum for negotiating a multilateral agreement is, for various reasons, WTO. In particular, this will enable them to negotiate a bottom-up approach, with the GATS providing a useful model for dealing with initial commitments and future liberalization. They should also consider the option that an agreement in WTO could operate as a stand-alone agreement, with a dispute-settlement mechanism devoid of cross-retaliation provisions.

- Given the heterogeneity of developing countries, the impact and implications of a multilateral treaty will vary widely among them. The vast majority of low-income developing countries and the LDCs are currently on the fringe of FDI flows. Although an MFI may not make a dramatic difference to this situation, they may look upon such a treaty as an additional tool for enhancing their investment climate and thereby increasing the chances of receiving some incremental FDI flows. ■

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The internationalization of telecommunications services firms in the European Union

Jeremy Clegg and Syed Kamall*

Until the early 1990s, telecommunications services in most national markets were provided by monopoly State-owned suppliers. Transnational corporations (TNCs) in the telecommunications services industry were a rarity. However, worldwide liberalization is leading to the demise of international collusive arrangements and to the emergence of competing international alliances of transnational firms. This article highlights the relevance of international business theory, and examines the choice of market entry routes available to internationalizing telecommunications services firms with the backdrop of the European Union (EU). The combination of EU market liberalization and technological convergence has led to the creation of new telecommunications services, transnational diversification by incumbents and a new breed of specialist service providers. Conventional telecommunications operators have little option but to engage in foreign direct investment (FDI) to service local markets. A variety of FDI entry modes are available. Global alliances exist to distribute advanced services to transnational clients. As a result of the diversification of telecommunications services, there is now a new generation of value-added service providers. This new breed has a wide range of foreign market servicing

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methods at its disposal. The policy debate in Europe had been dominated by the implementation of the formal opening of EU member States to full competition on 1 January 1998. The extent and rate of liberalization and pan-European integration in telecommunications varied considerably by industry segment and by member State. Questions still remain as to the power of national regulators. Their strength will determine the success of liberalization and the success of the Single Market Programme in telecommunications services. Regulation at the regional European and global levels is an issue that will remain under debate for some time.

Introduction

Until the early 1990s transnational corporations (TNCs) in the telecommunications services industry were a rarity.[1] Most national services were provided by monopoly, frequently State-owned, suppliers. The few instances of transnational activity in that industry were generally limited to State-owned developed country firms operating in the markets of developing countries within their home countries' spheres of influence, typically those of colonies and former colonies.[2]

The recent changes in the telecommunications industry worldwide could not be more profound. The advent of liberalization and internationalization is leading to the demise of the single collusive global cartel and to its replacement by competing international alliances. Novel and alternative technologies for providing

[1] The simplest definition of a TNC is that of a firm adding value in more than one country (Dunning, 1993; Buckley and Casson, 1985); but to fulfil this condition the TNC need not be a foreign direct investor in physical assets. Foreign affiliates can operate mainly through the rental of facilities (Casson, 1982a).

[2] Although not a domestic monopolist, for example the United Kingdom's Cable and Wireless had been nationalized in 1946. It originated as a private firm, formed in 1929, through the merger of many privately-owned United Kingdom companies specialized in international submarine cable and wireless telephony (Sharp, 1991). The firm remained government-owned and controlled until November 1981. Historically, its focus was international, initially based on colonial ties. It operates in some 70 countries (Public Network Europe, 1998).

telecommunications services have led to a new generation of types of service, in particular, value-added services. They have also opened the way for cross-entry between previously distinct industries.[3] This article focuses on the new phenomenon of TNC telecommunications services in European markets, particularly in the European Union (EU). Emphasis is placed on firms involved in foreign direct investment (FDI), many of which are incumbent operators. Our main aim is to review international business theory in order to understand better the recent international expansion of telecommunications services.[4] The steps taken towards liberalization and regulation of the industry, and the simultaneous involvement of telecommunications services TNCs are examined. European Union member states are now in the process of implementing the effective liberalization of non-reserved telecommunications services,[5] which for most was due in 1998. Issues of government and firm interaction in the changing international economy are acutely evident in this industry (Buckley, 1996; Dunning, 1992, 1994; Stopford, 1994).

The growth of telecommunications services

There has been a sustained expansion in telecommunications capacity within the EU, compared with the United States (table 1).[6] The weighted EU growth rate during 1986-1995 of 42 per cent compares favourably with the growth rate in the United States of 35 per cent, both areas having roughly comparable numbers of lines. However, the growth in capacity alone fails to reflect the value of business carried by the new and existing lines. (Unfortunately,

[3] Cave (1991) has argued that the close interactions among different network industries make them especially amenable to cross-entry. The convergence of technologies for telephony, broadcasting and entertainment, and the Internet enables firms to diversify, cross-enter and integrate forwards and backwards. This applies even to content providers, such as musical artists (Clegg, 1998a).

[4] As the European Economic Area also follows the European Commission's liberalization programme, some consideration is also given to Norway and to Switzerland, which shadow EU developments.

[5] Reserved telecommunications services are those that are retained by the State, e.g., for emergency services, police and military.

[6] The data in table 1 are for the growth of main fixed lines, and therefore do not reflect the growth of mobile networks and other forms of telecommunications capacity and services.

Table 1. The growth of telecommunications main lines in the European Union, annual and period percentage change, 1987-1995

(Percentage)

Country	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1986-95
Austria	-	3.13	3.25	3.38	3.88	3.75	3.66	3.25	2.85	1.84	33.02
Belgium	-	4.34	4.69	5.29	5.42	4.69	4.11	3.08	2.97	1.63	42.54
Denmark	-	3.17	2.95	2.01	2.22	1.36	1.84	1.83	2.07	2.55	21.84
Finland	-	4.09	4.44	4.53	3.41	1.78	0.90	0.68	1.46	0.32	23.68
France	-	3.73	4.13	4.32	4.24	3.61	3.44	2.66	2.27	1.27	33.83
Germany	-	3.12	3.02	3.68	10.54	5.25	5.55	4.18	6.23	3.06	54.26
Greece	-	5.28	4.39	4.70	4.24	6.11	7.31	5.50	4.89	3.75	56.83
Ireland	-	6.05	5.84	8.70	7.31	6.61	6.20	5.12	5.98	5.65	74.48
Italy	-	4.67	5.16	5.84	5.10	3.23	2.77	1.93	1.55	1.27	36.16
Luxembourg	-	2.91	3.39	5.51	4.16	4.39	7.53	4.18	3.29	3.88	46.72
Netherlands	-	3.40	3.72	3.46	3.74	3.39	3.07	3.18	3.01	3.31	34.68
Portugal	-	9.65	11.65	12.34	14.53	13.23	11.88	8.17	5.64	4.11	137.39
Spain	-	4.61	7.18	7.52	6.83	5.25	3.98	3.34	3.03	2.79	54.27
Sweden	-	2.00	2.20	2.05	2.32	1.85	-0.47	-0.32	0.96	0.77	11.91
United Kingdom	-	4.31	4.75	4.45	2.30	2.18	2.35	3.05	3.69	3.67	35.27
European Union average [a]	-	3.95	4.40	4.69	5.62	3.93	3.74	3.10	3.51	2.45	42.02
United States	-	3.70	2.35	2.29	2.75	2.44	3.15	3.49	5.15	5.25	35.02
European Union total (thousands)	127924	132961	138786	145258	153293	159280	165184	170285	176218	180523	-
United States total (thousands)	122203	126725	129709	132683	136337	139658	144057	149084	156769	165000	-

Source: International Telecommunication Union (1997b).

[a] Weighted average by size of market for 1986-1995.

Note: - Denotes data are not applicable.

comparable data on the growth of revenues (in real terms) are not available, but these are likely to exceed substantially the figures in table 1.) It is often the lesser developed EU economies, such as Spain and Portugal, that have offered the greatest growth potential. However, the more modest growth rates in the larger economies represent greater expansion in absolute terms, and so they also represent very attractive markets.

New technologies and infrastructure in the expansion of telecommunications services are becoming increasingly important (table 2). The annual growth rate of cellular mobile services during 1986-1995 exceeded that of conventional fixed-line telephony by quite an order of magnitude in most cases. The EU average annual growth rate is not infrequently above that of the United States. Over the same period, the share of mobile services in total capacity (taken as fixed plus mobile services) has risen, respectively in the EU and the United States, from just 0 per cent and 0.6 per cent in 1986 to 10.6 per cent and 17 per cent by 1995.

Notwithstanding the lower level of integration within Europe for telecommunications services, market size and growth of cellular mobile telephony are undeniably commensurate with those of the United States. If the same logic is applied to the currently segmented European telecommunications market as has been to European markets in other industries under the Single Market Programme (SMP), then market integration will increasingly be required to attract FDI from outside the EU and to retain investment within the EU by native EU firms. An integrated European market is one in which competition is effective throughout and the prices of services have converged between States. Owing to the nature of the telecommunications services industry, as with many service industries, competition can be made fully effective only through investment, not through trade. At present, each EU country has incumbents with high market shares, i.e. the equivalent of fairly closed economies in trade terms.

Mobile telephony has made greater progress towards market integration in respect of both pan-European investment and service provision than has fixed telephony. The new cellular mobile

Table 2. The growth of cellular mobile telecommunications in the European Union, annual and period percentage change in subscribers, 1987-1995

(Percentage)

Country	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1986-95
Austria	-	37.26	40.73	37.44	45.30	56.59	49.44	28.07	25.96	37.86	1907.62
Belgium	-	90.18	165.18	60.75	39.26	19.92	19.53	8.90	89.67	85.12	6087.47
Denmark	-	34.42	31.06	21.99	19.73	18.70	19.96	71.21	39.33	63.38	1328.10
Finland		44.14	46.05	51.06	43.06	25.25	25.14	29.60	41.41	56.76	1948.63
France	-	333.29	150.63	81.43	58.74	32.42	16.45	30.98	54.37	56.17	15129.16
Germany	-	104.82	102.60	65.67	66.61	95.24	82.60	82.57	40.36	50.57	15656.30
Greece	-	..	..	..	..	..	..	..	247.92	63.47	468.75
Ireland		131.67	81.29	115.54	84.11	28.00	37.50	38.86	44.03	79.55	10433.33
Italy	-	82.82	103.27	96.58	302.60	113.53	37.85	54.15	85.58	72.50	42624.46
Luxembourg		97.62	95.18	31.79	92.97	37.14	0.80	346.18	153.74	108.13	31850.00
Netherlands	-	58.17	36.36	69.70	41.07	45.57	44.35	30.12	48.61	59.81	3252.94
Portugal	-	..	..	..	133.64	93.85	195.73	171.67	71.40	96.44	12151.80
Spain	-	147.06	176.86	156.13	83.66	98.27	66.25	42.68	60.13	134.44	56707.24
Sweden	-	53.64	40.46	43.62	32.15	23.20	15.45	18.06	78.18	46.74	1698.40
United Kingdom	-	123.08	93.10	74.11	14.26	13.11	19.60	50.50	73.72	45.58	4312.14
European Union average [a]	-	95.24	79.30	65.44	57.16	45.98	37.24	52.81	66.14	59.28	13866.59
United States	-	80.52	68.13	69.56	50.56	43.05	45.99	45.11	50.75	39.99	4855.18
European Union total (thousands)	433	782	1347	2198	3054	4198	5582	8393	13666	21490	-
United States total (thousands)	682	1231	2069	3509	5283	7557	11033	16009	24134	33786	-

Source: International Telecommunication Union (1997b).

[a] Weighted average by size of market for 1986-95

Note: - Denotes data are not applicable.

.. Denotes data are unavailable.

infrastructures, and in particular the adoption of the GSM standard,[7] have resulted in the first pan-European service for the end consumer (European Commission, 1998). This has come through the conclusion of numerous roaming agreements.[8] The findings of a review of the SMP ordered by the European Commission are that the generally positive impact of the SMP would have been greater if member States had been more diligent in implementing the Programme (European Commission, 1997, p. 23). The issues of implementation and enforcement are especially pertinent to conventional fixed-line voice telephony. Progress in these respects is essential for the integration of EU telecommunications markets through effective competition and price convergence.[9]

The market for telecommunications services

There are several key distinctions between types of telecommunications services. The most crucial business area distinction is between voice and non-voice telephony. As a general rule, it is voice telephony that has been the preserve of monopoly providers. Because the networks constructed for voice telephony represented virtually the entire capacity for telecommunications services, at least up to the mid-1980s, by extension this conferred an effective monopoly on established firms for non-voice traffic. A conservative estimate would be that 80-90 per cent of total traffic is still in voice telephony. With liberalization, these business areas have become progressively distinct. Service providers have been able to enter non-voice markets, such as data transmission and value-added network services (VANS). This new entry is enabled through requirements on incumbents (some of which, until very recently,

[7] The global system mobile (GSM) is a digital mobile standard. Early cellular telephony was predominantly based on analogue technology, which unlike GSM was not interoperational between European countries.

[8] Agreements between network operators, whereby a subscriber in one country can automatically use a mobile network in another country. The number of roaming agreements rose from 70 to 471 between 1992 and 1995 (European Commission, 1998, p. 5).

[9] The Single Market Review of telecommunications services notes that data services have been the most liberalized and can claim to offer pan-European services using end-to-end interoperational networks (European Commission, 1998, p. 64).

enjoyed monopoly on voice services) to offer interconnection services, i.e. to carry calls to their final destination.

Another key distinction is between public switched telephone networks (PSTNs) and private networks. In contrast to the more familiar public variety, private networks are employed by firms for telecommunication solely within the firm. Typically, this private capacity is either owned or leased from service providers. These distinctions between the types of service and the competitive conditions under which they are provided extend from the domestic into the international domain. It follows that firms with private networks often possess substantial internal telecommunications capacity. This private capacity can be central to new network-based competition.

The international telecommunications services market is normally considered separately from the domestic market, particularly for regulatory purposes. However, market structure in domestic services has largely determined the structure of international markets. The consequence of domestic monopolies in telecommunications has been the segmentation of the market for international traffic into a collection of reciprocal bilateral monopolies.[10] The inevitable outcome has been high tariffs and excess profits earned on international traffic by the incumbents. Therefore, for historical reasons, most of the international capacity is in the hands of the dominant national suppliers, e.g., in the form of international fixed links. These established operators themselves also lease international capacity from satellite operators. Until recently, many national suppliers have enjoyed legal monopoly over the right to carry international calls. However, the growth of international cable and satellite networks has alleviated scarcity in international capacity, and new service providers have improving choice in the international routing of traffic (ITU, 1997a, p. 89).

As international calls necessarily originate and terminate within domestic economies, the international market cannot be entirely separated from the domestic. The concept of the "international hub" forms a link between the national and the international levels. This is

[10] Each partner in the bilateral monopoly handles both inbound and outbound traffic (ITU, 1997a, p. 119).

a location in which international exchange (switching) capacity is concentrated, and through which international calls between third countries can be routed. A country that enjoys international hub status clearly has a greater share of the total international market than one, which handles only its own spontaneously generated traffic.

From monopoly to competition

Telecommunications services prior to liberalization

Worldwide, the provision of domestic telecommunications services has customarily been highly concentrated, often subject to high degrees of government control, normally through state provision (Kamall, 1996). In the 1980s, this was still typically the case in most developed countries. The two conditions of market failure required for government intervention in the domestic market have customarily been identified as natural monopoly and externalities (Buckley, 1996).[11] The justification for intervention in the form of government ownership and control — that is, intervention of the most entrenched variety — has rested on the social efficiency of a single fixed-line network operating under conditions of decreasing long-run marginal cost. The technical, informational and transactional difficulties of multiple operators using a single efficient network had long been deemed to rule out the possibility of competition. Added to this has been the government-imposed objective in the form of the social responsibility of the industry to connect even unprofitable customers to the network.[12] In some countries, the driving force for state provision has also been a political one, deriving from the strong preferences of national Governments to retain control and sovereignty over communications (Clegg, Kamall and Leung, 1996). Resistance to liberalization has largely come from the incumbents, and from Governments, which often derive substantial revenue from their ownership of telecommunications services. Some Governments have also feared the possible deleterious effects of liberalization on

[11] Empirical research on the cost structure of fixed-line telecommunications has yielded mixed findings (Kennedy, 1997). However, a thorough econometric analysis of United States data by Hunt and Lynk (1991) found evidence of production conditions that refute natural monopoly.

[12] This has its counterpart in the "access deficit" borne by incumbent operators in liberalized markets, for which compensation is required.

employment, and on the quality of services delivered to unprofitable customers that might result from profit-motivated new entrants (ITU, 1997a, p. 12). The costs of this protection have been welfare losses in the form of high prices, low innovation and poor quality of service.

The path to liberalization

The market structure and regulatory regime of the telecommunications services industry can take one of three broad generic forms:[13]

- ***Monopoly***, where one enterprise (usually a state-owned enterprise or a state department) is responsible for providing all the telecommunications services in a particular country. This was generally the case for most countries until the 1980s, when national Post, Telegraph and Telecommunications authorities (PTTs) were responsible for both regulation and service provision.

- ***Limited liberalization***, where the number of licences is restricted. The number of licences available may be dependent on the business area. For example, any number of firms may be allowed to offer services to corporate clients, while the mobile market may be limited to only a few licensees. In some cases, a limited number of domestic licences may be awarded on either a national or a provincial basis. However, access to the more lucrative market for international traffic typically remains restricted.

- ***Full liberalization***, refers to the case where any number of firms will be offered licences as long as they meet certain minimum requirements. The United States is beginning to resemble a fully liberalized market, though in certain cases (e.g. for personal communications services) licences are awarded on the basis of open tender. In the EU, the 1998 effective liberalization of telecommunications services heralds full liberalization for

[13] The various alternative processes in privatization are set out in ITU (1997a, pp. 45-54).

most telecommunications sectors. However, exceptions will persist in sectors characterized by scarce resources, e.g., in the case of mobile telephony, where there is limited radio spectrum availability.

The pressure to liberalize

Globalization is leading to increasing competition between firms and between countries (Dunning, 1992). In telecommunications services, national Governments have long felt the need to guarantee protection within the domestic market. State monopoly represents the most resistant form of barrier to international trade and investment. In the case of telecommunications services, the pressure to liberalize came from a number of sources: from a coalition of business customers whose international operations relied on telecommunications; from firms employing technologies able to compete with conventional fixed-line telephony;[14] and eventually from telecommunications services firms themselves, both outside and within the EU, attracted by market opportunities abroad.

Liberalization has placed an onus on Governments to extract the most favourable terms possible for their domestic incumbents wishing to gain access to foreign markets. Until the World Trade Organization (WTO) agreement on basic telecommunications services (WTO, 1998), rules for the multilateral liberalization of telecommunications services has been completely lacking. This vacuum created the need for TNCs to pressure States to act in their interests, even if it were a piecemeal approach (Stopford, 1994). In terms of the critique offered by Peter Buckley (1996), there had been extensive rent-seeking lobbying by domestic producer interests. In the case of telecommunications, these interests were unified in the form of a single incumbent.

In telecommunications, the collaborative model of home government-TNC behaviour has extended beyond the domestic economy. When the domestic sector moves towards competition, the

[14] This includes firms with private networks and firms whose main business area generated capacity that could be used for telephony, such as cable service firms.

incumbent's interest turns not only to retaining some advantage in the home market, but also to opportunities in foreign markets. Once outside the domestic markets in which they are the incumbents, operators become ardent advocates of liberalization abroad, and expect their home Governments to support them.

Interested parties outside the EU played a crucial role in promoting liberalization. Operators from the United States sought expansion in the developed markets of Europe, and lobbied the European Commission to liberalize EU telecommunications markets (Ungerer and Costello, 1988).[15] The guiding principle has been reciprocal access, whereby the trade representatives of those countries that lead in the liberalization process demand the right to reciprocal access in the less liberalized economies. This has been the practice in the United States. The United States authorities relaxed restrictions on share acquisition into national telecommunications operators only for firms from countries it considers to be as open as the United States. Similarly, the Commission is reported to have stipulated that AT&T had to offer all EU operators equal access to its transatlantic network in order to win approval for the Uniworld alliance between AT&T and Unisource. The net result had been an impetus towards liberalization, but primarily on a bilateral, self-interest basis. The prospects for underlying levels of market access have been considerably improved by the conclusion (on 15 February 1997) of the WTO's multilateral negotiations on market access for basic telecommunications services.[16] The principles essentially concern most favoured nation access and cover competition safeguards,

[15] Regional incumbent operators in the United States were constrained from growing nationally and therefore could grow only through international expansion. However, liberalization (primarily in the United States) has bred a new type of operator that specializes in providing local area networks to corporate clients, which can be replicated readily in other international business centres.

[16] Basic telecommunications services have been defined by WTO as all telecommunications services, both public and private, that involve end-to-end transmission of customer-supplied information (e.g., simply the relay of voice or data from sender to receiver). Examples of these are voice telephony, data transmission, telex, telegraph, facsimile, private leased circuit services (i.e. the sale or lease of transmission capacity), fixed and mobile satellite systems and services, cellular telephony, mobile data services, paging, and personal communications systems. Value-added services, or telecommunications for which suppliers "add value" to the customer's information by enhancing its form or content, or by providing for its storage and retrieval, were not formally part of the extended negotiations.

interconnection guarantees, transparent licensing processes and the independence of regulators.[17]

The prime concern of the European Commission is to attain European integration. This has been the driving factor in European liberalization. The Commission has harnessed the desire of telecommunications firms to form international alliances to push forward the process of liberalization. Approval of the Global One alliance was made conditional on France and Germany bringing forward the date for the liberalization of alternative infrastructure in their home markets. The head of the Commission's competition directorate (DGIV) also indicated that approval of the Unisource alliance might depend on Spain committing to open up its home market by 1 January 1998.[18]

The role of regulation in the European Union

John H. Dunning (1994) makes the point that when liberalizing domestic sectors and exposing them to competition and inward FDI, Governments should not abdicate their social responsibilities. In general, the act of privatization and liberalization creates a single dominant (but private sector) firm in each domestic voice telephony market. The evidence suggests that incumbents enjoy significant advantages over new entrants in the early stages of competition (Clegg, 1996b). Apart from advantages of size and scope, incumbents tend to have far greater local market knowledge than entrants (Franklin, 1994). This is why it is presumed that existing competition law is inadequate to achieve sustainable competition and unable to

[17] At the close of the three-year negotiations, the commitments of 69 Governments (counting individually the 15 member States covered in the single European Commission schedule) were annexed to the Fourth Protocol of the General Agreement on Trade in Services (GATS) (WTO, 1998). By January 1998, 72 WTO member Governments had agreed to open their domestic markets to foreign companies. The GATS comprises part of the Final Act of the Uruguay Round and the Marrakech Agreement Establishing the WTO (the Marrakech Agreement) (ITU, 1997a, p. 123). The precise scope of each Government's commitments to liberalize is contained in the schedule of each country (WTO, 1998). A summary of these commitments under the WTO agreement on basic telecommunications services is presented in ITU (1997a, Table 6.3, pp. 103-6).

[18] In 1996 the Government of Spain announced that it would create a duopoly at the beginning of 1997, when the new entrant, Retevisión, was in a position to offer basic telephony services.

prevent incumbents from abusing their power. It is on those grounds that industry-specific regulation is justified. During liberalization, the role of regulation is an evolutionary one. Initially, regulators' actions have two key objectives, and the balance should shift from the first towards the second as liberalization progresses. The objectives are:

- To act as a proxy for competitive forces that are as yet absent or weak,[19] i.e. to induce competitive behaviour in a market dominated by an incumbent operator. In the early stages, this means creating effective competition to constrain the incumbent to behave as if it were in a competitive market. The incumbent is prevented from exploiting market power in existing markets (based on voice telephony). At the same time, national regulators have a responsibility to restrain incumbents from using dominant positions in voice telephony to expand into new and emerging markets ahead of potential competitors. This is the justification for domestic line-of-business restrictions.

- To condition the market so that full competition will be sustained in the future, i.e. to foster the self-sustaining conditions for competition; for instance, to promote competition based on alternative infrastructures,[20] often employing networks based on different technologies that can deliver the same services.

The proxying of competitive forces means catering to consumer interests. Measures include imposing retail price caps and enabling new entry, principally through access-based competition via interconnection with incumbents' networks (Butler, 1998; Gilland, 1995). The dismantling of the costs of switching between operators is also intrinsic to a competitive market. For example, an important principle is number portability between competing operators on the part of consumers. This facilitates unfettered carrier selection,

[19] The regulators in Finland, Sweden and the United Kingdom are already fulfilling this function.

[20] The two key concepts are those of infrastructure-based competition and access-based competition. It has been suggested that in the early liberalizing markets, such as the United Kingdom, policy placed too little emphasis on encouraging infrastructure-based competition (McCarthy-Ward, 1994).

although establishing it in practice has proven arduous (Public Network Europe, 1997a).

The first stages of (partial) competition are therefore based on service competition, rather than network competition. Full network-based competition relies on freedom of entry and exit, efficient rental markets, and the absence of any significant advantages of the vertical integration of services provision and network operation.

The enthusiasm of national Governments for competition, particularly new competition via FDI from foreign TNCs, is still not unalloyed. Within the EU there are widely varying levels of commitment to liberalization.[21] There is considerable uncertainty about the pace and implementation of liberalization by member States. The key European directives concerning liberalization are set out in table 3. The provisions of directives must be incorporated into national law in order to become binding. Although 80 per cent of member States bound to the 1 January 1998 deadline had transposed most of the new legislative framework (Ungerer, 1998), even when formally enacted the implementation of market liberalization depends crucially on the power and interpretative *bona fides* of national regulatory authorities. Adequate resources and freedom from political pressure and interference are essential.[22] There is the risk that the EU States least committed to liberalization and market opening will appoint the weakest national regulatory bodies. It is precisely because of this that some argue there should be a pan-European regulator (Clegg, 1996b).

The historically piecemeal nature of progress in telecommunications' liberalization in the EU is set out in table 4. The United Kingdom was the first to begin the process in Europe, in 1984. Other countries that were early in attaining the stage of effective competition are Finland and Sweden, with Denmark close behind. Most of the EU countries had formally opened their markets by 1 January 1998, followed by Luxembourg in July and Ireland in December 1998. At the rear are Portugal and Greece, which have made the least progress towards liberalization. The reasons for this

[21] An extensive record and analysis of the progress of EU liberalization in telecommunications services is to be found in EC (1998).

[22] See EC (1998, p. 28).

Table 3. Key European Union directives in telecommunications liberalization

Sector	Key directives	Key provisions
Terminal equipment	Commission Directive of 16 May 1988 on competition in the markets in telecommunications terminal equipment (88/301/EEC) OJ L131/73, 27.05.88	Requires member States to end restrictions on the sale of terminal equipment.
Value-added services. Data services. Services for closed user groups and corporate networks.	Council Directive of 28 June 1990 on the establishment of the internal market for telecommunications services through the implementation of open network provision (90/387/EEC) OJ L192/1, 24.07.90	Established principle that incumbent operators should make capacity available on fair terms to new entrants to liberalized markets.
	Commission Directive of 28 June 1990 on competition in the markets for telecommunications services (90/388/EEC) OJ L192/10, 24.07.90	Abolished the monopoly rights of incumbents over all services except public voice telephony and telex.
Leased lines	Council Directive of 5 June 1992 on the application of open network provision to leased lines (92/44/EEC) OJ L165/27, 19.06.92	Requires incumbents to publish terms and conditions for supplying leased lines to new entrants and established minimum set of leased line provisions throughout EU.
Alternative infrastructure	Commission Directive 95/51/EC of 18 October 1995 amending Directive 90/388/EEC with regard to the abolition of the restrictions on the use of cable television networks for the provision of already liberalized telecommunications services (95/51/EC) OJ L 256/49, 26.10.95	Requires member States to lift restrictions on the use of cable TV networks for telecoms services, other than public voice telephony; by 1 January 1996.

/…

(Table 3, continued)

Sector	Key directives	Key provisions
Mobile services	Commission Directive 96/2/EC of 16 January 1996 amending Directive 90/388/EEC with regard to mobile and personal communications (96/2/EC) OJ L 20/59, 26.1.96	Requires member States to abolish monopoly rights over mobile services and allow operators to utilize existing alternative infrastructure.
Open network provision	Directive 95/62/EC of the European Parliament and of the Council of 13 December 1995 on the application of open network provision (ONP) to voice telephony (95/62/EC)	Requires fair and equal access to infrastructure under current regulatory conditions and provides for protection of consumer rights. Amendment will be needed to take account of full liberalization in 1998.
Full competition	Commission Directive 96/19/EC of 13 March 1996 amending Directive 90/388/EEC with regard to the implementation of full competition in telecommunications markets (96/19/EC)	Requires Member States: • To introduce legislation by 1 July 1996 to abolish special and exclusive rights over alternative infrastructure for telecoms services other than public switched telephony. • To abolish special and exclusive rights over telecoms services including public switched voice telephony by 1 January 1998.

Source: compiled by Alicia M. Clegg and adapted from Clegg (1996a).

Table 4. The state of liberalization in European Union telecommunications services markets, 1991-2002

EU country	Date of effective liberalization	National operator (former PTT)	Date and method of privatization of national operator
Austria	1998	Post & Telekom Austria	100% state owned
Belgium	1998	Belgacom	1995: Sale of strategic stake
Denmark	1996/97	Tele Danmark	1994: International offering. State retains 51%
Finland	1994	Telecom Finland	Finnish Government has announced plans to sell up to 20% stake
France	1998	France Télécom	1997: International offering. State retains 80%
Germany	1998	Deutsche Telekom	1996: Public offering. State retains 74%
Greece	2001	OTE	1996 & 1997: 20% of equity sold on Athens Stock Exchange over two offers
Ireland	1998 (December)	Telecom Eireann	1996: Sale of strategic stake
Italy	1998	Telecom Italia	1997: Privatization completed through second offering
Luxembourg	1998 (July)	P&T Luxembourg	100% state-owned
Netherlands	1998	KPN	1994 &1995: Public offerings
Portugal	2000	Telecom Portugal	1995, 1996 & 1997: Public offerings. State retains 25%
Spain	1998 (December)[a]	Telefónica	Privately owned. State's remaining 20% equity sold in 1997
Sweden	1991	Telia [b]	100% state-owned
United Kingdom		1991 [c]	BT 1984-93: fully privatized over three international public offerings [d]

Source: updated from Kamall (1996).

[a] End of Telefónica/Retevisión duopoly in December 1998.

[b] Incumbent never possessed legal monopoly, but has only faced significant competition since 1991.

[c] Ending of BT/Mercury legal duopoly.

[d] The Government of the United Kingdom retains certain powers embodied in BT's Articles of Association, notably in connection with safeguarding the control of the company by preventing takeovers (Brooks, 1997, p. 73).

rump of countries failing to open their markets on schedule involve a mixture of technical backwardness and entrenched business and political interests in resisting change (Blackman and Denmead, 1996).

However, in the markets that are formally liberalized, the key challenge arises from establishing the principle of effective competition to establishing effective competition in practice. The problems in this respect pertain to three central issues: defining and applying the open network provision (ONP) principles, the setting of interconnection tariffs, and leased line access (EC, 1998, p. 27). For instance, Germany has adopted a minimalist definition of ONP principles, resulting in consistently inferior interconnection access for new entrants. Such barriers to entry favour the national incumbent operator and continue to segment national telephony markets (EC, 1998, pp. 27-28). All these developments mean that failure to progress towards effective competition in telecommunications markets is increasingly the result of inertia in implementing existing legal provisions, e.g., the failure to issue licences to compete with incumbents using either conventional or alternative infrastructures.

The future of regulation

The demand for regulation is a derived demand dependent on the shortcomings of the normal competitive processes. Competition reduces, but does not necessarily eliminate, the need for regulation. In telecommunications, effective standard-setting and regulation go hand in hand, as trade policy alone cannot guarantee competition and market access (Cable and Distler, 1995). These same authors raise the prospect that the first flush of international competition caused by technological convergence, liberalization and new entry may eventually give way to greater market concentration at the global level. If so, a commensurate policy response will be required.

Technological convergence means that alternative equipment and infrastructures can handle the same services. In particular, the replacement of analogue by digital-based services means that formerly disparate activities, such as telephony, data transfer, entertainment, and home shopping, can readily be handled by alternative infrastructures (McCarthy-Ward, 1994). Notably, data can be carried over voice networks, and vice versa, blurring the boundaries (ITU,

1997a, p. 93). Regulation in telecommunications requires that these competing networks should interconnect. The implications of the multiple technologies, evidenced in table 3, are that regulation should eventually be consolidated across the different means of delivering services. (A possible development path for the changing and future role of telecommunications regulation is outlined in box 1.)

Box 1. The changing role of telecommunications regulation

Pre-1998
Competition in most member States is limited.
Regulators prepare for liberalization.

1998
Full liberalization in most member States.
Consolidation within and between telecommunications sectors.
Regulators become proxies for market forces.

2001
Separate firms operate networks and provide services.
Regulation increasingly relies on EU competition policy, especially in services.

2005
The telecommunications sector forms the main pillar of the information society.[a]
The role of regulators changes to the enforcement of competition rules.[b]

Source: adapted from figure 5.2 in Blackman and Denmead (1996), p. 98.

[a] Consisting of content providers, information technology firms, broadcasting firms, linked by telecommunications service operators.
[b] Determined increasingly at the supranational level.

It is possible to identify at least three layers of rule-making and standards setting bodies: the national, the regional and the global levels (see Cable and Distler, 1995, fig. 9). The debate over regulation changes focus as one traverses these levels of analysis. At the national level, where some form of regulatory authority is generally already in place, the issues are those of implementation, of infrastructure versus access-based competition, and in particular of the setting of

tariffs for interconnection to incumbents' networks, price-capping regimes, number portability and so on. At the European level, the debate is over the timetable to achieve a single market, in the awareness that national distortions in regulation pose a considerable threat to market integration and rates of infrastructure investment. The benefits of centralization over the present system whereby national regulatory authorities (NRAs) implement EC directives through the principle of subsidiarity are argued to be such that eventually a pan-European regulator will be required (Pelkmans, 1998; Public Network Europe, 1997a).[23]

If this is the case, then the threat perceived by the EU is that a European regulatory solution may not be achieved "before events elsewhere in the world overtake us" (Worthy and Kariyawasam, 1998, p. 7). These possible events include global regulation, but also the risk that a slow timetable to European integration will mean the EU losing market share in world telecommunications services markets (and therefore employment), as excess capacity is taken away by competitors (Button, 1995). The state of progress towards developing regional structures for liberalization in Europe is seen by some as already "Perhaps too little too late" (Cable and Distler, 1995, p. 45).

The precise shape of the eventual rationalization and consolidation of regulation cannot be foreseen. The power of national regulators relative to pan-European TNCs may be insufficient, especially when those TNCs are global operators. Pan-European regulation would seem logical in the interests of an integrated European market, but national differences are likely to persist in the approach to regulation (Button, 1995). It is therefore reasonable to countenance the emergence of a world regulatory body, under the auspices of the ITU or WTO (Cable and Distler, 1995).

One of the key issues in telecommunications is the setting of standards which, as in many manufacturing industries, can become barriers to trade.[24] There is a natural tension between free trade and

[23] In 1997, the European Parliament forced the Council in the conciliation procedure on the Interconnection Directive to accept that the Commission study the merits of a European telecommunications regulator and employ the result in a review in 1999 (Pelkmans, 1998, p. 69).

[24] Standards are fundamental to free trade and investment in telecommunications (Cable and Distler, 1995, p. 28; Kindleberger, 1983).

setting of standards at the national or regional level, rather than at the global level. The expression of this tension will depend partly on the geographical compass of the dominant telecommunications firms that have an incentive to influence the evolution of standards. As V. Cable and C. Distler put it, "Regionalism has been seen as a middle way between cumbersome global standards setting and the proliferation of competitive, incompatible standards" (Cable and Distler, 1995, p. 29; Hawkins, 1992).

It is relatively easy for standards to be employed as technical barriers to trade, or to be perceived as such. A case in point is the universal mobile telecommunications system (UMTS) mobile telephone technology norm agreed by EU firms in the Nice-based European Telecommunications Standards Institute (ETSI). The EU norm is one of several systems ratified by the ITU for the replacement of GSM. The draft rules approved by EU Governments allow a limitation on the number of licences to be granted on the grounds of radio spectrum scarcity. The United States fears these may be employed by European Governments to favour European operators at the expense of United States rivals using systems not matching the full ETSI norm (Chapman, 1998).

One of the legacies of the past is the system of bilateral agreements between countries on accounting rates on international telephony, historically overseen by ITU (ITU, 1988; 1997a, p. 89). They are obsolete, being undermined by alternative calling procedures, and require reform to become a multilateral system, as in merchandise trade, based on non-discrimination and principles of symmetry in the rates (ITU, 1997a, p. 94). The regime that has governed the international telephony market falls outside the General Agreement on Trade in Services (GATS) of WTO. The free trade rules for telecommunications services under the GATS were produced as the outcome of sector-specific negotiations. They were not part of the overall multilateral negotiations under the Uruguay Round.[25]

The impact of the EU's SMP for telecommunications services is difficult to evaluate. According to customs union theory, countries

[25] Of all the sector-specific annexes to GATS, the Telecommunications Annex is by far the most elaborate (ITU, 1997a, p. 125). The relationship of GATS to the telecommunications services sector is annexed in ITU (1997a, pp. 123-28).

pursuing regional integration should move to free internal trade faster than the rest of the world. The GATS "is structured to allow for the primacy of governments' decisions on the pace of liberalization (e.g., if and when to make scheduled commitments in any particular service or sector)" (ITU, 1997a, p. 107). In this respect, the SMP is clearly forcing the pace of liberalization. However, as the ITU puts it, "Even among the most liberalized telecommunication regimes, there are and will remain, after basic telecommunications enter into force, substantial differences in the regulatory structures of different countries" (ITU, 1997a, p. 107). The granting of licences to operate, interconnection and ONP access, numbering plans and tariffs are still divergent between European countries. These prevent European operators from being able to create pan-European strategies and directly obstruct market integration (Public Network Europe, 1997a). One of the Programme's achievements is to oblige EU States to march in time, and to liberalize value-added services not covered in the GATS. In the past, the push towards liberalization has been specific to particular countries, such as the United States, the United Kingdom and the Nordic countries. With the SMP, the EU has begun to move towards faster progress in free trade in telecommunications services than the rest of the developed world.

The sources of new entry

New entrants to telecommunications markets come in three broad categories:

- *De novo* entrants.
- Entrants diversifying from other, possibly related, industries.
- Entrants who are telecommunications operators in other markets, diversifying horizontally abroad.

The need for industry-specific regulation is likely to decline with increased entry by large TNCs which significantly add capacity to compete with the incumbent. New entrants typically lobby authorities to give national regulators sufficient power to make markets contestable by enforcing fair interconnection agreements and dealing efficiently and effectively with disputes. As much as 50 per cent of

new entrants' revenues are paid to other operators as interconnection fees for the use of their networks (Blackman and Denmead, 1996). For their own part, incumbent firms aim to convince national regulators that their large market share *per se* does not necessarily lead to anti-competitive behaviour.

The developments outlined in figure 1 refer to both EU markets and markets for international telecommunications between member States. The formal coming into force of the WTO agreement on market access on 5 February 1998 (WTO, 1998) greatly assists new entrants, especially *de novo* firms that might not otherwise have the leverage to be able to secure market access on fair terms.

The motives for international business in telecommunications services

The standard motives for FDI are market seeking, cost-reduction seeking and resource seeking (Buckley, 1988; Dunning, 1993, 1994). The market entry literature presents exporting, licensing and FDI as the three stylized forms between which the internationalizing firm is able to choose in order to execute these motives (Buckley, Pass and Prescott 1992; Young, Hamill, Wheeler and Davies, 1989). For service firms, international franchising is appropriate in the international distribution of intermediate and final services (Burton and Cross, 1997).

Market seeking

The theory of international business suggests that involvement in foreign markets is strongly linked to the absolute size of the host market and the potential for market growth (Buckley and Casson, 1981). Indeed, local market servicing, or market-seeking, FDI is undertaken by most TNCs in manufacturing industries. Such FDI is usually seen as a response to the costs of serving a foreign market from a distance. Generally speaking, the larger the foreign market the greater is the tendency of the supplying firm both to prefer foreign production and to wish to own and control that production in the form of FDI.

Traditionally, the capital-intensive and infrastructural nature of the telecommunications industry has meant that to all intents and purposes, the exporting phase of international market servicing did not exist.[26] To use the terminology of J. Boddewyn, M. Halbrich and A. Perry (1986) telecommunications services have been considered to exemplify perfectly a "location bound service". It is for this reason that P. Enderwick (1986) pointed out that service industries display a higher degree of geographical concentration than many other activities. Business services follow the location of client activities, and residential services will also be strongly linked to household income. In the context of trade and location theory, the bulk of the value adding activities have customarily had their centre of gravity within the market to be served (Dunning, 1989). The tenacity of telecommunications service firms in seeking to establish and maintain a commercial presence in foreign countries is a testament to the market-seeking motive (ITU, 1997a, p. 33). A powerful example is the perseverance of foreign firms in China. Although officially prohibited to date from operating a network in the Chinese market, European and United States firms have tenaciously sought to cultivate good relations with the Chinese authorities in anticipation of the time when liberalization comes.[27] The vast potential size of the Chinese market is the only justification for the attentiveness of foreign telecommunications firms. These firms have opened numerous representative offices, and participated in network construction, with an eye on securing options on future development (Clegg, Kamall and Leung, 1996).

Cost-reduction seeking

Foreign operations to reduce input costs are strongly associated with the manufacturing industry. *Prima facie*, it would appear that cost-oriented investment relating to cheap inputs does not apply to the locational choice of telecommunications services firms. With modern technology, the industry is now highly capital-intensive, and labour costs are only a small proportion of total costs. However,

[26] The complexities of the international modes of supply in telecommunications services are presented in ITU (1997a, Table A.1, p. 126).

[27] China is not currently a signatory to the WTO agreement on the liberalization of international trade in basic telephony.

new technologies and liberalization have paved the way for a family of "alternative calling procedures" that seek cost advantages (see ITU, 1997a, pp. 92-93). International service operators, known as call-back operators, seek the cheapest facilities (in terms of the lowest tariffs) in order to route international traffic at low cost.[28] This will not necessarily be the most direct route between any two countries, and may involve the international redirection of a call. Call-back arrangements can be profitable when the tariff attaching to a call between two countries differs according to the country in which the call originates.

Similarly, through the re-routing of international traffic, operators in liberalized countries (with the lowest charges, notably the United Kingdom and the United States) have been able to "export" network operation services. This exception proves the rule that network operation services cannot be exported (EC, 1998, p. 113). In fact, the desire of countries to secure international hub status is another example that challenges conventional wisdom. The cost-seeking motive will become increasingly important as specialization progresses within the industry. Taking the full range of activities into account, especially value-adding services beyond routine network operation (such as call centres, research and development, etc.), telecommunications looks far more like any other industry. The potential for differentiation in services and vertical specialization in production is only now becoming apparent.

Resource seeking

There are two types of resource-seeking motives for international business. The physical resource-seeking motive is usually the cause of a TNC seeking access to raw materials abroad. Historically, this form of FDI has accounted for the emergence of vertically integrated TNCs in extractive industries, where firms seek to obtain security of supply. This motive has little role in the telecommunications industry, as firms are not sufficiently vertically

[28] Call-back operators are based in countries that offer cheap international telephony (such as the United States). The call-back operator arranges for the customer to be "called-back" from the lower tariff country, at a commensurately lower cost (ITU, 1997a, pp. 92; Young and Lee, 1996, p. 11).

integrated backwards to be influenced by the need for physical resources.

However, the strategic asset- or capability-seeking motive (Dunning, 1993) is applicable to the telecommunications industry. This motive concerns the development (or the acquisition) of assets that will help the firm to achieve its long-term strategic goals, such as securing the inputs of key elements in the production process. Examples of such inputs include technology, professional, managerial and financial skills and knowledge of various types, and marketing expertise. One of the most common ways to acquire these assets in the telecommunications industry is to form a joint venture with a partner with whom -- and from whom -- these capabilities can be learned. The acquisition of these assets is essentially a location-specific process, as the knowledge and skills sought are generated and embodied in people. The knowledge acquired can then be re-used in subsequent market entry projects to exploit market opportunities elsewhere.

Knowledge acquired from the collaborative operation of a joint venture affiliate has been dubbed "output knowledge" by E. Westney (1988). However, the joint venture partners may also wish to learn directly from each other and gain input knowledge from their partners. Examples of both varieties of motive are to be found in the international joint venture between Deutsche Telekom (Germany) and Ameritech (United States) in Hungary. Through their joint venture company, MagyarCom, these strategic investors operate the incumbent telecommunications firm of Hungary, MATÁV. The motives for this investment include learning about operating in an Eastern European country (in the case of both partners), and learning about competing in, and adapting to, a liberalizing market (in the case of Deutsche Telekom). The MATÁV operation also offers Deutsche Telekom the opportunity to learn about the skills and knowledge employed by Ameritech in the fully liberalized United States market (Clegg, Kamall and Tan, 1998).

Where the entrant firm or firms are members of an international alliance, the existing network that is acquired may also be considered as a strategic asset. For example, BT joined Concert with the intention of using the networks of its joint ventures in several European

countries to offer services to clients of Concert, the international alliance in which it has played a major role. Also, the companies comprising the international alliance known as Unisource had the same goal in mind when Unisource began to purchase equity stakes in developed countries as an alliance.

Governance factors

The growth of transnational telecommunications firms clearly points to the existence of certain transactional advantages inherent in FDI over other alternatives. In telecommunications, these alternatives include international collaboration via the non-affiliate, licensing of technology and the sale of management and marketing skills, usually via training contracts. The rationalization of the telecommunications industry into international alliances can be seen as a step on the way to more effective governance structures (Dunning, 1994). The sources of advantages to internalization driving this trend towards transnational reorganization can be identified as:

- Firm-specific advantages. Market entry is often based on the traditional form of firm-specific advantage. The existence of knowledge-based scale economies explains the growth of vertically integrated telecommunications TNCs. The creation of firm-specific advantages, such as technological, marketing and customer handling skills, conveys a degree of market power. FDI is generated when transnational organization is more profitable than the contractual alternatives. In the case of domestic (or regional) markets, the appropriate international business strategy based on a firm-specific advantage is a multidomestic one. The advantage can be re-used in different markets. In the market for services to TNCs a global strategy is required. Because services are experience goods, there is a close correlation between the standard of the service and the underlying acceptability and reputation of the supplier, implying the need for some level of screening. The reputation of foreign telecommunications firms can be exploited with large business customers and national regulators. This is borne out by the fact that telecommunications firms have tended to enter foreign markets by initially offering services to business customers.

These services are then extended to residential customers when the firm is able to compete on price.

- The existence of positive externalities between telecommunications demand in different locations.[29] This is a Coasian transaction cost explanation for the international extension of the telecommunications operators. In the international market, the demand for services in one location naturally leads to a demand in another location. Prior to liberalization, incumbent operators could not offer transnationally integrated services, although some specialist firms had emerged already by the end of the 1980s to provide international telecommunications services to TNCs based on leased private circuits.

  International business theory predicts that following the opening of markets TNCs will emerge in order to internalize this externality. There is an advantage conferred on service providers who can offer international telecommunication solutions of assured quality for transnational clients (Casson, 1982a). In practice, this means offering product portfolios that are available worldwide to transnational clients as part of a seamless international service (Blackman and Denmead, 1996). This explanation is very much related to network operations theory invoked by Neil Hood, Stephen Young and David Lal (1993) to account for the internationalization of telecommunications. As telecommunications operation is a network industry, there are also positive externalities in supplying adjacent areas, which can lead to a regionally focused strategy.

- Market structural considerations. These include oligopolistic interaction between operators originating in the same country or in different countries (Casson, 1987). State monopoly is the most entrenched form of trade barrier, and so historically most national incumbents have not perceived each other as potential

[29] Capello and Nijkamp (1995, p. 89) list four sources of externalities relating to all three combinations of demand and supply externalities.

rivals in their home markets. In the market for international calls, international agreements have governed accounting issues and have controlled behaviour. With liberalization, interaction naturally increases within both domestic and international markets. As the telecommunications industry becomes global, firms progressively come to see each other as competitors. National incumbent operators inevitably lose market share in their home markets as a result of liberalization. Entering newly opened foreign markets compensates for the loss of home market share. A direct outcome of this is the formation of international alliances operating in several different markets in order to reduce oligopolistic interaction. The smaller incumbent firms need to ally with international partners in order to compete against international new entrants in their home markets. The larger incumbent operators need to associate with foreign local partners in regional service alliances to compete in foreign markets. They also ally with international partners in global alliances both to limit rivalry and to alleviate the internal strategic conflict that would result from having different sets of partners in different markets.

- International real asset diversification in order to reduce risk (Rugman, 1979). Here, former monopoly providers consider investment opportunities overseas in order to reduce their dependence on their home markets. The erosion of stable monopoly profits on basic voice telephony forces incumbents to develop new services, but their domestic markets (especially with liberalization and line-of-business restrictions) are too small to extract adequate returns. The result is both product and international diversification.[30] Although international diversification in order to reduce risk is customarily viewed as a secondary motive for overseas involvement and operations, many service firms feel the need to diversify more acutely than manufacturing firms. In the absence of an export mode, many telecommunications firms newly exposed to liberalization, but with a need to raise private capital (on account of privatization),

[30] The product diversification motive was especially important for the first wave of United States firms entering the United Kingdom.

will find themselves grossly under-diversified. Finance theory suggests that recently incorporated former state monopoly operators (based in one country) will be faced with a higher cost of capital than the typical geographically diversified firm of comparable size.[31] The transactional efficiency of the transnational firm as a means of investor diversification (Casson, 1982b) means that geographical diversification offers the telecommunications operator the prospect of a significantly reduced cost of capital. This consideration adds to the pressure to internationalize rapidly, as investors in new share issues need to be convinced of the stability of the firms' future income stream. The pressure to diversify therefore favours the choice of time- and capital-saving routes, such as international joint ventures and alliances, and the pursuit of strategic assets to enhance competitiveness.

- The theory of real options. Given that there is no true exporting phase for basic network operation, minority ownership is a rational incremental internationalization strategy. In effect it attempts to keep real options open on future market development (Buckley and Casson, 1998; Casson and Gulamhussen, 1998; Trigeorgis, 1996). As a result of liberalization, one would expect to see a rapid expansion of minority holdings in local telecommunications operators by foreign operators. As operators diversify their portfolios of real assets, they become targets for full or partial acquisition. This combines with the diversification motive, as the purchase of equity in even medium-sized operators may confer FDI interests in a number of countries.

- Cultural and linguistic affinity. In the early stages of internationalization it is expected that the transaction costs of FDI are the lowest between culturally and linguistically similar counties with short "psychic distance" (Buckley and Casson, 1976; Johanson and Wiedersheim-Paul, 1975).

[31] The firm's market dominance will compensate to some extent by guaranteeing internal funds from monopoly profits and encouraging investors to expect higher returns.

The mode of foreign market entry

For the telecommunications firms looking to internationalize, there are four main methods for entering a foreign market:[32] buying a stake in an incumbent operator; establishing a joint venture with a local partner with its own network, but whose main business is not telecommunications; leasing lines; or the construction of a new network. Each of these entails FDI, as each involves at the very least the establishment of, or direct participation in, a business in the host economy. The leasing of lines will require the local incorporation of an affiliate, whose function is then to employ contracts to secure the necessary capacity.

Table 5 summarizes the available information on the extension of the leading entrants into the major European telecommunications markets, Norway and Switzerland. Many of these examples are in the form of regional service alliances, that is, intended to service domestic or regional markets, or both. A number of salient examples are drawn from the figure in the following discussion of the four dominant routes of market entry.

Purchase of stake in existing operator

The national operators in the smaller countries of Europe and those countries with antiquated networks are particularly keen to find strategic partners in order to fend off increased competition as a result of market liberalization. For example, the Governments of Belgium and Ireland have sold minority stakes in state-owned telecommunications operators to foreign telecommunications services companies. They hope that strategic partners will bring much-needed funds for investment, and knowledge to improve internal efficiency and marketing skills. This mode of entry allows foreign firms to enter the market swiftly without adding to the overall capacity or driving down prices — though prices will be driven down by the entry of new competitors after full liberalization. This mode relates to the

[32] As mentioned earlier, the growth of value-adding services is creating more scope for non-affiliate licensing, though it is not a leading strategy in terms of importance.

classic advantages of acquisition over greenfield entry discussed in the market entry literature (Young, Hamill, Wheeler and Davies, 1989).

Joint venture with local non-telecommunications firms

In the larger European markets, where the incumbent operator of the public network seeks no strategic partner, a common mode of entry for a foreign telecommunications firm is through a joint venture with a host country firm that operates its own private network. The attractions of a joint venture include the speed of access to the foreign market, coupled with the spreading of risk with a local partner. This route is the second most popular method of entry (table 5). There is only a very small residue of entrants that are wholly owned by foreign firms. The United Kingdom's BT has formed a joint venture with Banco Santander in Spain to provide telecommunications services in competition with Telefónica, the incumbent operator. The joint venture started by expanding the bank's existing private network in order to offer non-voice services to business customers. With liberalization in January 1998, the joint venture was able to offer voice services to both business and residential customers. BT has formed similar joint ventures in Germany, Italy and the Netherlands. By employing a host country firm's existing network, the foreign entrant is able to avoid investing considerable sums in building a completely new network. With technological convergence progressing in the communications industry, cable television operators are emerging as major players in local telephony. The extra revenue from carrying telephone traffic is helping cable companies to cover their initial network investment. In the United Kingdom, some cable companies have found that telephony revenues exceed those of their planned main business area of supplying television channels.

The immature state of competition within the majority of European markets means that apart from the incumbent there are very few established local public telecommunications operators. It is evident that, for the most part, foreign entrants seeking local partners must seek out local firms diversifying or wishing to diversify into telecommunications.

Table 5. Leading entrants into the major European telecommunications services markets, 1998

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
Austria						
(Telekom Austria)	Telecom Italia	Italy	Strategic partner to incumbent	1998	Telecom Italia (25%), Government of Austria (75%)	
(Mobilkom)	Telecom Italia	Italy	Strategic partner to incumbent Mobile operator	1997	Telecom Italia (25%)	
(Connect Austria)	Telenor	Norway	New licence (DCS 1800)	1997		
	Tele Danmark	Denmark				
	Viag	Germany				
	Orange	United Kingdom				
(Maxmobil)	Deutsche Telekom Siemens	Germany	Mobile operation	1996	Deutsche Telekom (25%), Siemens (14.8%)	
Belgium						
(ADSB consortium)	Ameritech	United States	Strategic partner to incumbent	1995.	Belgian Government (50.1%) ADSB consortium (Ameritech, Singapore Telecom, Tele Danmark and trio of Belgian banks) (49.9%)	Belgacom (incumbent operator)
	Singapore Telecom	Singapore				
	Tele Danmark	Denmark				
	US West	United States	Joint venture (cable TV)	1990s		Telenet Vlaanderen
(KPN Orange Belgium)	Orange	United Kingdom	New licence	Awarded 1998	Orange (50%), KPN (50%)	
	KPN	Netherlands				

(Table 5, continued)

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
(Belgacom Mobile)	AirTouch	United States	Construction (mobile)	1994	Belgacom (75%), AirTouch (25%)	Belgacom
(Mobistar)	France Télécom	France	Construction (mobile)	1995	France Télécom (90%), Telinfo (10%)	Telinfo
Denmark						
(Sonofon)	Bell South	United States	Construction (mobile)	1992	Great Nordic (53.5%), Bell South (46.5%)	Great Nordic
	France Télécom	France	Construction (data network)			
	AT&T	United States	Construction and leased lines			
	Telia	Sweden	Construction (cable TV)			
(Telia Danmark)	Telia	Sweden	New licence (DCS 1800)	1997	Telia (100%)	
(Mobilix)	France Telecom	France	New licence (DCS 1800)	1998	France Telecom (100%)	
(Tele Danmark)	Ameritech	United States	Strategic partner to incumbent	1998	34.4% acquired from state	Tele Danmark (incumbent operator)
France						
	BT	United Kingdom	Joint venture	1996	CGE (50%), BT (25%), Others (25%)	CGE
(9 Telecom)	Telecom Italia	Italy	Joint venture	1996	Bouygues (19.7%), Telecom Italia (80.3%)	Bouygues

(Table 5, continued)

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
	Vodafone	United Kingdom	Construction (mobile)	1989	SBC/Alcatel/ CGE consortium (83.5%)	CGE, Alcatel
	SBC	United States			Vodafone (16.5%)	
(Bouygues)	C&W [a]	United Kingdom	Construction (mobile)	1995 (awarded licence). Started service in 1996	BDT (55%), C&W (20%), Veba (17.5%), Paribas (3%), BNP (3.5%)	Bouygues, BNP, Paribas
	Veba	Germany				
	MFS	United States	Construction (fixed-line)	1995 (awarded licence)		
Germany						
(Viag Interkom)	BT	United Kingdom	Joint venture Also awarded	1995	Viag (40%), BT (40%), Telenor (10%),	Viag
	Telenor	Norway	Mobile licence		further Partner (10%)	
(Mannesmann Arcor)	AT&T	United States	Joint venture	1995/6	Mannesmann, AT&T-Unisource, Deutsche Bank and AirTouch have combined (49.8%) and Deutsche Bahn holds (50.2%)	Mannesmann, Deutsche Bank Deutsche Bahn
(o.tel.o)	BellSouth	United States			Veba (40%), RWE (37.5%), BellSouth (15.5%)	Veba, RWE
(Mannesamnn Mobilfunk)	AirTouch	United States	Construction (mobile)	1992	Mannesmann (65.5%), AirTouch (34.5%)	Mannesmann
(E-Plus)	Bell South	United States	Construction (mobile)	1994	o.tel.o (60.2%), Bell South (22.5%)	o.tel.o
	Vodafone	United Kingdom			Vodafone (17.3%)	
	MFS	United States	Construction (fixed-line)			
	COLT	United Kingdom	Construction (fixed-line)			

(Table 5, continued)

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
Greece						
(Cosmote)	Telenor	Norway	New licence	1997	OTE (70%), Telenor (30%)	OTE
(Telestet)	Telecom Italia	Italy	Construction (mobile)	1993	Telecom Italia (75%), Bell Atlantic (20%), Interamerican (5%)	Interamerican Intrakom, Data Bank
	Bell Atlantic	United States				
(Panafon)	Vodafone	United Kingdom	Construction (mobile)	1993	Vodafone (45%), France Télécom (35%), Intrakom (10%), Data Bank (10%)	
	France Télécom	France				
Ireland						
(Telecom Eireann)	KPN	Netherlands	Strategic partner to incumbent	1996	KPN (10%), Telia (10%), Irish govt. (80%)	Telecom Eireann (incumbent operator)
	Telia	Sweden				
(Meteor)	Western Wireless	United States	New licence	Awarded 1998	Western Wireless (60%), RF Communications (30%), The Walter Group (10%)	RF Communi-cations
	The Walter Group	United States				
(Esat Digifone)	Telenor	Norway	Construction (mobile)	1996	Telenor (40%), Esat Telecoms Holdings (40%), private investors (20%)	Esat Telecoms Holdings
Italy						
(Infostrada)	Mannesmann	Germany	Joint venture	1995	Olivetti (62.5%), Mannesmann (37.5%)	Olivetti
(ENEL)	Deutsche Telecom	Germany	Joint venture	1997	ENEL (51%), Deutsche Telecom (49%)	ENEL State Owned Electricity Utility
(Albacom)	BT	United Kingdom	Joint venture	1995	BT/BNL combined (45.5%), Mediaset (19.5%), ENI (35%)	Banca Nazionale del Lavoro, Mediaset and ENI, state oil & gas distributor

(Table 5, continued)

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
(Wind)	Deutsche Telekom	Germany	New licence	Awarded 1998		Enel
	France Telecom	France				
(Omnitel)	Bell Atlantic	United States	Construction (mobile)	1995	Oliman Holdings (40%), Bell Atlantic (19.7%), AirTouch (15.5%), CCI (10.3%), Mannesmann (9.2%) others (5.3%)	Olivetti, Banca di Roma
	Cellular Communications Inc	United States				
	AirTouch	United States				
	Mannesmann	Germany				
Netherlands						
(Libertel)	Vodafone	United Kingdom	Construction (mobile)	1995 (awarded licence)	ING (38.5%), Vodafone (61.5%),	ING Bank Corporate Investments
(Telfort)	BT	United Kingdom	Joint venture Also dual GSM/DCS licence in 1998	1996		Nederlande Spoorwegen (National Railways)
(Federa)	France Telecom	France	Dual GSM/DCS licence	Awarded 1998	France Telecom & DeTeMobil (80%), ABN Amro (10%), Rabobank (10%)	Investment Banks ABN Amro and Rabobank
	DeTeMobil	Germany				
	Tele Danmark	Denmark	New licence	Awarded 1998	Tele Danmark 100%	
(Brucop)	Tele Danmark	Denmark	New licence	2 Regional Licences	Tele Danmark (50%), Belgacom (50%)	
	Belgacom	Belgium		Awarded 1998		
(Casema)	France Telecom	France	Acquisition of cable operator	1997		United & Philips

(Table 5, continued)

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
(A2000)	US West	United States	Construction (cable TV)	1990s		Commu-nications
Norway						
(ElTele)	France Telecom	France	MoU	1997	MoU signed	ElTele, consortium of electricity companies
(Telia)	Telia	Sweden	New licence		100%	
(NetCom)	Singapore Telecom	Singapore	Construction (mobile)	1991 (awarded licence). Started service in 1993	NetCom Systems (25%), Ameritech (19.7%), Singapore Telecom (19.7%), Orkla (11%) and private investors	Orkla
	Ameritech	United States				
	Kinnevik	Sweden				
Spain						
(Retevisión)	Telecom Italia	Italy	Fixed line Also awarded new mobile licence in 1998	1997	Endesa, Telecom Italia, Union Electrica Fenosa and number small Spanish Savings Banks (70%)	Ensdesa and number of small Spanish Savings banks
	BT	United Kingdom	Joint venture	1994	BT (50%), Banco Santander (50%) Santander	Banco
(Airtel)	BT	United Kingdom	Construction (mobile)	1994 (awarded licence). Started service in 1995	AirTouch (21.8%), BT (15.8), Banco Central Hispano (14.1%) and others Hispano	Banco Santander, Banco Central
	AirTouch	United States				
	France Télécom	France	Construction (data network)			
Sweden						
(Telenordia)	BT	United Kingdom	New licence	1998 Bought Licence		
	Telenor	Norway				

(Table 5, continued)

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
	Tele Danmark	Denmark				
(Tele2)	C&W	United Kingdom	Joint venture	1993		Kinnevik
	Millicom	Luxembourg				
(Europolitan)	AirTouch	United States	New licence		AirTouch (51%), Vodafone (19%), private investors	
	Vodafone	United Kingdom				
	BT	United Kingdom	Construction (fixed-line) and leased lines	1990s		None
	Telenor	Norway				
	Sonera	Finland				
	Tele Danmark	Denmark				
Switzerland						
(Diax)	SBC communications	United States	Joint venture		Swiss Electricity Companies (60%), SBC (40%)	Consortium of Swiss Electricity Companies
(Sunrise)	BT	United Kingdom	Joint venture		Union Bank, Federal Railway and Migros (51%), BT and Tele Danmark (49%)	Union Bank, the Federal Railway and Migros
	Tele Danmark	Denmark				
(Orange Communi-	Orange	United Kingdom	New licence	Awarded 1998	Viag (40%), Orange (40%), Swissphone (20%)	Swissphone Engineering & Cantonal
cations)	Viag	Germany				
					Bank of Vaud	
	Veba	Germany	Construction (cable TV)			Local cable TV company
United Kingdom [b]						
(C&W Communi-	Nynex [c]	United States	Construction (fixed-line and cable TV)	1990s [d]	C&W (52.6%), Nynex (18.5%),	C&W
cations)	Bell Canada	Canada			Bell Canada (14.2%) [e]	
(Orange)	Hutchison Whampoa	Hong Kong	Construction (mobile)	1990s		British Aerospace

(Table 5, concluded)

Host country *(and affiliate where known)*	Foreign entrant(s)	Home country of foreign entrant	Mode of entry	Date of entry (if known)	Structure of venture (if known)	Local partner(s)
(One-2-One)	United States West	United States	Construction (mobile)	1990s	C&W (50%), US West (50%)	C&W
	AT&T [f]	United States	Construction (fixed-line) and leased lines	1990s		
	ACC	United States	Leased lines	1990s		
(Ionica)	Sonera	Finland	Stake in non-incumbent operator	1996		Ionica
(Telewest)	US West, TCI [g]	United States	Construction (cable TV)	1990s		
(Cabletel)	NTL Inc	United States	Construction (cable TV)	1990s		
(Eurobell)	Deutsche Telekom	Germany	Construction (cable TV)	1990s		
(Tele2)	Millicom	Luxembourg	Fixed line	1997	100% Millicom	
	MFS	United States	Construction (fixed line)	1990s		

Source: information compiled by the authors and Connie Lyle of Omega Partners from the international business and financial press.

[a] For brevity, Cable & Wireless is frequently referred to in the table as C&W.
[b] There are hundreds of operators in the United Kingdom, many of which are partly owned by foreign investors. Only a few companies are listed here.
[c] Nynex has since merged with Bell Atlantic, but maintains a separate corporate identity in many markets.
[d] Cable & Wireless began operations in the United Kingdom in 1984. Nynex and Bell Canada both entered the cable TV market in the 1990s. The merged company was created in 1996.
[e] The remainder is reserved for a public offering
[f] The future of AT&T's United Kingdom operations is in doubt following the agreement of an international joint venture with BT.
[g] TCI has since been taken over by AT&T.

Note: percentages shown in the table may not sum precisely to 100 due to rounding.

Leasing lines

The internationalization of telecommunications services firms and the generation of *de novo* entrants has been greatly enhanced by the newly contestable liberalized markets. Where there is an efficient rental market for the use of existing operators' networks, it is possible for firms to enter by leasing capacity. The rental market may be sustained by regulation requiring the availability of interconnection agreements between new entrants and incumbent firms. Additionally, existing operators may regard the sale of capacity purely as a source of revenue, and as an opportunity to spread fixed costs. The effect is to permit new entrants to occupy niches in the market and to assume the risk of increasing capacity utilization.

Typically, when a foreign firm is unable or unwilling to link up with a host country partner, it may choose to enter the market by leasing bulk capacity from an existing operator at a discount. The entrant then resells services under its own name using a network of leased lines. Reselling leased capacity allows the entrant to establish an early market presence and to generate revenue towards expanding its network either by installing new lines and switches, or by leasing more capacity. Often, new entrant firms use leased lines as a short-term entry strategy. AT&T entered the United Kingdom market with a strategy of leasing a large number of lines while it initiated the construction of its own network. In Belgium, several foreign firms offer their own services over lines leased from Belgacom.

The global service alliances (GSAs) typically employ the leasing of lines to offer their services. These include many advanced services, as well as international simple resale (ISR).[33] A distinctive feature of international resellers is that in order to offer services they do not have to install their own infrastructure, although some do (Young and Lee, 1996, p. 10). Resale is based on a combination of bulk switched capacity, international private leased circuits (IPLCs),

[33] International Simple Resale has been defined more precisely as the provision of services over international leased lines with connection to the PSTN at both ends. Such traffic bypasses the international accounting rate system that exists between PSTN operators (ITU, 1997a, pp. 92-93; Young and Lee, 1996, p. 462).

satellite transmission and owned capacity, with some offering value-added services (such as enhanced billing) (Young and Lee, 1996, p. 10). It is typical for ISRs to rent IPLCs to offer switched voice services and to purchase PSTN capacity. The ISR therefore leases lines, often from the incumbent operators at bulk discount rates, divides up the leased capacity, adds a mark-up and then sells services to customers at rates below those charged by national operators. The customers of resellers comprise non-telecommunications firms who lease capacity from ISRs in order to reduce their international communications costs.

As host markets grow, specialization and vertical disintegration are becoming more common. This is heralded by the emergence of new lines of business, and followed by the entrance of specialist firms for the supply of network and switching capacity, commonly known as "carriers' carriers". Here the carriage of a call is separated from its origination and termination phases (ITU, 1997a, p. 89). Such firms (or business divisions) are specialists who exist to obviate excess transactions costs in the rental of switching capacity; they do not themselves provide telecommunications services to end users. Even if the emergence of "carriers' carriers" leads to an efficient rental market offering non-discriminatory access to infrastructure, as the host market grows it may nevertheless become more efficient for entrant firms to move from the leasing of capacity to direct ownership of network infrastructure, i.e. backward vertical integration.

In the longer term, the telecommunications services industry is likely to experience both vertical disintegration and vertical integration. Some, especially *de novo* and small, entrant firms, may prefer to trust the rental market. Other larger entrants may employ the use of both owned and leased capacity to maximize flexibility. The long-term efficiency of the rental market, and the commoditization of network operation services, will be a major determinant of the extent to which service providers vertically integrate. Certainly, the existence of efficient rental markets for capacity revolutionizes the traditional view of the telecommunications industry as one in which the fixed-cost barriers to entry produce an inevitability of natural monopoly.

Construction of a new network

This mode of entry may be considered as analogous to greenfield entry for manufacturing firms.[34] There are two leading variants: investment in a fixed network and investment in a mobile network. The construction of a fixed network is the least favoured mode of entry since it requires the most substantial type of initial investment. However, Mercury, now a subsidiary of Cable & Wireless, did construct a completely new network in the United Kingdom in the 1980s, bolstered by the leasing of lines under interconnect arrangements with the incumbent BT for parts of its trunk network and for local loop connections. Mercury was able to commit the large sums needed for building its own network because the United Kingdom industry regulator (OFTEL) guaranteed that it would be the only competitor to BT for a period of six years, from 1984 until 1990. It is doubtful whether Mercury would have invested such large sums over the same period if the Government had not sanctioned a legal duopoly (Brooks, 1997).

The decision to build a *de novo* network is largely dependent on the extent of host market size, as with any greenfield entry. Vebacom, Cable and Wireless' joint venture with Veba and RWE in Germany, planned to invest heavily in its own network in order to emerge as a main competitor to Deutsche Telekom. However, this is not a pure greenfield investment, but rather an extension, since Veba and RWE already possess large communications networks of their own.

The cost of constructing a new network is declining due to technological developments.[35] Cellular radio technology has allowed mobile networks to be installed quickly and at lower cost than fixed-

[34] Build/transfer arrangements also exist, often owing to government requirements. They are prevalent in infrastructure construction in developing countries, where the incumbent typically remains state-owned (ITU, 1997a, pp. 58-9).

[35] This covers mobile and fixed wireless systems. Technical progress also offers opportunities to use the infrastructure of non-telecommunications utilities to carry telecommunications, for example, the use of the national electricity grid to support telecommunications lines for the United Kingdom telecommunications operator Energis.

line networks. Initially, mobile telephony is typically offered as a premium service generating larger profit margins for operators. However, as the cost of mobile telephony falls relative to fixed-line services, more and more residential customers subscribe to mobile services. The construction of wireless networks seems to be the favoured route by which to enter all markets, including the thinner and smaller ones. The falling costs of entry via the construction of mobile networks may mean that this route will be increasingly employed to enter markets to compete against existing fixed networks.[36]

The pattern of activity in the European Union

From an overview of the available evidence, it appears that the purchase of a stake in an existing operator is rare, with most examples being located in the smaller European hosts. This may be due to tardiness in privatizing national incumbents, and to political preferences for incumbents to remain locally owned. The majority of foreign entry is via joint ventures with local non-telecommunications firms, many of which are local utility companies with existing private network capacity or network potential. This method of entry has been favoured in the major markets of Europe, notably France, Germany, Italy, the Netherlands and the United Kingdom. The acquisition of a licence to enable the leasing of lines to provide services is a common strategy. The construction of fixed networks by foreign firms, whether in joint venture with local partners or not, is characteristically an entry method selected for markets, or parts of markets, that are dense and substantial. Here, France, Germany, the United Kingdom and the fast-growing Spanish market are good examples.

The pattern of internationalization that we see is very much what theory would predict for network operation, in which there is no conventional exporting phase. Established EU telecommunications operators have numerous equity shareholdings abroad. These testify to the need to form alliances and diversify income streams (ITU,

[36] This is the case in Germany, where Viag Interkom, BT and Telenors' joint venture, has been awarded a mobile licence. Viag will build a national network employing both its own mobile network and leased fixed lines.

1997a, table 3.4, pp. 36-37). This is especially apparent for cellular mobile telephony, in which the theory of real options applies particularly well, owing to the freedom to buy and sell equity stakes. The Single Market Review for telecommunications services noted that the service providers in mobile telephony are predominantly domestic in origin, with foreign involvement generally limited to minority equity shareholdings (EC, 1998, p. 38). This has been attributed to the fact that (unlike in data services for example) it has been generally difficult for firms to apply for licences directly outside their country of origin (EC, 1998, p. 64). However, even in the absence of restrictions, the underlying strategy of diverse investments is logical. The strategy is not intended to support a uniform or unified service, but rather to keep real options open on future market development (Public Network Europe, 1998).

The location-bound nature of infrastructural investments encourages a strategy of entering low-risk countries. An example is that of Ameritech, the largest United States investor in European telecommunications (including Eastern Europe), with investments in public telephone operators in Belgium, Denmark and Hungary (Public Network Europe, 1998). It explicitly espouses a strategy of diversification into low-risk European markets. The importance of cultural and linguistic affinity in explaining patterns of internationalization is greatest for new foreign investors. This factor has been important for the involvement of Telefónica de España and Portugal Telecom in Latin America. It is also combines with incrementalism in the form of network extension in the strategy of Deutsche Telekom's expansion into Austria and in the example of the desire by Nordic firms to redefine their domestic markets to encompass the whole of the Nordic region. The same applies to the dominant Swiss operator, Swisscom, in expanding its domestic market to include adjoining regions in neighbouring EU countries (Public Network Europe, 1998). Colonial ties are diminishing in importance in explaining patterns of internationalization (ITU, 1997a, p. 46).

Global service alliances

In recent years the largest telecommunications services firms have formed international alliances in order to provide a single point

of contact for transnational corporate customers (ITU, 1997a, p. 33). These global service alliances (GSAs) are strategically distinct from the area-focused regional service alliances (RSAs). Global alliances cater for transnational clients' demand for global network coverage. They represent the transnational response to the transnational business customer calls' market, while RSAs are used to enter foreign domestic and regional markets. Global service alliances are a transaction cost-reducing solution to TNCs' frustration of having to deal with a number of disparate telecommunications companies and countries, each operating under different regulatory regimes, simply to maintain communications between headquarters and affiliates.

In 1998, there were three main GSAs: Concert, Uniworld and Global One (box 2). The typical organization of a GSA is a core equity joint venture between leading telecommunications operators and a nexus of contractual distribution agreements. Distribution, akin to franchising arrangements, will be arranged through both affiliates (e.g., local joint ventures) and through non-affiliate telecommunications service providers in a large number of countries. These alliances offer the advanced services (such as advanced billing) developed by the equity partners.

As box 2 explains, the membership of GSAs is subject to radical change, as the strategic partners seek to optimize their global portfolios. It is possible that GSAs will experience increasing competition in the future. Specialist firms already exist to which clients outsource their telecommunications management. Also, as domestic and international markets become blurred, further strategic changes will be required to reconcile operators' GSAs and RSAs.

Contractual forms of international business

The changing technological nature of telecommunications has spawned an increased diversity in telecommunications services, in particular the growth of value-adding services beyond simple network operation. This means that greater opportunities now exist for international licensing, franchising and collaborative arrangements in general.

Box 2. Global service alliances

Concert
After the merger of MCI and WorldCom, BT entered into the process of buying MCI's interest in Concert Communications Services, the joint venture BT of the United Kingdom operated with MCI of the United States since 1994. AT&T is committed to the AT&T Unisource alliance until July 2000, but after that time the two companies will concentrate on the development of the AT&T/BT Global Venture.

AT&T—BT Global Venture
It was announced in July 1998 that the two companies would combine the trans-border assets and operations of each company. The venture is to have three key businesses: a global voice and data business; a global sales and service business; and an international carrier services business.

Uniworld
Uniworld in 1998 was an alliance of two separate alliances: WorldSource and Unisource. At its core, Unisource NV owned 60% and AT&T owned 40 % of Uniworld. In turn, Uniworld owned 20%, AT&T 40%, Singapore Telecom 16%, and KDD of Japan 24% in AT&T WorldPartners. The members of the WorldPartners Company distributed WorldSource Services. It was a partnership of AT&T, KDD, Telstra of Australia and Singapore Telecom. Unisource is a partnership of Telia of Sweden, the Swisscom, the Swiss PTT and KPN Telecom of the Netherlands. Unisource NV joined the WorldSource alliance by becoming an equity owner in the WorldPartners Company in June 1994.

WorldSource Services in 1998 were distributed through the following member companies: AT&T Canada, Alestra of Mexico, Telebras of Brazil, Telstra of Australia, Hongkong Telecom, VSNL of India, Indosat of Indonesia, KDD of Japan, Korea Telecom, Telekom Malaysia, Telecom New Zealand, PLDT of the Philippines, Singapore Telecom, Chunghwa Telecom of Taiwan, Communications Authority of Thailand, Bezeq International of Israel and Telkom of South Africa.

Due to AT&T's commitment to the newly-formed global venture with BT, the WorldPartners alliance (which began in 1993) will not be extended past year-end 1999.

Global One
Dating from 1996, it remains (in 1998) a joint venture between Deutsche Telekom, France Telecom and Sprint of the United States (in which the Franco-German partners own a 20% stake).

Source: information compiled by Connie Lyle of Omega Partners from the international business and financial press, and from EC (1998, figure 12.2, p. 118).

In some cases, network operation firms may employ non-FDI market entry and development strategies, such as technical service agreements, management contracts or training contracts. Such strategies may be adopted not only where FDI is currently prohibited or discouraged, but also where market size is limited, or where the foreign firm wishes to learn more about the market before deepening its commitment. An example of this is the joint venture formed for the purpose of training between France Telecom and MATÁV, the Hungarian incumbent, in the early 1990s. Contractual alternatives are not necessarily a forced second-best strategy, as they may allow a potential entrant to gather market intelligence on the host country prior to liberalization or privatization, and to evaluate potential local partners.

While contractual forms of international business existed before liberalization, and still do between network operators, there has been a shift away from narrow technologies for basic network operation. As under the GSA model, some of the fastest growth is to be found in the worldwide distribution of services. There is also rapid growth in application technologies that hybridize new and old media, and in the technology for VANS.

Much trade in technologies conforms well to the model of licensing in international business theory. Examples of applications include the licensing of fixed radio access (FRA) technology,[37] Internet telephony and voice recognition services. Technologies and applications such as those can be exploited worldwide. For instance, Ionica in the United Kingdom developed a fixed wireless access network technology first deployed by Sonera Oy (the Finnish incumbent, formerly Telecom Finland) in collaboration with Telecom (Nortel) of Canada. Nortel was then licensed to manufacture and sell the equipment worldwide (Ionica, 1996). There are many examples of telecommunications operators engaging in the non-affiliate licensing of applications technologies. For instance, AT&T licenses many network-based technologies for VANS. In 1994, AT&T began

[37] Fixed radio access technology enables a fixed-line service to be offered using wireless in the local loop. The local loop is the local circuit infrastructure for telephony distribution to customers, as distinct from trunk or long-distance infrastructure; for example.

licensing its proprietary VideoPhone technology with agreements with Hitachi Ltd, Sanyo Electric Co., Sharp Corporation and the Victor Company of Japan Ltd (JVC) (AT&T, 1994). Operators, typically from the most liberalized markets, such as BT, Telia, Telenor and TeleDanmark, are also generating consultancy work (ITU, 1997a, p. 39 and p. 41). These firms' consulting affiliates sell soft skills, as well as the customary technical support for scientific technology, such as skills to accompany teleworking.

A good example of a specialist firm that has no involvement in network operation and that has grown up to develop and license value-added technologies is Lernout and Hauspie (L&H) (headquartered in Belgium). According to the theory of international business (Buckley and Casson, 1976, 1985; Dunning 1993), firms that lack the internal complementary resources (especially management and capital) to engage in FDI are more likely to choose international non-affiliate licensing to service foreign markets (Clegg, 1990). As a smaller enterprise producing technologies with worldwide applications L&H is a natural licenser. This firm produces technologies in the areas of automatic speech recognition, text-to-speech and digitized speech compression. These technologies have applications in telecommunications as well as in computers and multimedia, automotive and consumer electronics. In the telecommunications and information technology (IT) sector L&H licenses to AT&T, Novell, Philips and Samsung electronics. Its strategy is to use explicitly international non-affiliate licensing, rather than pursue the alternative of competing with its customers by developing hardware or application-specific software products. By the end of September 1995, L&H had around 70 non-affiliate licensing agreements worldwide (Bradshaw and Glassman, 1996, pp. 276-283).

Much of the increasing diversity of applications in telecommunications arises because of technological convergence and technologies for computer telephony integration (CTI). New phenomena, such as Web-integrated call centres, are a case in point, whereby customers can access a call centre via the World Wide Web (Clegg, 1998b; 1998c). New telecommunications media, such as Internet protocol (IP) telephony, are likewise spawning new hybrids. Sonera has developed a system called Neophone that integrates

cellular mobile and PC-based telephony (Hopkins, Lakelin and Sherwood, 1998, pp.125-132*)*.

Apart from technology licensing, there are now a myriad of application-specific technologies, producing products to handle speech and data. As barriers to entry in telephony fall, firms have been created that find it relatively easy to diversify into related areas. The more specific and computer-oriented the application, the more feasible is the exporting of software products to final users as a means of international competition, in a way that is little different from international merchandise trade. An example of this is VocalTec Communications Ltd. (headquartered in Israel), a software development firm that specializes in developing products that enable the transmission of voice, fax and multimedia over IP networks. It also develops open systems to bridge IP networks to the PSTN. VocalTec has formed alliances with other international telecommunications providers to operate its own virtual worldwide PC-to-phone IP telephony network (Hopkins, Lakelin and Sherwood, 1998, pp. 144-158).

Conclusions

The telecommunications sector is a perfect example of a service industry in which market opening and FDI have progressed hand in hand. The transnationalization of the telecommunications industry and the increasing pressure for liberalization are closely intertwined. The emergence of pan-European TNCs, originating both from within and from outside Europe, has added to the demand for the integration of the European telecommunications markets.

In the predominant market segment of conventional voice telephony, internationalization has generally meant transnationalization. International liberalization has resulted in a wave of FDI and in global and regional service alliances. As the market matures and as the new complexion of the industry is revealed, based less on basic network operation and more on the newer applications technologies, the full range of forms of international business have become more apparent.

International business theory accounts reasonably well for the fact that the bulk of internationalization in network operation consists of full-bodied local production concentrated in the centres of economic activity. This is FDI of a market-seeking character. At present it is also predominantly based on the exploitation of firm-specific advantages. The technological, financial controllership and marketing skills of firms conditioned by competition in their home markets, most notably from the United States, clearly underpin competitive advantages in European markets.

The strategic asset motive has also emerged as important. Also evident are regional strategies, based on geographical or cultural proximity. It is possible that efficiency-seeking FDI in telecommunications will become more prominent in telecommunication TNCs' strategies. As basic structures are completed, the routing of traffic and the relocation of value-adding activities may become larger issues. International business theory also explains the form of FDI, and the reasons why entry strategies differ by firm and by market segment, as well as by country. The acquisition mode may become more popular with the growth of new operators. These new firms offer fresh acquisition targets, often with attractive portfolios of investments and real options of their own. Oligopolistic trends are hard to prove with the level of data currently available. However, it seems likely that strategy is very much shaped by expectations about rival behaviour. The failure to enter a country, or to join a particular venture, will almost certainly leave an increased opportunity for a competitor. The formation of a global service alliance is likely to serve a strategy of reducing rivalistic interaction. It is also a means of securing global business and diversifying.

Voice telephony remains the dominant form, but as yet it is the least competitive, largely owing to the historical inertia caused by vested interests. The newer market segments of value-added services are the most liberalized and competitive, precisely because they have been comparatively free of such interests. In these segments, large and small firms alike are able to employ international non-affiliate licensing and franchising as a means of internationalization. It is possible that network operation may eventually become akin to a commodity and become largely separate from service competition.

Service competition, especially product differentiation in value-added services, would then emerge as the main arena for international competition via both affiliate and non-affiliate strategies. Once network operators have attained sufficient transnational status, technological convergence and the growing importance of value-added services is likely to mean that in the long term value-adding technologies will be the leading source of international growth.

Standards for international connectivity have been set at the international level for over a hundred years. There are arguments for the centralization of standards-setting and regulation above the national level to reduce distortions. There is undoubtedly an incentive for indigenous service providers to influence the setting of standards in their favour at the national or regional level. For their part, national and regional Governments may desire to secure future footloose investment. In the European context, such behaviour would be approximate to a "fortress Europe" in telecommunications based on technical non-tariff barriers. A more positive approach is for the EU to move more swiftly than the rest of the world towards free trade. Under both approaches inward FDI would result, though of different characters. FDI responding to free trade is more likely to be of long-term benefit. For this reason, the implementation of full competition under the telecommunications services SMP dominates the policy debate in Europe.

Questions still remain over the adequacy of provision for national regulation and over the future of regulation at the regional and global levels. FDI is likely to be part of the solution to the threat of the regional cantonization of telecommunications policy. It is the leading agent of free trade in telecommunications services and directly contributes to competition and integration at the regional and global levels. It is not unreasonable to envisage that in the longer term a global forum or body for the promotion of free trade in telecommunications services will be required. At the very least, such a body would be able to reconcile the setting of standards and the maintenance of free trade, and to coordinate the roles of regional policy forums. ■

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Getting a lift: modernizing industry by way of Latin American integration schemes. The example of automobiles

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The industrialization process in Latin America is very much epitomized by the evolution of the automobile industry. During the import-substituting era, the conflictive relationship between automobile transnational corporations and host Governments produced in countries like Brazil, Mexico and Argentina the local assembly of overpriced, obsolete and poor-quality vehicles. In the new era of heightened global competition, United States and European car producers have responded to the challenge of Asian (Japanese) producers, in part by extending their international production systems by way of regional integration schemes in Latin America. The United States automobile transnational corporations (General Motors, Ford and Chrysler) established a very competitive export base in Mexico in the context of the North American Free Trade Agreement for the purpose of supplying the North American market with competitive small cars. European automobile transnational corporations (such as Fiat and Volkswagen) are modernizing their operations in Brazil and Argentina in the context of the Southern Common Market in an attempt to defend their competitive situations in that market. An examination of the intersection of three sets of factors — international market tendencies, corporate strategies, and national (and, increasingly, regional) policies — indicates the importance of the special provisions and transition periods of regional integration schemes in determining the foreign direct investment and trade trends of the automobile industries of Latin America. For policy makers, the correct application of the right instruments at the appropriate moment can produce important advances in the international competitiveness of the local automobile industry by way of foreign direct investment and can result in a significant boost for the industrialization process of Latin American countries.

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The automobile industry during the era of import-substituting industrialization

The Latin American automobile industry of the 1980s had been established by way of import-substituting industrialization. Vehicle assemblers wishing to establish local operations were required to submit investment programmes to national Governments for authorization. To receive the authorization, they had to comply with certain performance requirements, such as meeting minimum levels of local content, achieving export targets, and compensating imported components and parts with exports. In some cases, vehicle producers were required to export parts produced by local firms. Additionally, national firms or joint ventures enjoyed preferences over transnational corporations (TNCs), (for example, the production of auto parts was sometimes reserved for them), and profit remittances and capital repatriation were limited. The level of national value-added (or local content) was dictated by the national automotive regimes (usually in the 60-90 per cent range), and local authorities spelled out which auto parts were required to be assembled locally. Finally, price controls were often placed on the sales of vehicles in the national market. In exchange, the industry was given very high tariff protection (often more than 100 per cent) and this, coupled with quotas and other non-tariff barriers, virtually prohibited imports.

Nationally assembled vehicles in Latin America were far from world-class and proved quite difficult to export. The assemblers faced a tense bargaining relationship with government authorities concerned with the permanent balance-of-payments deficit generated by the combination of substantial component imports, scarce vehicle exports and significant financial outflows (profit remittances, royalties, etc.) of the automotive firms (Jenkins, 1977; Newfarmer, 1985; Bennet and Sharpe, 1985). Some of the principal aspects of the conflicting interests between government policy and corporate strategies concerned vehicle prices, profit remittances, import compensation, export volumes, local content and suppliers networks and relationships (table 1). The fact of the matter is that all of the economic agents of the industry seemed to play make-believe. The federal Government and the automotive sector authorities pretended that the national industrialization process was being deepened by extending it into more complex manufacturing activities. The auto TNCs

pretended that they assembled suitable vehicles at reasonable cost. The local businesspeople made believe that they produced viable auto parts. Unionized labour in urban automobile plants made believe that their levels of productivity justified their high salaries. But the industry did not make a lasting contribution to the industrialization process and it went into a skid when the debt crisis enveloped the region in the 1980s.

Table 1. Conflicting interests in the import-substituting automobile industry of Latin America, around the 1970s

Aspect	Government policy	auto TNCs′ strategy
1. principal aim: to increase …	industrialization	profits, market shares
2. national automobile prices	lower	higher
3. exports as % of production	higher	lower
4. import compensation	higher	lower
5. profit remittances	lower	higher
6. local content	higher	lower
7. auto part suppliers	national	in-house or imported
8. promotion of joint ventures	more	less

Source: compilation by the author.

Apparently, the sole success of this policy-led promotion of the auto industry in Latin America was to create a supply of vehicles to the domestic market; however, it did so far below international standards of efficiency and quality. The most typical products of national automobile industries in the region at the time were archaic vehicles such as the Volkswagen Beetle in Mexico, the General Motors Chevette in Brazil and the Ford Falcon in Argentina. In the import-substituting industrialization context, national automobile industries could not achieve the scale of production necessary to become efficient enough to be internationally competitive.

In terms of the production of vehicles in the early 1980s (table 2), the Brazilian auto industry, with an annual average of 913,200 units during 1980-84, was more than double that of Mexico (440,600 units), which in turn was more than double that of Argentina (182,700 vehicles). Exports were few and far between: 20 per cent of Brazilian production, 5 per cent of Mexican production and 2 per cent of Argentine production. Virtually no vehicles were imported. In the

Table 2. Mexico, Brazil and Argentina: vehicle production, exports and imports, 1980-1997

(Thousands of units)

Year	Mexico			Brazil			Argentina		
	Total production	Export production	Imports	Total production	Export production	Imports	Total production	Export production	Imports
1980	490.0	18.2	-	1 165.1	157.0	-	281.8	3.6	-
1981	597.1	14.4	-	780.8	212.6	-	172.4	0.3	-
1982	472.6	15.8	-	859.3	173.3	-	132.1	3.2	-
1983	285.5	22.4	-	896.4	168.6	-	159.8	5.2	-
1984	358.0	33.6	-	864.6	196.5	-	167.3	4.2	-
Annual average 1980-1984	440.6	20.9	-	913.2	181.6	-	182.7	3.3	-
1985	458.7	58.4	-	966.7	207.6	-	137.6	0.8	-
1986	341.0	72.4	-	1 056.3	183.2	-	170.5	0.4	-
1987	395.2	163.0	-	920.0	345.5	-	193.3	0.5	-
1988	512.8	173.1	-	1 068.7	320.4	-	164.1	1.7	-
1989	641.2	196.0	-	1 013.2	253.7	-	127.8	1.8	-
1990	820.5	276.8	-	914.4	187.3	2.7	99.6	1.1	-
1991	989.3	350.6	-	960.0	193.1	27.8	138.9	5.2	17.2
1992	1 080.9	382.5	6.1	1 073.7	341.9	45.1	262.0	16.45	65.0
1993	1 080.1	471.9	8.6	1 391.4	331.5	97.4	342.3	30.0	109.5
1994	1 097.4	575.0	74.9	1 581.4	377.6	218.2	408.7	38.4	174.3
1995	931.2	778.7	27.7	1 629.0	263.0	369.0	285.4	47.7	101.1
1996	1 211.3	970.9	88.9	1 813.9	305.7	223.7	312.9	109.0	151.7
1997	1 337.4	984.4	137.4	2 067.0	412.0	302.6	445.9	208.2	..
Annual average 1995-1997	1 160.0	911.3	84.7	1 836.7	326.9	298.4	348.1	121.6	126.4[a]

Sources: Data primarily from national automobile producers' associations: AMIA (Mexico), ANFAVEA (Brazil) and ADEFA (Argentina).

[a] 1995-96 only.

mid-1980s, as a consequence of the transnational bank debt crisis in Latin America, the national automobile industries went into a severe decline. They recovered their 1980 production levels only many years later (1993 in the case of Brazil and Argentina, 1988 in the case of Mexico). Apparently, the Latin American automobile industry could not get out of first gear during the import-substituting industrialization era.

The new setting for the Latin American automobile industry in the 1990s

The 1990s brought a complete revolution to the automobile industries of these countries (table 2). By 1995-1997, the level of national vehicle production had well surpassed that of the early 1980s (nearly 3 times for Mexico, 2 times for Brazil, and 1.9 times for Argentina). Exports exploded as compared with those of 1980-1984 (45.8 times in Mexico, 36.8 times in Argentina, while Brazil was the exception with only 1.8 times). Imports became a factor in the domestic market (reaching the equivalent of 49 per cent of production in Argentina in 1996, 22.7 per cent in Brazil in 1995, but only 10.3 per cent in Mexico in 1997). These automobile industries were being transformed from national islands with scarce interaction with the international economy into important actors of the international automobile industry. Thus, the automobile industry has again become a very prominent element of the industrialization process in Latin America, especially for the larger and more industrially advanced countries of the region.

Foreign affiliates of TNCs have traditionally dominated the automobile industry of Latin America. In 1996, 12 of the 50 largest TNCs by sales in Latin America were subsidiaries or affiliates of auto TNCs operating in Mexico, Brazil and Argentina (table 3). They occupied seven of the top 10 places in terms of sales by all TNCs in Latin America, and four of the top 10 spots of *all* firms in Latin America.

The five principal auto TNC networks in Latin America — those of General Motors, Volkswagen, Ford, Chrysler and Fiat — accounted for over three quarters of the consolidated sales in Latin

Table 3. The principal automobile firms operating in Latin America, by sales, 1996

(Millions of dollars)

Rank [a]		Company	Country of			
All [b]	TNCs [c]	(host country)	origin	Sales	Exports	Imports
5	1	Volkswagen (Brazil)	Germany	7,003.3	555.6	1,000.5
7	2	Chrysler (Mexico)	United States	6,455.4	2,936.0	2,695.1
8	3	General Motors (Mexico)	United States	6,345.6	4,532.5	4,410.0
10	4	General Motors (Brazil)	United States	5,432.9	611.6	4,675.4
12	5	Fiat (Brazil)	Italy	4,742.9	329.9	2,670.2
18	8	Ford (Mexico)	United States	3,879.1	2,387.1	1,940.8
19	9	Ford (Brazil)	United States	3,830.1	849.2	425.0
49	19	Mercedes Benz (Brazil)	Germany	2,130.9	249.0	956.8
63	20	Nissan (Mexico)	Japan	1,800.0	1,050.9	2,229.8
85	28	Ford (Argentina)	United States	1,464.6	338.7[f]	805.1
89	30	Volkswagen (Mexico)	Germany	1,450.0	1,160.7	1,034.1
109	37	Volkswagen (Argentina)	Germany	1,229.7	237.1[f]	544.6
120	[d]	SEVEL (Argentina)	Argentina	1,169.1	-	156.8
125	45	CIADEA (Argentina) [e]	France	1,121.3	133.3	293.5

Source: based on information from *America Economía* (1997a, b and 1998).

[a] Among the 500 largest.

[b] All firms.

[c] Only TNCs.

[d] Locally owned assembler of Fiat and Peugeot.

[e] Joint venture with Renault.

[f] 1997.

America of all auto TNCs in 1996. Their combined sales were the equivalent of about one quarter of sales of all TNCs in the list of 500 largest companies, and about 8 per cent of the sales of all companies on that list (*America Economía*, 1998, pp. 89-92). Thus, the renovation and modernization of the automobile industry has direct implications for the industrialization process as a whole in Latin America.

The new situation of the automobile industry in Latin America is determined by three groups of interrelated factors:

- international market tendencies;
- corporate strategies; and
- national and regional policies.

In *international markets*, hyper-efficient Asian producers create a severe challenge to other producers (Mortimore, 1997). In an industry plagued by over-capacity (annual vehicle production exceeds demand by 25-33 per cent), producers from Japan and, to a lesser extent, from the Republic of Korea are challenging the dominant automobile TNCs by further expanding exports and extending their regional systems of integrated production through foreign direct investment (FDI). Based on better manufacturing technology, superior organizational practices and higher quality standards, the Toyota production system has been winning world trade shares and North American and Western European production shares. New plants of Asian automobile TNCs have been established in North America and Europe. The extension of auto TNCs' integrated production systems to regional markets of developing countries represents the latest chapter in that challenge. But, while the United States and European auto TNCs are well-established in the Latin American automobile industry, Japanese and other Asian auto companies are, with very few exceptions (namely, Nissan's operation in Mexico), virtually absent.

Corporate strategies to face up to the Asian challenge in the world automobile industry differ according to the competitive situation and the existing international production system of individual auto TNCs. In major markets, at least two separate divisions of auto TNCs exist. The three largest firms — General Motors, Ford and Toyota — each producing over 5 million units a year -- constitute the first division and represent a group apart. They are engaged in global competition. They pay particular attention to *the United States market*. The more numerous second division includes other expansive Japanese companies -- Nissan, Mitsubishi and Honda -- the more defensive European companies — Volkswagen, Fiat, Peugeot Citroën (PSA), and Renault — and Chrysler, the smallest of the United States Big Three (recently acquired by Daimler Benz). A three-way competition among Western European, United States and Japanese auto TNCs has developed in *the Western European market*. Also, while the Asian challenge has yet to be extended to Latin America, the United States and European auto TNCs operating there apparently have that eventuality very clearly in mind, as their recent investments suggest (see below).

National and, increasingly, regional policies now play a very significant role in promoting the improvement of the automotive industry in Latin America. The new purpose of government policy is to facilitate the regional corporate strategies of the auto TNCs in order to achieve national or regional goals, such as improving international competitiveness and modernizing technology and organizational practices. One of the novel elements in the relationship between auto TNCs and host countries in the 1990s, especially in developing countries, is the use of regional integration schemes to enlarge markets and allow locally established assemblers to improve efficiency through economies of scale. Regional integration schemes offer auto TNCs easier access to widened markets — often combined with federal or state FDI incentives. The principal new integration schemes of Latin America during the 1990s are the North American Free Trade Agreement (NAFTA), which joins Mexico with Canada and the United States as of 1 January 2004, and the Southern Common Market (MERCOSUR), which joins Argentina, Brazil, Paraguay and Uruguay as of 1 January 2000.

At the same time, Governments have been careful to require the new and established auto TNCs to meet certain conditions, such as regional content obligations. In other words, these trade agreements contain special provisions for the automobile industry of the regional integration scheme. Moreover, transition periods for import tariff rates, local content and trade balancing requirements apply during the run-up to full application of the special provisions of the regional integration scheme. On balance, while conditioning still exists during the transition period, the emphasis of government policy has turned more to attracting FDI and facilitating corporate strategies. The new relationship between auto TNCs and host Governments is much more consensual in terms of defining common goals and much less conflictive with respect to policy implementation.

Mexican autos in NAFTA: how United States auto TNCs improve their competitiveness in the North American market

The "story" of the transformation of the Mexican automobile industry has been thoroughly analysed elsewhere (Mortimore, 1995; Calderón, Mortimore and Peres, 1996). It demonstrates that Latin

American industry *can* be restructured and transformed, and that a country's integration into the international production system and its international competitiveness can be improved. The evidence in the Mexican case is dramatic. FDI on the order of $10 billion — first in modern engine plants, later in world-class passenger vehicle plants — completely transformed the industry and made it the most important industry in the Mexican economy (more so if one includes the fast-growing in-bond assembly, or *maquiladora* activities of auto parts). Between 1990 and 1997, Mexican automotive industry exports increased 4.6 times, from $4.5 to $20.8 billion (table 4). Over 90 per cent went to the North American market. By 1996, Mexico accounted for 10.4 per cent of North American imports of passenger vehicles, 10.8 per cent of commercial vehicles, 12.6 per cent of engines and 8 per cent of auto parts. The automobile industry came to account for over 21 per cent of the value of Mexico's total exports to North America.[1] Productivity increased notably as production and exports grew, while employment declined for the automotive industry. The five foreign affiliates of auto TNCs operating in Mexico — Chrysler, General Motors, Ford, Nissan and Volkswagen — are among the principal exporters not only of Mexico but of all Latin America (table 3).

In terms of relevant *international market factors* explaining the evolution of the Mexican car industry, the Japanese challenge to United States and Western European auto TNCs and the subsequent chronic over-capacity and increased competition are among the driving forces of United States and European auto investments in Mexico. The United States and European countries initially reacted to the expansion of Japanese producers by imposing export restraints and quotas on them. That did not represent a long-term solution, as the Japanese auto TNCs demonstrated an ability to jump trade restrictions by investing in transplant factories inside the United States and European markets.

The *corporate response* of the Big Three United States automobile producers—Ford, General Motors and Chrysler — to the Japanese challenge shared a common element. To face up to

[1] Calculated using the ECLAC computer programme on international competitiveness, CAN PLUS. More information is available upon request.

Table 4. Performance of the Mexican automobile industry, 1990-1997

Item	1990	1994	1995	1996	1997
Production (thousands of vehicles [a])	820.5	1 097.4	931.2	1 211.3	1 338.0
- for the domestic market	543.7	522.4	152.5	240.4	353.8
- for export	276.8	575.0	778.7	970.9	984.4
Employees (thousands of persons)	57.7	49.7	41.8	44.3	44.8
Auto industry exports [b]	4.5	10.4	15.3	19.6	20.8
- % to North America	91.2	90.3	94.0	..	..
- % of North American auto imports	3.82	7.91	8.62	10.85	..
- as % of all Mexican exports to North America	15.6	20.8	19.9	21.6	21.8
Auto industry imports [b]	5.8	11.5	9.5	10.4	13.0
Auto industry trade balance [b]	-1.3	-1.1	5.8	9.2	7.8

Source: information from the Asociación Mexicana de la Industria Automotiva (AMIA), Instituto Nacional de Estadística Geográfia e Informática (INEGI) and calculations from CANPLUS and PADI computer software of the Economic Commission for Latin America and the Caribbean (ECLAC). North America = United States and Canada.

[a] Passenger, commercial and others.
[b] Billions of dollars.

competition, especially in the North American market itself, they all chose to invest in modern engine and vehicle plants in a nearby low-cost production site, Mexico. They imported to the United States entry level 4- and 6-cylinder front-wheel-drive passenger vehicles, and they incorporated in-bond assembly activities of auto parts into their North American production systems. Even before the 1994 Mexican foreign exchange crisis cut sales in the Mexican market itself, all three of them were exporting to the United States market two thirds or more of their passenger vehicle production in Mexico. The large-scale investments of the two other major auto TNCs operating in Mexico, Volkswagen and Nissan, had more to do with their attempts not to be locked out of the promise of the NAFTA. New entrants -- BMW, Mercedes Benz, Honda --established affiliates for the same reason; however, they initiated their production with small-scale operations aimed at the domestic market.

Finally, *national policy* was an important factor for the Mexican automobile industry, both during the import-substituting industrialization epoch and thereafter. The transition in Mexico was

smoother than in other Latin American countries because international competitiveness became a national policy goal much earlier in the evolution of the industry. The 1977 Automotive Decree established annual foreign exchange budgets for auto TNCs operating in Mexico, which enticed established assemblers to mount modern engine facilities to meet export targets. The 1983 Decree permitted producers to introduce additional vehicle production lines destined for export that required only 30 per cent national content (rather than the 60 per cent required for other production lines) as long as they were self-sufficient in foreign exchange. That planted the seeds of the subsequent boom in passenger vehicle production and export. The 1989 Decree made sectoral policy even more flexible for the purpose of accommodating the new corporate strategies of the major producers by introducing more flexible import facilities for auto TNCs operating there and lowering national content in all vehicle production lines to 36 per cent. International competitiveness thus replaced import substitution and Mexicanization as the crucible of success in the industry (Mortimore, 1995, pp. 64-66). In a considered manner, the Government got out of the way of the established auto TNCs so that they could implement their integrated continental production strategies. At the same time, the role of the NAFTA special provisions for the automobile industry (free trade among members by 2004, rules of origin) and the transitional period rules (progressive reduction of import restrictions, trade balancing requirements and local content obligations) were central to the successful transformation of the Mexican automotive industry (see below).

The experience of *Ford* is a good example of the nature of the transformation of the Mexican automotive industry at the company level. It integrated its operations in Mexico into its continental production system. Like other North American producers of passenger cars, Ford had been losing competitiveness in the United States market itself. Its new international corporate strategy seemed to rely more on forming strategic alliances with, or taking minority capital participation in, rivals possessing superior technology or organizational practices, as was the case with Mazda (Ford holds 25 per cent of Mazda Japan and 50 per cent of Mazda United States). Mazda was important to Ford's attempt to put together a «world car» based on the Escort model. In fact, developing new models at

reasonable cost had been considered one of Ford's major weaknesses. Ford's new investments in Mexico, about $3 billion during 1982-1992, were aimed at improving its competitive position in the North American market in respect of smaller cars. By 1993, almost 5 per cent of Ford's global production of passenger cars took place in Mexico (Vickery, 1996, p. 160).

Ford's original production facilities based in Cuautitlán, close to Mexico City, were established in the 1960s to assemble cars and trucks for the domestic market. Representative of many of the automobile operations set up in the import-substituting framework in Latin America, they were described as «horribly inefficient» (*Expansión*, 1993, p. 53). The assembly of the Ghia, Topaz, Cougar and Thunderbird passenger car models reached an annual capacity of only 60,000 units. Ford's new strategy began in 1983 when it established the Chihuahua engine plant with an annual capacity of 200,000 units for incorporation in the Topaz and Tempo models produced in the United States. This plant has been described as «a high-volume, export-oriented facility meant to compete with the most successful engine plants anywhere in the world», and it demonstrated that «advanced production processes can successfully be transferred to newly industrialising countries» (Shaiken and Herzenberg, 1987, pp. 2 and 119). During 1992-1993, it was expanded to an annual capacity of 500,000 units, in part to supply the new Mondeo model being assembled in various parts of the world with the new high-technology Zeta engine.

The next major new investment was to raise the annual capacity (to 160,000 units) of the Mazda-designed Hermosillo assembly plant for Mercury Tracers, which was established in 1986 and expanded in 1990 to include the Escort model. It represented Ford's attempt to apply Japanese flexible technology and organizational methods to a world-class plant located in northern Mexico (Carrillo and Montiel, 1997, pp. 10 and 16). This plant was designed to achieve quality and productivity standards to match or exceed its best international rivals in these critical areas. It produced the highest-quality Ford car in all of North America and possessed the fifth highest quality rating of 46 car assembly plants in North America at the time (Shaiken, 1995, p. 24). The rest of the Ford facilities in Mexico consist of 11 in-bond

assembly operations, mostly in Ciudad Juárez, Chihuahua, and three auto part joint ventures with Mexican firms for the manufacture of windshields, aluminium cylinder blocks and plastic parts. Ford's success with flexible production techniques in Mexico was uneven, varying considerably from plant to plant (Carrillo, 1995, p. 1134). Cuautitlán was being restructured to reform the old import-substituting industrialization style of production, while the Chihuahua and Hermosillo plants were greenfield sites incorporating world-class technology and organizational practices from the beginning. Ford is currently investing in the modernization of its engine plant in Chihuahua.

The transformation of Ford's Mexican operations is apparent in its products. During the 1978-1982 period, Ford sold locally assembled models, such as the Fairmont, the LTD/Gran Marquis and the Mustang, in the domestic market. During 1983-1987 they were replaced by the Topaz, Cougar and Thunderbird models, all still produced exclusively for the domestic market in the ageing Cuautitlán plant. Aside from the Fairmont in 1978 and 1981 and the Topaz in 1985, the annual scale of production of any individual model never exceeded 20,000 units, and no exports were recorded until the Tracer model came on stream in the new Hermosillo plant in 1987. The 1988-1992 period witnessed the explosion of Tracer and Escort exports, both of which averaged more than 50,000 units a year. The export operations of the Tracer and Escort became the dominant aspect of Ford's Mexican production facilities for passenger cars. In 1996, Ford Mexico had sales on the order of $3.9 billion, exports (including vehicles and parts) estimated at $2.4 billion (up from $143 million in 1985 and only $20 million in 1980) and imports of less than $2 billion. Only recently has Ford again taken a serious interest in improving its domestic market share in Mexico; it hopes to improve its participation in the subcompact segment by way of imports of the Fiesta model (*Business Mexico*, 1997, p. 63).

In sum, changes in Ford's corporate strategy during the 1980s had a significant impact on Mexico. The centrepiece of the new strategy was to specialize in one engine (the modern Zeta engine) and two passenger vehicles (the Mercury Tracer and Ford Escort), all for exports. Ford's passenger car production for the domestic

market fell to only 10,000 units in 1996 as a consequence of the foreign exchange crisis of 1994. The strategy did not originally entail modernizing and making internationally competitive the existing Cuautitlán plant, the production of which was destined only for the domestic market. Rather, it was based on *new* and *high technology* engine- and vehicle-assembly facilities, the production of which was destined primarily for the highly competitive North American market. In this way — and based on investment on the order of $3 billion — Ford successfully integrated its new Mexican facilities into its North American production system. It represented a clear example of a NAFTA strategy by a United States Big Three auto TNC.

The overall success of the transformation of the Mexican automobile industry can be measured by the distinct responses of the industry to severe foreign exchange crises. In 1982, domestic demand for vehicles nose-dived, and with it the fortunes of the industry as a whole, since locally assembled vehicles were not good enough to export. In 1995-1997, as a consequence of the foreign exchange crisis that had started in December 1994, domestic demand collapsed; however, this time exports exploded (see tables 2 and 3). The new export orientation of the industry allowed it to weather the storm. The industry had finally found stability based on increased scale, modern plants and higher quality standards, all of which permitted the export of the new locally assembled vehicles to highly competitive markets.

What role did the special provisions and transition period rules of NAFTA play in this transformation? The NAFTA rules served to *consolidate* the integration of the Mexican automobile industry into the existing Canada-United States Auto Pact to the benefit of the United States auto TNCs. The most relevant aspects of NAFTA in this respect are the following:

- It progressively eliminates barriers to trade between Mexico and North America in automobiles and parts over 10 years (1994-2004);
- Tariff-free intraregional trade must meet the NAFTA rules of origin for the industry -- that is, at least 62.5 per cent of the value-added must come from NAFTA sources. The net-cost

formula ensures that imports from non-NAFTA sources will be traced through the production chain;[2]

- It alters significantly the existing Mexican automotive regime. The Big Three United States auto TNCs seem to appreciate these following changes in the Mexican automotive regime (see the presentation of the American Automobile Manufacturers Association --AAMA -- to the United States International Trade Commission (USITC) panel evaluating NAFTA (USITC, 1997, p. D-47):
  - It progressively eliminates the limits on automobile imports to Mexico which are based on the level of sales of local assemblers in that market, thereby facilitating imports by United States auto TNCs (it might be recalled that non-United States auto TNCs, VW and Nissan, had the largest domestic market shares for passenger vehicles in Mexico in 1994, with about 41 and 27 per cent, respectively);
  - It amends the "trade-balancing" requirement of the Mexican sectoral policy;
  - It alters the national value-added rules by reducing the level of Mexican-sourced parts during the transition period, by counting in-bond assembly (*maquiladora*) output as national content; and eliminating national value-added rules after 2004; and
  - The FDI rules allow NAFTA investors -- that is, those from Canada and the United States -- to convert national suppliers into subsidiaries (others are limited to a 49 per cent capital shareholding limit). NAFTA investment norms take precedence over Mexican national ones.

Some specific indications of impact on the automotive industry in Mexico are evident in tariff and trade data: United States tariff levels during 1993-1996 fell from 2.7 to 0.6 per cent for vehicles and from 1.7 to 0.6 per cent for parts, helping United States automotive imports from Mexico to grow from $4.6 to $11.7 billion for vehicles

[2] One might recall that a sticky dispute in the Canada-United States Free Trade Agreement had to do with Honda Civics made in Canada and exported to the United States. The dispute concerned how much of the motor was Canada-sourced and how much was Japan-sourced, and whether the norms of origin were met.

and from $3.7 to $7.1 billion for parts. United States import market shares of Mexican vehicles rose from 6.5 to 13.4 per cent for vehicles and from 16.6 to 23.7 per cent for parts (USITC, 1997, pp. 6-51 to 6-65).

Nonetheless, the real significance of these special provisions and transition period rules goes beyond trade considerations. The NAFTA accord for the automobile industry is a means by which the United States auto TNCs increase their advantages over competitors in certain defined market segments of the North American market by way of their special access to Mexico as a low-cost, high-quality export base. "Thanks to NAFTA, Mexico's car industry is now an integral part of that in the United States" (*The Economist*, 1997a, p. 18). A secondary aspect, up to this moment, is improving their competitive situation in the Mexican domestic market.

For Mexican policy makers, NAFTA has permitted the consolidation of a modern, internationally competitive automobile industry that boosts the new process of industrialization without provoking balance-of-payments problems. During 1995-1997, the industry generated a strong balance-of-payments surplus on the trade account (table 4).

The MERCOSUR automobile industry: how less competitive European auto TNCs forge a subregional fortress

The transformation of the MERCOSUR automobile industry has been substantial, although less dramatic than the Mexican one. For example, in 1995-1997 Brazil produced 50 per cent more vehicles than Mexico (table 2); however, Mexico exported almost three times as many vehicles as Brazil (and more than seven times the number of Argentina). Automobile production in these MERCOSUR countries is far less integrated into the international market. Both the Brazilian and Argentine automobile industries stagnated during the 1980s and did not recover their 1980 level of vehicle production until 1993, much later than Mexico. Nevertheless, significant changes are now taking place in the principal national components (Brazil and Argentina) of what will become the MERCOSUR automobile industry.

The revival of the Brazilian automobile industry was impressive if variable (table 5). Production between 1990 and 1997 rose from 914,400 to 2,067,000 units and labour productivity improved substantially as production rose and employment declined. During 1990-1993, production for the export markets grew more rapidly than that for domestic consumption; however, during 1993-1996, production for export actually declined (recovering in 1997) and the domestic market became even more predominant. This was explained, in good part, by the success of Brazil's speciality: the "popular car". These are stripped down economic cars with engines of less than 1,000 cubic centimetres. They represented three quarters of total passenger vehicle sales in 1998. The battle for market shares in the Brazilian market is focused on the "popular car". Over 40 per cent of the (relatively low) value of Brazil's automotive industry exports go to Argentina (up from 2.4 per cent in 1990), and they represented over one fifth of *all* exports to MERCOSUR (up from 14 per cent in 1990). Sharply increased automobile imports, beginning in 1995, produced a significant trade deficit on balance of payments ($2.1 billion in 1997) in Brazil.

Table 5. Performance of the Brazilian automobile industry, 1990-1997

Item	1990	1994	1995	1996	1997
Production (thousands of vehicles [a])	914.5	1 581.4	1 629.0	1 813.9	2 067.0
- domestic market	712.6	1 203.8	1 366.0	1 506.8	1 655.0
- exports	187.3	377.6	263.0	305.7	412.0
Employees (thousands of persons)	117.4	107.1	104.6	101.9	106.1
Auto industry exports [b]	1.9	2.7	3.0	2.4	4.6
- % to Argentina	2.4	35.1	30.8	42.3	..
- % market: MERCOSUR auto imports	17.53	15.63	14.00	14.64	..
- as % of all exports to MERCOSUR	14.3	21.5	20.7	20.5	..
Auto industry imports [b]	0.7	2.6	4.8	4.9	5.4
Auto industry trade balance [b]	1.2	0.1	-1.9	-2.3	-0.8

Source: information from Associaçâo Nacional dos Fabricantes de Veículos Automotores (ANFAVEA), plus CANPLUS and PADI computer software programmes of ECLAC.

[a] Passenger, commercial and other.
[b] Billions of dollars.

The Argentine automobile industry also responded positively to the new situation. Vehicle production (table 6) jumped from about 100,000 units in 1990 to 408,800 in 1994 before the foreign exchange crisis hit Argentina and produced temporary backtracking (312,900 units in 1996, rising to 445,900 the following year). Vehicle exports shot up from virtually nothing in 1990 to 109,000 units in 1996, rising to 208,200 the following year. From a small base, the value of automobile industry exports more than tripled between 1990 and 1994. The renewed automobile industry proved capable of tripling the value of exports again during 1994-1997 (from $1 billion to $2.8 billion), when domestic demand collapsed due to the foreign exchange crisis of 1995. The destination of such exports was almost exclusively Brazil (86 per cent in 1996). Argentina significantly improved its import market share of the MERCOSUR automobile industry (from 8.9 per cent to 16.1 per cent over 1990-1996). By 1996, over 18 per cent of Argentina's exports to its MERCOSUR partners emanated from the automobile industry. Unfortunately, the industry produced a growing trade deficit at the same time, reaching over $2 billion in 1997. The Argentine industry tended to specialize in midsized to large automobiles (with engines in the 1,500-2,500 cubic centimeters range).

Table 6. Performance of the Argentine automobile industry, 1990-1997

Item	1990	1994	1995	1996	1997
Production (thousands of vehicles [a])	99.6	408.8	285.4	312.9	445.9
- domestic market	98.5	370.1	232.7	203.9	237.7
- exports	1.1	38.7	52.7	109.0	208.2
Employees (thousands of persons)	17.4	25.7	21.4	22.7	25.0
Auto industry exports [b]	0.3	1.0	1.4	1.8	2.8
- % to Brazil	35.0	75.4	90.0	85.5	..
- % market: MERCOSUR auto imports	8.92	12.48	12.93	16.10	..
- as % of all exports to MERCOSUR	6.0	18.3	18.2	18.6	..
Auto industry imports [b]	0.4	3.4	2.4	3.3	4.9
Auto industry trade balance [b]	0.1	-2.4	-1.0	-1.5	-2.1

Source: Asociación de Fabricantes Automotores de Argentina (ADEFA), various industry publications and CANPLUS and PADI computer programmes of ECLAC.

[a] Passenger, commercial and other vehicles.
[b] Billions of dollars.

Again, three groups of factors — international market tendencies, corporate strategies and national policies — are useful analytical categories for examining the competitive situations of the Brazilian and Argentine automotive industries. The *international market tendencies* of most relevance were, of course, related to the Asian challenge that is taking place in the global automobile market. As was mentioned, United States auto TNCs were losing home market shares to challengers from Japan and the Republic of Korea. In Western Europe, the situation was even more critical due to the fact that European auto TNCs lost home market shares to *both* Asian and United States auto TNCs. Trade restrictions did not halt the onslaught, as both the United States (earlier) and Japanese (recently) auto TNCs used FDI to establish modern plants within the frontiers of the European Union. The weak international competitiveness of European auto TNCs was also demonstrated by the fact that many had exited from the United States market during the 1980s when the Asian challenge intensified. Generally, European auto TNCs possessed weaker international systems of integrated production. Placed in this context, the MERCOSUR market – with over 2 million registered vehicles in 1995 – was comparable in size to important European markets, such as France, the United Kingdom and Italy (Quadros *et al*, 1997, p. 4). It was an interesting market for new, more efficient, entrants, or one to be defended by those already installed there. In 1996, the main participants in the Brazilian automobile market, by number of vehicles sold, were Volkswagen (34.2 per cent), Fiat (25.9 per cent), GM (22.2 per cent), and Ford (10.6 per cent). In the same year, the principal participants in the Argentine domestic market were SEVEL (a local firm assembling Fiat and PSA vehicles: 23.5 per cent), CIADEA (Renault: 19.6 per cent), Volkswagen (18.6 per cent) and Fiat (8 per cent).

The *corporate strategies* of the European (and United States) auto TNCs in MERCOSUR demonstrated that they were determined to defend or expand their national market shares of the MERCOSUR members' markets. In Brazil, for example, announced investments in new plant and equipment by auto TNCs reached $17.2 billion in August of 1997 (Tonooka, 1997). The principal investors ($11.9 billion) are the existing producers, particularly General Motors ($3.3 billion), Volkswagen ($3.1 billion), Fiat ($2.5 billion) and Ford ($2.5

billion); whereas new entrants ($5.3 billion) were less ambitious, excepting Renault ($1 billion) (see *Latin Finance*, 1997, p. 70). In Argentina, both the investments made during 1991-1995 ($2.2 billion) and those planned for 1995-2000 ($4.5 billion) were concentrated in the same four auto TNCs, that is, Fiat ($642 million), General Motors ($1.1 billion), Volkswagen ($280 million) and Ford ($1 billion) (*Latin American Weekly Report*, 1997, p. 83). The common thread in their investments was to modernize, specialize and increase the scale of production. Clearly, the European (and United States) auto TNCs were doing so to defend their existing market shares in one of the last notable regional markets not dominated by the Asian challengers.[3]

National policies have been very important for the automobile industry in the MERCOSUR countries. In this respect, the "story" of the Brazilian automotive industry has been more than adequately dealt with by others (Quadros *et al*, 1997; Ferro, 1995; Posthuma, 1995). Basically, there were three major attempts to jump-start the moribund automobile industry: in 1990, 1993 and 1995. These efforts represented important zigzags in sectoral policy and only produced a solid effect once the hyperinflationary environment had been eliminated through the Plan Real, such that automobile demand recovered and the auto TNCs began to invest heavily in modernizing their plants. In 1998, nonetheless, demand declined, and this negatively affects primarily the European TNCs with expanded plants (*America Economía*, 1998, p. 22).

The *1990-1992 strategy* involved an effort to revitalize the automobile industry through its closer integration into the international industry (Ferro, 1995, p. 3), by producing modern models whose scale of production could be extended by way of significant exports. International competitiveness was to be achieved gradually so as not to disrupt the industry; however, a substantial increase in the imports of vehicles and components was foreseen. Productivity and quality levels were to be enhanced and local sales promoted via price reductions based on tax and production cost decreases. This

[3] Toyota has operated in Brazil since 1959, producing a low volume of jeeps (less than 6,000 units a year). It recently announced new investments: $600 million in Sao Paulo to produce 80,000 Corollas and $150 million in Argentina to produce 25,000 vehicles. The investments of other Japanese auto TNCs concerned small plants with capacities of less than 15,000 units.

strategy became manifest in several initiatives. One was the market liberalization programme based on allowing increased import competition for vehicles. Imported vehicles were programmed to rise from practically zero to the equivalent of 20 per cent of domestic sales in 1996 (ANFAVEA, 1995, p. 54). Another initiative was the Sectoral Chamber approach to industrial organization. It sought to include all major participants -- federal and state Governments, private sector producers (including vehicle assemblers, component and raw material suppliers and vehicle retailers), and labour -- in negotiations aimed at improving the overall welfare of the industry, rather than the individual short-term interests of each participant (Posthuma, 1995, p. 16). One concrete result was the sharp drop in car prices in Brazil and the consequent rise of local demand for automobiles. A third initiative had to do with new exports to Argentina stemming from Protocol 21 of the 1988 Programme of Integration and Cooperation between Argentina and Brazil, which laid out a programme for tariff-free automobile trade based on reciprocal quotas for vehicles in order to compensate for foreign exchange imbalances. That was incorporated into Economic Complementation Agreement No. 14 between Brazil and Argentina, which ran until 1994.

The *1993 strategy* was characterized (Ferro, 1995, p. 2) as aiming at a more self-sufficient industry in which TNC vehicle producers specialized in smaller, less sophisticated and cheaper products better suited to local market conditions, according to government officials. This became manifest in the "popular car" policy that reduced the tax burden on economic vehicles from 34.5 per cent in 1990 to 17 per cent in 1993. As a result, the price of "popular" vehicles dropped from around $10,000 to $7,300, and that category of vehicle became by far the most dynamic element of the domestic market. The rapid rise in the number of imported vehicles (reaching the equivalent of almost one quarter of the number of vehicles produced in Brazil in 1995) created a weakened balance-of-payments situation. That provoked an emergency increase in tariff protection (to 70 per cent), combined with import quotas (on the order of 50,000) for vehicle importers that did not possess assembly operations in Brazil. Thus, the "popular car" initiative and increased tariff protection were two aspects that came to characterize this phase of the development of the Brazilian automobile industry.

The *1995 sectoral strategy* was a mixture of the two previous ones and re-emphasized the role of industrial policy and the MERCOSUR venture in producing greater international competitiveness. The third Sectoral Chamber agreement of that year was thought to represent a new industrial policy being first applied to the automobile industry (ANFAVEA, 1995, p. 93). The new Automotive Regime allowed auto assemblers to import more parts and components to modernize their vehicles (local content had dropped from 95 per cent to about 60 per cent), but only if they were able to do so without aggravating the balance-of-payments situation. They had to compensate imports with exports. At the same time, important federal incentives for foreign investors were defined (sharply reduced tariffs on imported capital goods, price stability, accelerated depreciation for capital equipment, tax reductions for auto parts firms that started to export, etc.). Considerable incentives were given to foreign investors by state Governments in north and north-eastern Brazil to influence the location of the new plants of auto TNCs. About the same time, new tariff reductions were programmed from 35 per cent in 1995 to 20 per cent in 2000 in accordance with the MERCOSUR negotiations. Thus, a new push was given to the industry, both within and outside the context of the MERCOSUR accord signed in 1994.

The new interest of auto TNCs in Brazil was clearly reflected in the dimension of their investments. During 1990-1995, relatively modest investments were registered, primarily to modernize existing plants; however, for 1996-2000 huge investments were announced, primarily to set up new, more "world-class" vehicles, such as the Fiat Palio, the GM Corsa and the Ford Fiesta, which were to facilitate more export-based operations. Much of this recent investment activity takes place because of the promise of the MERCOSUR integration scheme and reflects the rising profile of MERCOSUR in corporate strategies. It portends a more investment-led integration scheme that promises to affect strongly the level of production and exports of the Brazilian automobile industry in the near future.

The Argentine automobile industry also underwent significant changes (Fiel, 1997; Bolsa de Comercio de Córdoba, 1996; UADE, 1996). A curiosity of this case is that, in the late 1970s, several auto TNCs operating in the country left (Citroën, General Motors and

Chrysler) or sold out to local capital (Fiat and Peugeot were purchased by the Macri group to form SEVEL). Furthermore, as a result of a financial crisis in Renault in 1992, the majority of its shares held in Argentina were taken over by the Antelo group to form CIADEA. Thus, in Argentina, locally owned producers of licensed models had the largest domestic market shares (for example, in 1992, SEVEL had 41.8 per cent and CIADEA 23.4 per cent of domestic auto sales), something quite uncommon in the Latin American automobile industry. The renewed interest of auto TNCs in the Argentine market resulted in investments that produced sharp changes in domestic market shares by the first half of 1997: Volkswagen (32 per cent), Ford (18 per cent), and Fiat (16 per cent) sharply increased their shares and took back the lead from locally owned firms. CIADEA (18 per cent) and, especially, SEVEL (8 per cent) lost market shares (FIEL, 1997).

Essentially three national policy factors explain the revival of the automobile industry in Argentina: the effects of macroeconomic policy, the 1991 special regime implemented in the industry, and the boost given to automobile exports to Brazil via bilateral and subregional accords. In respect of the former, the 1991 Convertibility Plan rescued Argentina from its hyperinflationary macroeconomic environment by anchoring the new national currency to the dollar, thereby reducing inflationary expectations and bringing national price rises down to practically zero. The effect on disposable national income produced a surge in the local demand for automobiles. On the negative side, up to 1995, Argentine macroeconomic policy had relied too much on short-term capital inflows, culminating in a sharp recession characterized by the contraction of disposable incomes and high unemployment (about 18 per cent). This severely dampened domestic demand for automobiles in 1995. As national automobile demand was volatile due to macroeconomic instability, exporting has gained attractiveness for auto assemblers operating in Argentina.

The Agreement to Reconvert the Automobile Industry of 1991 offered very significant advantages and benefits to automobile producers with concrete re-conversion plans. Market liberalization allowed national producers to import vehicles (with a 2 per cent tariff), while others did so through a limited (with a ceiling of 10 per cent of national sales) bidding system (with a 20 per cent tariff). The level

of local content was reduced from 80 to 60 (later 50) per cent. But imports by auto producers still had to be compensated for by exports. Domestic prices were reduced to promote sales (prices dropped by 33 per cent in 1991). Thus, producers received strong incentives to invest in the rationalization and modernization of their plants and in the development of exports, to allow for more imported vehicles, components and parts. Auto TNCs responded with new investments, based on plans for new vehicle exports to Brazil.

The Brazilian market became Argentina's principal automobile export outlet. The need to compensate bilateral trade in the context, first, of Protocol 21, later, of the Economic Complementation Agreement No. 14, became increasingly important. Initially, the quotas for Argentine car exports to the Brazilian market were small (rising from 5,000 units in 1989 to 35,000 in 1994). Later on they increased rapidly, and Argentina was supplying 103,000 of the 226,000 autos imported by Brazil in 1996. In other words, administrated trade was a fundamental factor in the renewal of Argentina's automobile industry, and MERCOSUR was central to the development of the Argentine automotive industry.

An examination of the new corporate strategy of one of the principal auto TNCs operating in both Brazil and Argentina -- *Fiat* -- demonstrates very clearly the relevance of the MERCOSUR integration scheme in this sector. The subregional auto production network of Fiat has taken on a privileged role in the context of the corporate strategy to extend and restructure their operations in the Brazilian and Argentine markets.

Fiat does not figure among the top global auto TNCs in terms of sales; however, within Western Europe it is fifth in terms of market share. Its international production system for passenger cars is limited essentially to Europe (including the Mediterranean basin) and Brazil. In Latin America, it had pulled out of direct car production in Argentina and Colombia in the 1970s and 1980s. It is now re-establishing and fortifying its presence. In 1993, over one quarter of Fiat's worldwide production of passenger vehicles took place in South America, primarily Brazil and Argentina. Fiat is definitely basing an important part of its global strategy on the Brazilian and the MERCOSUR markets.

In Brazil, major investments by Fiat -- whose subsidiary became the largest foreign enterprise in terms of sales made -- related to the "popular car" programme, increasing its domestic market share from 14.6 per cent in 1990 to 33 per cent in 1996. Its overall production in 1996 reached 539,658 vehicles (passenger cars: 477,775; commercial vehicles: 61,883). The Uno model in its "popular" and other versions accounted for 204,300 units (or 42.8 per cent) of passenger car production and was Brazil's second best-selling car. At the same time, Fiat accounted for over half of Brazil's vehicle exports during 1991-95. The new Palio model had been designed specifically for developing-country markets and represented the new orientation of Fiat in Brazil. The Palio accounted for 157,862 units (or 33 per cent) of Fiat's passenger car production in Brazil in 1996. Fiat exported 100,886 vehicles (equal to 19 per cent of its production), mainly to Argentina, concentrating on four models: Duna (25,536), Uno (23,280), Fiorino (24,452) and Spazio (15,840). Fiat was to transfer all its Uno production from Italy to Brazil. The supplies of these operations in Brazil were transformed from import-led to domestic: by 1996, it ceased to be the biggest vehicle importer in the country (imports dropped to 8,833 units from 89,870 the year before). Fiat had restructured and transformed its Brazilian Betim plant to specialize in two major domestic models (the Uno and the new Palio) as part of these strategies. During 1990-95, productivity rose by 50 per cent, and the new scale of production was evident in its principal models — the Uno and the Palio — both of which in 1997 were to surpass an annual production level of 250,000 units. Fiat became more focused in competitive terms, and its $2.5 billion investments announced for 1995-2000 (for the Palio/Tipo models, an engine plant, truck production and parts manufacture) will consolidate its lead. In 1996, Fiat-Brazil had sales of $4,742.9 million, exports of $329.9 million (about 7 per cent of sales) and imports of $2,670.2 million (8 times the value of exports).

In Argentina, Fiat re-established itself as a direct producer after an absence of almost 20 years. Back in the hectic 1970s, its local operation merged with that of Peugeot, then sold to a local group that assembled and sold Fiats under licence. In 1995, Fiat decided to implement a daring new corporate strategy in Argentina based on the promise of MERCOSUR, and at the same time to fulfil the requirements of the Argentine and Brazilian auto regimes with regard

to compensated trade. As a result, Fiat's market share jumped from zero in 1994 to 7.5 per cent in 1996, before reaching a hoped-for 28 per cent in 1997, according to the Director of Argentine operations (*Formula XXI*, 1997, p. 8). It directly produced 22,654 units in 1996 (the Duna and Uno models), while its ex-licensee SEVEL still assembled some models (the Duna, Vivace, Spazio and Uno) in sharply declining numbers. The Duna was the second best-selling model in Argentina. Small numbers of Alfa Romeos were imported. Motors and transmission gears were also manufactured in Argentina.

The new strategy of Fiat in Argentina revolved around two central elements. One was to return to direct production of vehicles for the local market. The other was to produce autos for export to Brazil (the Palio in an estate version and the "popular" Mille based on Brazilian parts). Fiat made a $600 million investment in a new plant in Córdoba to produce the estate version of the modern Palio/ Sienna lines. The 5,000-employee plant will have a capacity of 200,000 vehicles a year and the associated FDI of auto parts producers should reach $130 million. Fiat also has a modern engine plant in Argentina. In contrast, in 1996, Fiat's local partner SEVEL had sales of $1,169.1 million and did not export.

The Fiat strategy represents a major commitment of a relatively small and not very internationalized auto TNC to establish a major presence in the MERCOSUR subregion. It improves its competitive situation by way of large-scale investments in new plants to specialize in one or two models in Brazil and Argentina. It hopes to export the Palio to Asia and Eastern Europe. According to company reports, Fiat wants to become the biggest carmaker in Latin America. Its capacity in Brazil-Argentina should rise by 50 per cent, from 636,000 to 967,000 units, by the year 2000 (Posthuma, 1997, p. 4). In 1998, however, Fiat was forced to suspend production several times at its new plants in Brazil and Argentina due to falling demand (*America Economía*, 1998, pp. 26-28).

An examination of the Fiat strategy in Brazil and Argentina suggests that it is a making major commitment by way of huge investments in those markets. The focus seems to be, first, to defend its market shares in the huge Brazilian market, especially the "popular car" segment, and, second, to take advantage of the MERCOSUR

scheme for automobiles to generate sufficient exports to compensate for imports. In that manner, Fiat can meet both the requirements of the Brazilian Automotive Regime and the trade obligations in the run-up to MERCOSUR.

What role did MERCOSUR play in the revitalization of the Brazilian and Argentine auto industries? According to *The Economist* (1996, p. 10): "the motor industry, in fact, has led the way towards making MERCOSUR a single market". It should be noted that the MERCOSUR market implies as of 1 January 2000 a subregional automobile industry based on:

- a relative high common external tariff (proposed to be 20 per cent) ,
- tariff-free internal trade for locally assembled vehicles meeting the MERCOSUR rules of origin (proposed to be 60 per cent regional content), and
- compensated trade and the prohibition of trade-distorting incentives.

The automotive industry accounts for 30 per cent of the trade between Brazil and Argentina, rising from $6.4 to $14.8 billion between 1993 and 1997. Argentina enjoys a $900-million surplus in vehicles, while Brazil has about the same surplus in parts. A major difference with the NAFTA auto industry is that the expanded MERCOSUR market holds promise but it is not yet a completely established fact. Nevertheless, the promise of the expanded market proved a strong attraction for auto TNCs, as is evident in their investment plans.

A comparative evaluation of the NAFTA and MERCOSUR experiences

In the Latin American automobile industries examined — that is, Mexico within NAFTA and Brazil and Argentina within MERCOSUR — forceful processes of modernization are at work, based on substantial investments in plant and equipment that create major increases in production capacity of new models. As a result of the increased scale of production, improved production techniques,

modern organizational practices, and new supplier networks and relationships, these plants demonstrate impressive increases in productivity and efficiency. The vehicle production capacities foreseen for the year 2000 for Mexico (2 million units), Brazil (2.5-3.0 million) and Argentina (800,000) will greatly exceed their levels of production at the beginning of the 1990s (Mexico, 820,500; Brazil, 914,400; and Argentina, 99,600 units). Foreseen domestic demand for the year 2000 will not exceed one half of total capacity. Thus, success will depend on the ability to export both to their partners in formal integration schemes and beyond. In this sense, the international competitiveness of each national automobile industry can be taken as a first benchmark for evaluating these experiences.

Data (table 7) indicate that the only significant expansions of export market shares concern Mexico and Argentina. Mexico increased its import market share in North America from 0.69 per cent in 1980 to 10.85 per cent in 1996. Argentina improved its import market share in the Latin American market from 1.95 per cent in 1990 to 6.45 per cent in 1996 and in the MERCOSUR market from 8.92 per cent in 1990 to 16.1 per cent in 1996. Brazil's improvement in market share in Latin America during 1990-1996 (from 7.43 per cent to 7.46 per cent) was marginal and must be contrasted with its overall decline since 1980. Another interesting observation is that NAFTA countries (especially Mexico) are increasing their import market shares in the North American market (from 49.36 per cent to 58.67 per cent during 1990-1996), as are the MERCOSUR partners in the MERCOSUR market (from 27.90 per cent to 31.84 per cent during 1990-1996). This illustrates the point that each regional integration scheme favours its own members. The changes in the Mexican automobile industry are to a large extent consolidated, while the major changes to the MERCOSUR automobile industry are still mostly expectations linked to the new FDI inflows in new automobile plants.

Press reports suggest that the Brazilian and Argentine automobile industries are less internationally competitive because they are less efficient. One example is a phenomenon called "the Brazil cost". This concept is defined to include all those factors that, taken together, make it 38 per cent more expensive to build a factory

Table 7. Import market shares of the automotive industry, 1980-1996

(SITC 713, 781, 782 and 784 in various markets)

Region and country	1980	1985	1990	1995	1996
1. OECD market					
Argentina	0.03	0.01	0.03	0.02	0.02
Brazil	0.56	0.72	0.65	0.43	0.39
Mexico	0.38	1.44	2.07	3.69	4.33
MERCOSUR	0.59	0.73	0.67	0.45	0.41
NAFTA	24.41	30.35	22.08	26.35	25.94
2. North American market					
Argentina	0.01	0.01	0.02	0.02	0.02
Brazil	0.62	0.76	0.93	0.52	0.51
Mexico	0.69	2.38	4.72	8.62	10.85
MERCOSUR	0.63	0.78	0.95	0.54	0.53
NAFTA	50.67	50.49	49.36	56.28	58.67
3. Western European market					
Argentina	0.04	0.01	0.03	0.02	0.02
Brazil	0.49	0.70	0.49	0.36	0.32
Mexico	0.14	0.15	0.29	0.21	0.19
MERCOSUR	0.53	0.71	0.52	0.38	0.35
NAFTA	3.30	2.04	2.93	3.38	3.29
4. Latin American market					
Argentina	0.64	1.92	1.95	5.98	6.45
Brazil	10.47	9.94	7.43	8.47	7.46
Mexico	0.44	1.20	1.35	2.96	3.62
MERCOSUR	11.69	11.71	9.61	16.03	14.35
NAFTA	30.87	37.45	50.37	36.50	42.30
5. MERCOSUR market					
Argentina			8.92	12.93	16.10
Brazil			17.53	14.00	14.64
Mexico			1.40	2.58	4.23
MERCOSUR			27.90	30.42	31.84
NAFTA			17.74	13.10	13.68

Source: based on the CAN PLUS and CAN SUR computer programmes of ECLAC.

or launch a product in Brazil than in an industrialized country (such as a poorly trained workforce, fluctuating economic rules, port bottlenecks, deteriorated highways, opaque laws, antiquated or corrupt bureaucracies, excessive taxes and exorbitant interest rates) (*America Economía*, 1996, p. 25). One states that Brazil is "an unusually

difficult place to make vehicles" (*The Economist*, 1998, p. 60). In the case of Argentina, it has been suggested that the need to compensate exports results in non-optimal scales of production. Fiat produces a version of its new Palio model in a relatively less efficient plant in Córdoba, rather than the huge integrated facilities in Betim, Brazil (*The Economist*, 1997b, p. 58). A further indication of sub-optimal efficiency is the fact that Ford Chile finds it cheaper to import the Escort from Spain than from neighbouring Argentina (*America Economía*, 1997b, p. 26).

MERCOSUR has also faced external criticism from official sources. A draft World Bank paper suggested that MERCOSUR diverted international trade by way of its preferences and barriers, with the result that it promoted inefficient plants which were incapable of competing internationally. It maintained that the trade boom was artificial, sustained by tariffs and other barriers that insulate local manufacturers from international competition (*SUNS*, 1996, p. 3). Even MERCOSUR's advocates admit that "efficiency patterns in MERCOSUR auto trade are not optimal" (Rodríguez, 1996, p. 72). This external criticism was compounded by the fact that the United States, the European Union, Japan and the Republic of Korea all threatened to request a dispute panel in WTO because of Brazil's 1995 import quotas and tariff rates that discriminated against automobile importers with no local production facilities. Brazil eventually resolved the matter through bilateral negotiations that raised the quotas for the European Union, Japan and the Republic of Korea. The United States seemed intent on taking the case to WTO.[4]

Thus, according to the first benchmark — efficiency and international competitiveness — there exist significant differences in these automobile industries. That of Mexico, in the context of NAFTA, is far superior to those of Brazil and Argentina in the context of MERCOSUR, since it is capable of exporting most of its production to a very competitive market that has relatively low tariff protection.

A second benchmark has to do with how the auto TNCs modernize their operations within the integration scheme. Auto TNCs must advance their national or regional production systems beyond

[4] At press time, the dispute had still not been definitely resolved.

the cost advantages that some developing countries possess for the assembly of vehicles (representing about 15 per cent of total costs). The initial surge in FDI by auto TNCs in certain developing countries rested on that factor. The auto TNCs are now obliged continually to modernize their production technology and organizational practices and to push those competitive advantages through their entire supply network, which represents the other 85 per cent of a vehicle's total cost. That includes bodies and their parts (25 per cent), engines and transmissions (25 per cent), final drives, suspensions, steering and braking systems (15 per cent), and others (20 per cent) (O'Brien and Karmokolias, 1994, p. 22). This has clear implications: the globalization process marginalizes those auto TNCs that do not remain competitive in terms of modern technology, organizational practices, human resources and supplier networks and relationships.

Auto TNCs still produce *in-house* most of the body and body parts, and engines and transmissions; however, outsourcing has increased notably. Also, they reduce the number of overall suppliers and tend to rely on a small group of first-tier auto parts TNCs to supply components or sub-assemblies. The Toyota production system is being copied by its competitors. The auto-parts TNCs dominate the production of final drives, suspension, steering and braking systems, as well as electrical systems. They subcontract parts from the second- and third-tier suppliers. Thus, to maintain quality standards, ensure timely delivery and push some of the research, development and design costs onto auto parts suppliers, the auto TNCs are reducing their in-house production of auto parts. They also are establishing a relatively small group of component providers as the heart of their competitive supplier network. The supplier networks tend to accompany the auto TNCs in the expansion of their international production systems via FDI in developing countries.

In terms of supplier networks, quite significant differences are emerging in the comparison between Mexico and Brazil and Argentina. It has been mentioned that, in Mexico, Ford's engine plant in Chihuahua and its passenger vehicle plant in Hermosillo represented first attempts to locate world-class production facilities in a developing country (Shaiken, 1995, p. 15). Ford used its participation in Mazda to bring Japanese technology to the Mexican automobile industry. A new aspect evident in the Mexican industry

is what has been referred to as "a third-generation *maquiladora*" (Carrillo and Hualde, 1997), relying not on cheap, unskilled labour, nor on the rationalization of such (the Toyota system), but on highly skilled, knowledge-intensive aspects.

An example is that of the Delphi plant of General Motors, which was transferred from Indiana (United States) to Cuidad Juárez (Mexico). This is the first time that General Motors has transferred abroad one of its seven research-and-development centres. This new plant, based on highly skilled labour and technicians, designs prototypes of solenoids and sensors by way of integral or full package research, design and development. In other words, its purpose is not to manufacture but to design better ways to manufacture. A sister firm in the same industrial cluster in Cuidad Juárez manufactures the products and supplies the United States operations of General Motors, Toyota, Honda, Ford, Isuzu, Mercedes Benz and BMW. Thus, the Mexican automobile industry has been increasingly modernized through the installation of world-class plants for engines, vehicles and, as the General Motors example suggests, auto parts.[5]

A different experience was that of the new truck and bus plant of Volkswagen in Brazil, which was called "the most advanced in the world" (*The Economist*, 1996, p. 13), in that it was supposed to achieve 50 per cent more efficiency by going a step beyond the Toyota model. Its principal innovation consisted of what was called the "modular consortium" (Marx, Salermo and Zibovicius, 1996). Volkswagen required seven of its principal suppliers of sub-assemblies (engines, chassis, suspension, cabin, wheels, carpeting and painting) to invest in modular operations inside the Volkswagen plant (*Business Latin America*, 1996a, p. 2; *Business Week*, 1996, p. 52). They were individually responsible for their module and the final integration of

[5] Another interesting feature of the Mexican experience is that, although there was a period of extreme restructuring of the national auto parts industry due to increased import competition in which many inefficient national firms were pushed to the wall, new, more competitive, national companies have arisen in that industry. For example, Unik, which is the auto parts arm of the local Desc group, purchased during 1996-1997 some operations of auto parts TNCs, such as Robert Bosch, Borg Warner and Dana, to become the most important producer of manual transmissions in all of North America. It exports 60 per cent of its production to the United States, up from only 26 per cent before NAFTA (*Expansión*, February, 1998, p. 37).

the vehicle; in fact, they were not paid until the final, defect-free vehicle left the plant. The major suppliers coordinated the second- and third-tier ones. VW attempted to push more responsibility, including research and development, on to the major suppliers. While organizationally appealing, the results did not live up to expectations: "Originally touted as the most advanced in the world, this plant has been plagued by problems, and a senior company official now dismisses it as 'an experiment'" (*The Economist*, 1997a, p. 18). Productivity at the Resende plant was less than half that at comparable United States and European plants (*The Economist*, 1998, p. 60).

Thus, the second benchmark — modern practices to push competitive advantages through the supply network — also suggests that the Mexican automobile industry in the context of NAFTA has produced more significant, lasting, and promising results.

A third benchmark concerns the stability and importance of the rules and regulations of the automotive industry within each integration scheme. The coherence with national policy is another important element by which to compare these experiences. In this regard, it must be said that the road to MERCOSUR has been rough mostly because of the clash of national and regional policies in Brazil and Argentina. Three major preoccupations have emerged. One is an internal dispute that arose due to the fact that the transition period was not clearly defined (unlike NAFTA) or long enough. The situation became particularly tense between Brazil and Argentina in respect of the automobile industry during 1995, and only long and difficult bilateral negotiations led to certain fundamental clarifications in early 1996. They decided to live with their differences in areas such as import duties, tax treatment and the measurement of local content, attempting to work towards convergence (*Business Latin America*, 1996b, p. 2). In an attempt to iron things out, Brazil recognized and accepted the Argentine auto regime (incentive-based) until end-1999. Argentina, in turn, accepted the Brazilian one, mainly the "popular car" policy. Brazil, after some delay, exempted Argentina from its new emergency quotas for the automobile industry and eventually recognized Argentina's outstanding claim of uncompensated imports for 1992-1994 of around 85,000 units. Shortly thereafter, the new Brazilian auto policy aimed at promoting new FDI in local production

(which was later coupled with the Brazilian States' FDI incentives competition) resulted in new Argentine complaints, this time about FDI diversion. In other words, while the expanded market was a great attraction, bilateral disputes perplexed the auto TNCs and ultimately influenced the nature and timing of their FDI in vehicle and parts plants (*Business Latin America*, 1996b, pp. 2-3). At one stage, Argentina requested FDI diversion compensation from Brazil. Argentine auto assemblers apparently suggested that vehicles receiving such subsidies should not be allowed to enter Argentina duty-free. Evidently, national priorities did not always coincide with subregional ones (Abreu e Lima Florencio and Fraga Araùjo, 1996, pp. 64-65). Currently, disputes have again arisen over the common external tariff for autos and the level of regional content for auto parts.

Thus, the third benchmark — the stability and coherence of the rules and regulations of the industry — suggests that those of MERCOSUR have demonstrated considerably more variation and conflict than the NAFTA ones. In the automotive industry, the lack of definition of the transition period rules provoked conflict among MERCOSUR members and undoubtedly inhibited some investors.

These three benchmarks indicate one general conclusion: there have been considerable differences between the experience of the Mexican automotive industry with the special provisions of NAFTA, and those of the Brazilian and Argentine automotive industries with the special provisions of MERCOSUR. The former has been much more successful than the latter at giving the industrialization process a significant and sustained lift.

Policy implications

Policy-making in the automotive industry of Latin America during the import-substituting industrialization process was based on a conflictive relationship between auto TNCs wishing to operate in the local market and government policy makers trying to guide the evolution of that industry and control its balance-of-payments impact. In this setting, the national automotive industries never became competitive in any significant manner. Apparently, policy makers did

not take into account, in a serious manner, either the changing competitive situation of the automotive industry in international markets, or the evolving and distinct corporate strategies of the principal auto TNCs.

Three policy lessons stem from this analysis. First, policy makers must take a proactive stance and must include international market factors and corporate strategies in their strategic visions of what is in the "realm of possibilities" of the automotive industry located within their borders. A careful understanding of the intersection of national policy interests, international market situations and corporate strategies can promote non-confrontational alternatives in which national and corporate goals tend to coincide. For example, Mexican policy makers achieved a very competitive automotive industry by understanding the reaction of first-division United States auto TNCs to the Asian challenge in their home market. The case of Ford was illustrative of an aggressive corporate strategy in Mexico using modern Japanese technology in world-class plants to face up to that challenge. On the other hand, Brazilian and Argentine policy makers seemed to acquiesce in the efforts of second-division auto TNCs trying to create a subregional fortress to escape from the heightened competition evident in the international market. The former was an aggressive strategy to compete better, the latter a defensive one aimed more at avoiding competition. In this respect, one might ponder the question: why did the Brazilian and Argentine authorities not target the highly competitive Japanese auto TNCs to modernize and make internationally competitive their automobile industries?

Second, the time to devise and implement policies of this nature is *now*. Policy makers can still influence the way auto TNCs invest and structure their international, regional and sub-regional productions systems. They can do so by way of policy instruments of regional integration schemes that incorporate widened markets, special provisions — free trade among members, regional rules of origin, import considerations, external tariff protection, etc. — and transition period rules — local content levels, trade compensation, national tariff protection, etc. FDI incentives now round out the package of relevant policy instruments. These are important options

in a world in which the new rules of WTO, especially as regards trade-related investment measures (TRIMs), establish progressively severe limits on the use of industrial policy instruments, such as performance requirements, trade balancing and trade restrictions. Policy makers interested in having a more direct effect on the implementation of their priorities in the automotive industry in particular (such as international competitiveness, modern technology and organizational practices, cluster-building through extended supplier networks, more highly-skilled jobs), and their industrialization process in general must do so now, before new rules further limit such possibilities. In this context, it is of interest to note that the NAFTA included a longer transition period (1 January 2004) than MERCOSUR (1 January 2000). It would appear that the MERCOSUR transition period was too short to accommodate the major changes required.

Third, the combination of widened markets, special provisions and transition periods of regional integration schemes can be very effective in influencing auto TNC and auto-part TNC FDI in international, regional and subregional production systems. But investors, especially the most competitive ones putting the challenge to the others, can be discouraged or confused by disputes taking place among member countries. In MERCOSUR, deteriorating macroeconomic situations resulted in policy zigzags on import duties, the application of quotas, the use of FDI incentives, and disputes over particular aspects of the transition period rules (such as trade compensation or how to measure national content).

Finally, it seems apparent that, to the extent that the right policies are correctly implemented at the appropriate moment, the higher the probability that the industrialization process will receive a big boost. The strategic vision of policy makers still has an important impact on the degree of success of national industrialization processes, even in a globalizing world. ■

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RESEARCH NOTE

International trade: the "glue" of global integration

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International trade is still the most important vehicle through which international economic involvement links national and regional economies. The suggestion that international production has assumed the leading role still remains to be proven. The role of international trade is assessed in terms of its contribution to global welfare (allocative efficiency), both in terms of arm's-length trade in primary products and its importance as a means by which transnational corporations integrate the operations of their spatially disparate assets. Indeed, the negative impact of regionalism on global welfare may be mitigated by the private benefits that transnational corporations generate under an open international system, but can be accentuated by competition among blocs by way of limiting the supply of international public goods.

Introduction

In his persuasive paper forecasting the emergence of an integrated global economy despite the recent growth of regional (stumbling) blocs, Stephen J. Kobrin (1995, p. 16) asserted that "internationalized production has replaced trade as the 'glue' binding international transactions".[1] The purpose of globalization and/or

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[1] This note assumes that the supposed regional blocs will have substantial variation among their members in terms of economic development, i.e. blocs will include both labour-surplus (developing) and labour-short, industrialized countries.

international integration is to enhance world allocative efficiency:[2] this underlies the argument for free trade and freedom of establishment. If one were to identify whether trade or international production is more important, the relative weight of the two phenomena should be measured by the degree to which each of them enhances world welfare.

This note suggests that Kobrin denigrates the importance of international trade unduly. It asserts first that international trade *outside* the auspices of transnational corporations (TNCs) still plays a vital role (the "glue") in promoting a multilateral system of international exchange even in the *face of regional blocs*. A due consideration of the role of international trade in promoting global efficiency should be based on the assessment of the per-unit gains of trade. Second, international trade *within and between* TNCs is the "glue" that binds "international production" together: indeed, there is little point in distinguishing between the two.[3] International trade, therefore, probably still constitutes the most vital component of the economic gains to be achieved in the brave new world of globalism.[4] This note also briefly addresses Kobrin's thesis that globalization is preferable to regionalism and puts greater emphasis on the possibility of serious economic instability (Gray, 1990), as well as on the role of TNCs and trade in overcoming the inefficiencies of regionalism.

Trade as "glue"

This section offers four qualifications to Kobrin's proposition that international production is a more important glue of global integration than trade:

[2] For many economists, the term "welfare" implies allocative efficiency only, with no concern over income distribution. This is a simplistic view, as the existence of impoverished "excluded" countries testifies to the imperfectness of the existing regime of international public goods. For a disheartening description see Robert D. Kaplan (1996). H. Peter Gray (1998a) argues that globalization is likely to emphasize the difficulties facing poor countries and gives analytic support to the arguments of *Human Development Report 1996* (see United Nations Development Programme, 1996).

[3] Kobrin (1991) recognizes the role of intra-firm sales in cementing operations within hierarchies.

[4] Gray (1998b) examines the contribution of trade in Schumpeterian goods to global welfare.

First, there is a straightforward question on the interpretation of data. When, in 1990, the sales of affiliates exceeded world exports, this did not mean that the value added by affiliates abroad exceeded world exports. Much of the value of sales of foreign affiliates consists of imported raw materials, intermediate or finished goods.[5] By the same token, the value of exports should be corrected for the import content of exports (particularly for *entrepôt* transactions). The time may come when the value added of affiliates will exceed world exports, but that time has not yet been proven to have arrived.

Second, international trade may be more important than proximity in the transfer of knowledge, as a case study on Sweden has shown (Sjöholm, 1996). While both trade and geographic proximity (independent variables) show positive relationships with the number of references to previous (foreign) patents by uninational Swedish firms (the dependent variable), only the trade variable is robust. The test applied in the case study allows for the presence of foreign TNCs' affiliates in Sweden from the country in which the referred-to patent is registered.[6] But because the study focuses on patent applications by uninational Swedish firms, foreign affiliates make their way into the tests only as a control variable.

Third, the contribution of trade to linking different regions depends much on the types of traded goods and services and their different contributions to global welfare and to the integration of the global economy. The ability of the trading relationship to withstand impediments (the "glue" component)[7] will be positively related to the per-unit gain from trade. Hence, it is important to differentiate among the different types of trade according to their contribution to world welfare when an

[5] Probably from a related affiliate or from the parent corporation (Hipple, 1995; UNCTAD, 1994). Mark Casson (1986, chapter 1) distinguishes clearly between "finished" and "final" goods: a finished good is lodged in the marketing chain at the wholesale or the retail level, while a final good is being sold.

[6] Since much of Swedish trade consists of exports and imports of large firms, Sjöholm recognized that his results were sensitive to differences in the pattern of trade for small and large firms.

[7] In this context, it means trade barriers among regions.

assessment of their relative roles in maintaining a global system is made.

When TNCs promote integration (i.e. globalism) through international production, their effects must be gauged against the next best modality of serving foreign markets, i.e. by the net benefits of internalization.[8] Internalization gains are mainly involved with the production of Schumpeterian goods which require the incorporation of firm-level proprietary technology and the efficient management of resources outside the home country (Hirsch, 1976; Aharoni, 1993; Gray, 1998b): it is by no means clear that the net total welfare gains generated by the internationalized production of these goods are, per unit of value, necessarily of the same order of magnitude as international trade in primary productions within or between regions.[9] Two examples of differences in what may be called "bonding quality" are given here.

Primary products are essential to the prosperity and current industrial structure of many countries. While the international exchange of such goods for Schumpeterian goods or simply for other primary products is not as predominant as in the first half of the twentieth century, it is still crucial. Imports which are not competitive with domestic production (Gray, 1976, pp. 45-49) contribute greatly to world welfare: they can comprise vital energy and raw material imports in Japan and other industrialized countries which lack self-sufficiency in coal or petroleum reserves, food imports into densely populated countries, or technology-intensive imports into low-income and middle-income countries. The existence of international trade in such goods must ensure important transactions among regions and blocs and will contribute to the preservation of a multilateral global system.

Downstream products which incorporate primary resources are likely to be produced either near the location of the primary product or near the market (Gray and Walter, 1983): the crucial determinant

[8] The net benefit of internalization is the difference between the achieved economies of common governance and the economies to be achieved from close relationships (Gray and Lundan, 1993a).

[9] The gains from trade of the different categories of goods may be presumed to have roughly the same order of magnitude at the margin, but gains from intramarginal trade can vary substantially (Gray, 1986).

is the ease and cost of transportation. It seems improbable that, when a bloc is dependent on imports of primary products, it will seriously impede imports of intermediate goods manufactured near the source of the primary product.

Petroleum is probably the single most important primary product, and it is mainly traded under the auspices of TNCs. While modern technologies are important in this industry, the technologies and linkages can be made available to countries with petroleum reserves in many complex forms including exploration contracts, and turnkey projects for both extraction and refining. Despite the importance of TNCs in the industry, petroleum is not the type of good which Kobrin has in mind when he contrasts the importance of international trade and production.

Marketing and distribution (M&D) activities can constitute a large proportion of the value added by affiliates of TNCs (internationalized production). It is important to note here that long-term relationships between ostensibly arm's-length firms can generate economies of close relationships (quasi-hierarchies), which are likely to be only slightly inferior to economies of common governance (Gray and Lundan, 1993a, pp. 646-648). Thus, M&D activities could be provided by host-country distributors at only a small loss in global efficiency. M&D affiliates are likely to account for a large fraction of sales by foreign affiliates but will add relatively little to the glue of internationalized production.[10]

Finally, there is the question of the degree to which TNCs themselves rely on international trade in goods and non-factor services to improve the efficiency of their own firm-level operations.

It is useful to recognize that intra-firm trade and trade with established partners are important means by which TNCs increase their overall efficiency;[11] in this context, intra-firm trade can be described as the "glue" that allows TNCs to integrate their individual

[10] Raymond Vernon (1979) points out that new (versions of) products are introduced to foreign markets much more quickly when the TNC has a foreign M&D affiliate in the foreign market. This suggests a dynamic efficiency in favour of intra-firm trade over close-relationship trade.

[11] For an analysis of intra-firm trade see Gray and Lundan (1993b).

units. When Gray (1996) dynamized John H. Dunning's eclectic paradigm and confronted the current conditions of oligopolistic rivalry among TNCs competing in global markets, he found that, to maintain their competitiveness, TNCs need to be as efficient as their rivals in enhancing the quality of the portfolios of ownership and locational assets; and need to be at least as efficient as their rivals in exploiting and integrating the two sets of assets. It is in the efficient exploitation of (linking) locational assets that TNC-related international trade (including predominantly intra-firm trade) is crucial. Here again, the difference between trade in intermediate goods has far greater per-unit importance as a "glue" than trade in finished goods sent to wholesale affiliates. Table 1 draws on F. Steb Hipple's (1995) authoritative empirical study on United States trade in which TNCs are involved. TNC-related trade accounts for more than 50 per cent of the international trade of the United States, while intra-firm trade accounts for roughly 40 per cent of total trade. "Wholesale trade" amounts to more than 43 per cent of TNC-related trade and, in the latest year, more than 45 per cent of intra-firm trade. The establishment of interacting global production networks, identified by intra-firm trade in manufactures, allows the TNCs to optimize the exploitation of their portfolio of locational assets. It has increased steadily over the three sample years as a share of a fast-growing volume of total international trade. These data suggest that the importance of international trade has increased for international production of TNCs.

Table 1. United States TNC-related international trade, 1975, 1982, 1989

(Percentage)

Item	1975	1982	1989
Affiliate-related trade			
TNC-related trade/total United States trade	54.7	52.7	52.8
Trade of TNC manufacturing affiliates/TNC-related trade	36.5	37.3	48.1
Trade of TNC wholesale affiliates/TNC-related trade	42.7	48.4	43.6
Intra-firm trade			
Intra-firm trade/total United States trade	40.6	35.9	39.6
Intra-firm trade by manufacturing affiliates/intra-firm trade	39.4	40.3	47.8
Intra-firm trade by wholesale affiliates/intra-firm trade	39.4	46.7	45.4
Total trade (in billions of dollars)	109.3	216.4	363.8

Source: Hipple (1995), pp. 39, 41 and 43.

Note: Hipple's methodology is complex. For the inherent complexities, see the original study. Note that the benchmark surveys which are the source of Hipple's data do not address international trade in non-factor services.

The relative disadvantages of globalization

This section takes up three points that qualify Kobrin's analysis:[12] the ability of TNCs to overcome impediments to trade; an enhanced probability of financial crises; and the probability of a shortage of the international public goods needed for globalization.

Close linkages between foreign affiliates and parent corporations probably provide a stronger link per unit value than arm's-length trade. Indeed, TNCs are capable of lobbying in host countries (blocs) in favour of openness, deeper integration and, particularly, for free trade in intermediate products. Moreover, TNCs are fully capable of transferring knowledge across boundaries so that impediments to trade will potentially affect only the ability of TNCs to integrate production vertically in different blocs. If the blocs contain (as assumed in footnote 1) a wide range of levels of development/industrialization, only scale economies are left as an argument for globalization rather than regionalism in the activities of TNCs.[13] The gloomy forebodings of regionalism seem to neglect the fact that the major TNCs have already integrated global production; thus, regionalism would prevail only at the expense of existing arrangements.

A greater risk of major financial crises exists in the absence of a hegemon of sufficient strength or of a "committee hegemon". The dollar is no longer above suspicion (Gray, 1996b), as chronic current account deficits encourage a steady increase in easily-encashable, foreign-owned, dollar-denominated financial assets. In addition, the greater ability of residents to speculate against a currency through the use of derivatives makes the existing global financial system less able to withstand a major financial shock.[14] Such a danger would be likely to be enhanced if individual regions developed their own currencies to rival the key currency (e.g. the euro) and cooperation

[12] This qualification focuses on relative weights and probabilities rather than any points that Kobrin (1995) would have omitted in this discussion.

[13] Kobrin's (1995) concerns about impediments to research-and-development alliances suggest that he thinks regionalism will be more isolationist than seem probable to this author.

[14] Globalization will enhance the allocative efficiency of the global economy at a cost of reducing its stability-efficiency (Gray and Gray, 1981, p. 55).

among the central bankers did not sufficiently address the problems of stability and efficiency.

The final danger is that the system of regional blocs would fail to generate sufficient international public goods to ensure adequate inter-bloc cooperation. Here the danger is that the Western-hemispheric bloc would be likely to reduce its contribution to international public goods (Gray, 1997) and that the rival blocs would be unwilling and unable to assume the vacated role. The danger of a system of regional blocs disintegrating into an isolationist mentality is real -- the more so as blocs begin to compete in a neomercantilist fashion.

There remains one point which suggests that the probability of regionalism may be higher than that of globalism. The task of reaching political agreement on a global basis is overwhelming. It may be that the world will achieve greater allocative efficiency because regional blocs have a higher probability of being achieved. The crucial question is the degree to which these blocs are cooperative or neomercantilist.

Conclusion

This note suggests that TNCs may act importantly to build bridges across regional boundaries. They will accomplish this by virtue of their heavy reliance on international trade as a means of linking their geographically separate activities (international production). Indeed, it is questionable whether a clear analytical distinction could be made between the two activities. TNCs can also be expected to counter tendencies towards neomercantilism or isolationism in regional blocs.

However, in agreement with Kobrin's main thrust, the negative fallout of a system of regional blocs is manifested in an inadequate supply of international public goods in both the financial and non-financial spheres. The weakening of the ability of the United States to act as hegemon is already apparent, and competitive regionalism could prove disastrous. ■

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BOOK REVIEWS

World Investment Report 1997: Transnational Corporations, Market Structure and Competition Policy

United Nations Conference on Trade and Development

(New York and Geneva, United Nations, 1997), xxxv + 377 pages

The *World Investment Report 1997* (*WIR 97*) sheds new light on one of the most important issues of the current international agenda: the relationship between foreign direct investment (FDI) and competition policy. Besides the useful information about the major trends of FDI and competition legislation, the essential issues of the discussion are addressed in this UNCTAD publication.

The evidence presented suggests that two extreme and simplistic views should be rejected.: first, the naive notion that FDI by itself would assure competitive markets in developing countries; second, the opposite and xenophobic stand that the entry of transnational corporations (TNCs) in the various national domestic markets of the developing world would necessarily lead to economic dominance and/or abuse of market power.

As underlined in the overview of the study, FDI may have an ambivalent impact upon market contestability:

> *"Foreign-direct-investment liberalization, by removing formal barriers to the entry of FDI, can increase the contestability of national markets and inject greater competition into them. However, because of the ownership-specific assets of TNCs, their transnational organizational structures and the relatively greater competitive strengths that they often have vis-à-vis domestic firms, FDI could also increase concentration, and TNCs could indulge, like dominant firms generally, in restrictive and anticompetitive practices" (p. xxv).*

And again, at the end of the overview:

> *"While FDI liberalization can increase competition in markets and thereby contribute to economic efficiency, growth, development and ultimately, consumer welfare, there are limitations to competition. They arise in particular when markets tend naturally towards high level of concentration and when market outcomes conflict with other policy objectives" (p. xxxiv).*

However, a general proposition of particular interest for the policy maker can be derived from *WIR 97*: *the more foreign direct policies are liberalized, the more important competition policy becomes.*

The argument can be divided into two points. First, FDI liberalization, extensively documented in *WIR 96* (UNCTAD, 1996) and also in table 1.4 of *WIR 97*, has succeeded to a great extent because a set of other liberalization policies has been implemented, such as trade liberalization, privatization and deregulation. Competition policy, in turn, is an essential ingredient for those liberalization policies. Indeed, none of the above processes can be fully undertaken without the implementation of competition law and policy. In order to reap all the benefits from economic reform, it is necessary to have a global approach in which competition policy has a role of increasing importance. As stated in *WIR 97*:

> *"... to the extent that contestability and competition considerations gain in importance in shaping policies, and the more liberal trade and FDI policies become -- but at the same time do not always lead to contestable markets -- competition policy becomes 'primus inter pares' among policy instruments used to maintain contestability and competition" (p. 211).*

Furthermore, sound competition policy may be by itself an attraction for FDI. Therefore, *competition policy is an essential factor for the success of FDI liberalization.*

Second, FDI liberalization provokes structural changes in national economies, which require particular attention on the part of competition authorities. According to the study, nearly half of the FDI inflow of developing countries occurred through mergers and acquisitions. It is useful to recall some of the typical scenarios involving horizontal cross-border raised by *WIR 97* in this respect (pp. 196-200):

- A foreign firm makes an acquisition in a market to which it has already been exporting;

- Two foreign firms agree to merge their facilities in the market where they operate in the development country;

- A foreign firm enter in a market by menas of a joint venture with a local firm, but is likely to have entered it separately and competed with the local firm had it not had the opportunity to buy the domestic dominant firm;

- A parent firm acquires or makes an alliance with an enterprise abroad which is a source of competition for the domestic market;

- A foreign investor assumes control of an essential facility.

A number of interesting policy issues and challenges can be derived from the above scenarios. First is the need for a meticulous merger review mechanism. But many developing countries, which are at the early stages of implementation of competition policy, still do not have such a mechanism. Some authorities have even argued that due to the cost of merger control it would be appropriate for competition agencies to concentrate exclusively on conduct.[1] While the concern with the scarcity of resources is a legitimate one, most of the scenarios presented by *WIR 97* could be dealt with appropriately only if the country in question had some kind of merger review. Consideration of the international flows of capital requires a more careful and precise

[1] Such an argument has been put forward by Beatriz Boza, the president of INDECOPI, the Peruvian competition authority.

definition of the relevant markets in both the product and the geographic dimensions. It also has implications for the evaluation of entry barriers.

The discussion of the possibility of independent entry by a foreign firm instead of its acquiring a domestic company is a relevant one, although it does raise considerable challenges for the analysis. As the United States jurisprudence on the potential competition doctrine suggests, it is not a trivial matter to prove that without the opportunity of acquiring a domestic firm or at least having a local partner, a foreign company would in fact undertake the investment.[2] The standard of proof required by the courts in such cases has been a very rigorous one in the United States, and it is likely (and desirable) to be the same elsewhere.

Furthermore, the fact that a high percentage of FDI is derived from M&As should be interpreted carefully. Although the association of TNCs with domestic enterprises may, in some instances, lessen competition, it is also true that it is this possibility that often makes entry easier since it reduces the cost differential between the incumbents and the potential entrants in terms of the available information about the national market. If domestic firms resort to associations with foreign partners to improve their competitive capacity, the final result may be increased rivalry and not the contrary.

As correctly underlined in *WIR 97*, international cooperation among competition authorities becomes particularly important as international production becomes a more significant element in the world economy. Indeed, there has been an increase in transactions, which affect several jurisdictions; technical cooperation and consistency are essential for solid decisions in such cases.

Market-power inducements by host countries may have negative effects. One should balance different policy objectives without giving exclusive attention to anyone of them. Although FDI is desirable, it is important to avoid restrictions to trade and competitive behaviour

[2] The recent discussion about CADE's decisions on two alliances between Brazilian breweries and leading United States breweries illustrates the point. For more details, see CADE's Internet homepage at http://www.mj.gov.br/cade.

of firms. Anti-competitive behaviour becomes more likely if the Government grants privileges that restrict entry.

The above discussion should lead to the conclusion that *the more FDI policies are liberalized, the more important competition policy becomes.* Indeed, without competition policy:

- The pace of liberalizing reforms, including FDI liberalization, could be reduced;

- FDI liberalization could have welfare reducing effects under certain circumstances, especially those associated with anticompetitive M&As;

- The lack of stable and well-known competition rules could inhibit foreign investors in search of simple and transparent rules.

The challenges to building up a sound competition policy are enormous, and the gap between developing and developed countries remains large. Indeed, although there has been a dissemination of competition laws around the world (as shown in figure V.1 of *WIR 97*), the degree of enforcement of such laws in many new jurisdictions is far from satisfactory. Eliminating this institutional under-investment in competition policy should therefore be a priority of an adequate development strategy. ■

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Governments, Globalization and International Business

John H. Dunning, ed.

(New York, Oxford University Press, 1997), 518 pages

In this volume, John H. Dunning tackles a monumental task: to analyze the changing relations among national Governments and international enterprises, past, present and future. In his ambitious effort, he is supported by an able cast, which includes among others Richard G. Lipsey, Susan Strange, Stephen Kobrin, John M. Stopford and Edward M. Graham, not to mention a dozen distinguished country specialists. Along with some familiar themes that they and others have explored elsewhere, their joint efforts include numerous insightful observations, intriguing speculations and plausible hypotheses. But all told, their reach exceeds their grasp. The book has little to offer that is not already well explored in other sources.

Dunning's introduction warns the reader that globalization is changing the relations of international business to government; that there is no first-best response to these changes on the part of government; and that government's role may prove to be more important to business at the two ends of the development process than in the middle stages. To explain the anticipated rise in the Government's role in an increasingly complex world, he refers to "rising transaction and coordination costs" in a world dominated by international networks, and to the growing need of society to deal with "social externalities". But these are only a scholar's way of saying that Microsoft and Citicorp may prove capable of creating real challenges for future Governments, and that the proper education of a future workforce may prove to be a major problem for national Governments.

The body of the book comes in three parts, the first being entitled "The Analytical Framework". Five lively essays follow, but they succeed principally in revealing the complexity of the problem. Dunning leads off with an effort to find such a framework. He draws on history, philosophy and economics, tries bravely to create a synthetic framework, but finds little comfort or clarification in what

he has created. Lipsey follows with an elaboration of how economists have thought about the business-government relationship, especially in the past half- century. His summary is a highlight of the book, but it covers familiar territory and closes with inconclusive pointers to the future. Dunning returns in a new role, to explore the emerging behaviour of business; but, as he readily admits, his analysis is largely that of Michael Porter warmed over, and it has only a little to say about business-government relationships. Strange's contribution carries no surprises. With her usual verve, she fires off a brief volley at the ethnocentricity of Americans and the nearsightedness of the market worshippers, then offers her own brief list of the problems confronting business and government. Kobrin winds up the contributions of the heavy lifters with a provocative essay that elaborates the concepts of globalization and networking and that explores imaginatively their implications for state autonomy and state sovereignty. Kobrin is prepared to consider the possibility of revolutionary changes in the nature of nationhood and the functions of the State; but he is not prepared to bet a great deal on his own speculative projections. Kobrin (p. 400) winds up his review with an observation that reflects some of the tone and spirit of this part of the book: "We assume that time's arrow is unidirectional and that progress is irreversible; that there is a historic progression from classical to medieval to modern to -- perhaps -- post-modern. That assumption may be wrong."

For those who are looking for a set of succinct workmanlike accounts of the changing patterns of business-government relationships around the world, however, the second part of the book may prove a sufficient reason for adding it to their library. Ten essays manage to blanket most of the world. From the list of areas omitted, however, one suspects that the choice depended as much on the availability of authors as on any other criterion. Almost absent are references to the Russian Federation, China and India, three countries that could be major actors in world markets in the decades to come. Their absence is all the more significant because the essays that the book does offer point to one strong lesson: the reactions of Governments to changes in the international environment, while sharing some tendencies in common, have nevertheless retained considerable elements of diversity; and one factor contributing to

the diversity has been the distinctive aspects of the past history and culture of the countries concerned.

The third and final section of the book contains two wind-up essays. One is a speculative piece by Stopford, an essay that shares the uncertain tone of his fellow contributors regarding future developments in business-government relations. But the final essay by Graham, addressing the question of whether there should be multilateral rules on foreign direct investment, responds in a less equivocal tone. After surveying the "mish-mash" of existing agreements, mainly bilateral or regional, Graham sees the need for some new multilateral rules. Having already written exhaustively and authoritatively on the subject in other publications, however, he offers only the most cursory defence and elaboration of his views. So the reader is left to pursue other sources for a more thorough exploration of the issue.

All told, the book can be viewed as an opening shot in scholars' efforts to generate responses to some vital questions: How are the profound changes in international economic relations that have developed over the past few decades altering relations between business and government? What do these changes portend? And how can these outcomes be improved? The answers, I suspect, will not emerge as the product of one enveloping theory or arresting paradigm. Given the basic character of the changes in the international environment, adaptations to these changes are bound to take time, entailing new relationships between enterprises and Governments as well as new institutions t!hat reflect these relationships. In helping to fashion those changes, scholarly research, analysis and advocacy have critical roles to play. ■

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Multinational Firms and International Relocation

Peter J. Buckley and Jean-Louis Mucchielli, eds.

(Cheltenham, Edward Elgar, 1997), 272 pages

The subject of this edited volume is of great importance to all those with an interest in the impact of increased globalization. Indeed, this issue has been discussed by the United Kingdom House of Commons Trade and Industry Select Committee, as well as in the French Senate Report on *Délocalisation* and the *World Investment Report 1994* (UNCTAD, 1994). The book is extremely informative and well written, as one would expect given the stature of the contributors. It seeks to address the concerns of the developed world that foreign direct investment (FDI) has the effect of "exporting jobs" to low-wage countries. This has become particularly pertinent, given the high rates of unemployment among unskilled workers in Europe and North America.

The book however seeks to widen the analysis from the somewhat static self-interested perspective of the developed world, and to evaluate the situation in a more holistic framework. The chapter by Jean-Louis Mucchielli and Philippe Saucier, for example, presents a convincing argument for encouraging (or at least not discouraging) FDI in low-wage countries. They argue that such FDI stimulates technological development in both the host and home countries. This argument is also illustrated in the chapter by F. Harianto and JA. Edward Safarian, in their discussion of the development of South-East Asia. They show that the initial development of labour-intensive processes in the ASEAN countries has over time led to more capital-intensive, and skill-intensive production, boosting exports and growth. Unlike the chapter by Mucchielli and Saucier, however, this analysis does little to assuage the concerns of Western policy makers, seeking to alleviate unemployment. Peter J. Buckley and Mucchielli in their chapter argue that any attempt to prevent FDI to low-wage countries will simply cause subsequent problems, in terms of low profitability of firms and unemployment in the home country.

Pierre André Buigues and Alexis Jacquemin in chapter 4 illustrate this in terms of the trade effect of FDI. They show that low-wage countries have been steadily increasing their exports to the European Union (EU) over the past 20 years, both in absolute and relative terms. Their attitude towards this phenomenon is that it is simply a fact of life, and that there is nothing that EU Governments can, or should, do to reverse this. As such, they advocate policies designed to improve skill levels in the EU and to boost the comparative advantage that the EU has, or ought to have, in high value-added activities. Interestingly, however, they do not advocate significant labour market reform, which has been one of the major differences in policy between the United Kingdom and the rest of the EU.

Three of the chapters -- by Edward M. Graham, Yoko Sazanami and Ching, and Giovanni Balcet -- focus on the strategies of firms from specific home countries, the United States, Japan and Italy, respectively. Balcet shows that Italian transnational corporations (TNCs) have invested abroad not because of any change in the patterns of comparative advantage, but through increased international integration in the relevant industries, notably textiles and clothing. Balcet then argues that in such industries, FDI and exports are largely complementary. Such transferring of low-skill production to low-wage economies is part of a longer-term global strategy, while the high value-added production occurs in the home country.

Graham reports similar results, for United States TNCs, based on a cross-sectional analysis. He argues that that there is no evidence of the United States exporting jobs to low- wage economies, although he finds tentative evidence of export substitution by United States firms in Europe. There is no evidence that this is determined by employment costs, however, rather than by the desire to locate production closer to the final market.

Sazanami and Ching, and Terutomo Ozawa in their respective chapters, report similar results for Japan and its investments in North America and the EU. However, they do find evidence of low-wage employment being transferred to South-East Asia. Again, however, exports are seen as complementary to FDI, so that the impact on

domestic employment is unlikely to be significant. Ozawa continues the analysis with respect to the Japanese auto industry, arguing that the Japanese firms' advantages are based on manufacturing techniques, which are easily transferable. As such, it is the dissemination of such ideas, partly through FDI, which is the greatest threat to Japan's trade surplus in motor vehicles. Hideki Yamawaki addresses a slightly different question, that of Japanese exit from the United States and EU. He shows that 100 per cent foreign-owned subsidiaries tend not to be relocated, while joint ventures are more likely to be temporary investments. The data, however, are not particularly conclusive.

In his chapter, Buckley analyses the location decision as a dependent variable of the horizontal and vertical links within an industry. As such, any attempt by policy makers to influence this decision directly will not be welfare-enhancing. Indeed, this is a trend throughout the volume. Buckley's analysis is based on his previous model of the decision concerning the timing of FDI, based on the costs of licensing or exporting. There is no doubt, however, that Governments do seek to influence this through tariffs and investment subsidies.

The message of the book is that the location decision is one that is based on market forces determining comparative advantage. It is surprising, and perhaps disappointing, therefore, that there is not a chapter that deals with intra-EU relocation. There have been several examples recently of firms relocating within the EU, motivated by government subsidy. There is also evidence of TNCs within Europe being given incentives not to relocate: Ford's decision to stay on Merseyside in the United Kingdom is a good example of this.

The book admirably takes a holistic and long-term view of the location process. The authors argue that relocation decisions based on comparative advantage are in the long-term interest not only of the firm, but also of the host and source countries. Within this framework, it is clear that Governments should not seek to influence such decisions, as global welfare will be maximized by market forces. However, it is undoubtedly the case that Governments do seek to

influence this process. While it is laudable to argue that market forces should prevail, more analysis of the impact of intervention would be appropriate here. ■

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Current Issues in International Business

Iyanatul Islam and William Shepherd, eds.

(Cheltenham, Edward Elgar, 1997), 264 pages

This book is one of several volumes that have attempted recently to respond to the question of whether international business (IB) is and should be a separate field of enquiry. The editors commissioned a series of papers, organized in four parts, that deal with a wide range of topics in IB: its history and evolution, its interdisciplinary roots and some of the current issues and controversies about future directions and priorities for research and teaching. Sadly, like a similar endeavour by Brian Toyne and Douglas Nigh (1997), no clear direction is established, nor is a convincing case made for the separateness of IB as a field of scholarship. Many of these papers could just as easily have appeared in discipline-based collections. Yet, as Stephen Young states in the concluding chapter, there is both a need to promote "interdisciplinary research and highlight more clearly the boundaries of international business"; he concludes by warning that, unless international business studies "get[s] closer to practitioners … IB research runs the risk of becoming isolated from the work of the international executive".

Any collection of current research topics must run the gauntlet of criticism that, on the one hand, the papers are too narrowly conceived and that on the other they are too theoretical. The eclectic nature of IB makes it especially exposed to this dilemma, just as it has been since its inception in the late 1950s. At that point, as part 1 of the book reminds us, the fledgling field was struggling to find its identity in the United States, where much of the business school movement was then located. The view was emerging that earlier theories, generalizations and research techniques developed in response to domestic norms were neither general nor universal. Separate attention was thus needed to address the new issues and greater complexities introduced by the growth of cross-border commercial activity and to challenge the dominance of the United States-centric view of the world.

Kenneth Simmonds' provocative chapter makes the case that IB has been a discipline right from the beginning. He argues that a discipline needs to be able to apply existing theory to arrive at predictions that "fit the details of particular situations". He feels that economists' attempts to apply their own rigour to the field have been limited, because "they work outward from generalization, while International Business requires the rigour of particularization"; he goes on to argue that the time dimension is critical in allowing one to understand a chain of causality and thus "IB seems to produce greater understanding when the skills of the historian are harnessed in preference to those of the economist" (pp. 16-17).

Despite this lively start, the momentum of debate is not maintained in part 2 of the book, comprising three chapters on the theme of IB as an interdisciplinary field. Instead of interdisciplinary reviews, the papers reinforce Toyne's view of IB as a "fragmented adhocracy" that limits progress to specific applications of theory drawn from elsewhere. Thomas Brewer's chapter on the contribution of thinking from an international political economy perspective is equally fragmentary within its focus on issues of power and transnational corporations' impact on public policy. John H. Dunning's chapter is a rather conventional review of the contribution of economics. Too bad he did not pick up Simmonds' challenge.

Part 3 is a collection of essays on a miscellany of topics, among which two stand out: strategy and human resource issues. George Yip argues that the field cannot progress much until it develops a more rigorous theory to understand the growing cross-border interdependencies. Christopher Bartlett and Sumantra Ghoshal revisit their well-known theme of organizational capability in a vein that owes no allegiance whatever to IB as a field. Both papers make familiar arguments. Indeed, Ghoshal had earlier made much the same point. At a 1992 conference, he attacked works by such noted authors as Eleanor Westney and Gunnar Hedlund: "collectively .. they reflect a field of enquiry that is inconsistent in its assumptions, incoherent in its approach and stagnant in its direction" (Toyne and Nigh, 1997, p. 361). Much the same criticism could be made about Nancy Adler's and Dafna Izraeli's paper on gender issues and the one on how human resources bear upon strategy choices. What, apart from the

international context for the arguments, have these papers to do with building a sense of direction in the field when their antecedents come from domestic frameworks?

The strong sense of *déjà vu* provokes the thought that IB has made an important contribution to the understanding of complex cross-border activities, but has been overtaken by events. All traditional disciplines, one might argue, have expanded their scope and thus removed the need for the separate set of analytical lenses that Simmonds described. There is, perhaps, a very strong case to be made for IB to remain as a separate field of *teaching*. The sheer weight of numbers of students clamouring for international courses that connect to the reality of international management gives telling indication that the traditional functions do not adequately illuminate the complexities in the classroom. Judging by the evidence presented in this volume, the same cannot be said for research and the underlying scholarship.■

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Brian Toyne and Douglas Nigh (1997). *International Business: An Emerging Vision* (Columbia, South Carolina: University of South Carolina Press).

International Technology Transfer by Small and Medium-Sized Enterprises

Peter J. Buckley, Jaime Campos, Hafiz Mirza and Eduardo White, eds.

(London: Macmillan Press, 1997), 504 pages

Two disparate literatures have uncovered trends that seem to be contradictory. On the one hand, a number of studies have found that small and medium-sized enterprises (SMEs) are playing an increased role in the developed economies (Loveman and Sengenberger, 1991). On the other hand, a very different literature has identified an increased trend in transnational activities (Kindleberger and Audretsch, 1983). That SMEs are becoming more important precisely at a time when transnational relationships intensify poses something of a puzzle to the traditional literature of the transnational corporation. This literature has traditionally believed that success in foreign markets required large size (Vernon, 1970). Small firms were thought to be at a disadvantage compared to larger firms, because of the fixed costs of learning about foreign environments, communicating at long distances, and negotiating with national Governments, leading Richard Caves (1982) to conclude in his comprehensive review of the literature on the multinational enterprise that "these costs constitute an important reason for expecting that foreign investment will be mainly an activity of large firms". Similarly, Alfred Chandler (1990) concluded from his exhaustive historical research that "to compete globally you have to be big."

Fujita (1995) showed that, in fact, SMEs have not at all been excluded from transnational activities. This volume provides pathbreaking insights by uncovering one of the main reasons behind Fujita's findings – the key role played by SMEs in the process of technology transfer from the developed to the developing countries. To reach these insights was not a simple task. The editors assembled an international team of accomplished scholars spanning a wide range of countries. There were 13 research groups based in seven developed countries – Canada, France, Germany, Italy, Japan, the United Kingdom and the United States – and six based in developing countries – Argentina, Brazil, India, Korea, Mexico and Singapore.

This volume provides considerable insight on three major topics involving the transnational activities of SMEs. The first is to test the validity of the traditional theories of the multinational corporation when applied to SMEs. The second is to shed light on the nature and main features of the process of technology transfer from the developed to the developing countries. The third major topic involves the impact of the international operations of SMEs on recipient firms and countries.

This volume will prove invaluable to both scholars and policy makers. The rich empirical analyses are generally guided by an implicit underlying theoretical framework that serves to organize the data. This leads to a number of rich and insightful policy conclusions.

The first part of the volume provides an overview of the role of SMEs in foreign direct investment. In Chapter Two, Masataka Fujita documents the role of transnational activities by SMEs, while the policy implications of that role are identified by Campos, et al. in Chapter Three. The second part of the work focuses on technology suppliers. Case studies are provided for Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. The third part of the volume focuses on the technology recipients and includes case studies on Argentina, Brazil, India, Korea, Mexico and Singapore.

One of the most important findings of the volume is that the transnational activities of SMEs do not simply mirror those of their larger counterparts. We have the authors of this pathbreaking volume to thank for providing overwhelming evidence that the transnational activities of SMEs are (1) important and (2) distinct from those of large corporations. An important challenge for future studies of the multinational corporation is to develop theories of transnational activities that are distinct for SMEs.■

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Imitation to Innovation: The Dynamics of Korea's Technological Learning

Linsu Kim

(Boston: Harvard Business School Press, 1997), 272 pages

There are many ways to explain the "Korean miracle" of the last few decades (see, for example, Amsden, 1989). Kim's *Imitation to Innovation* sheds new light on this intriguing phenomenon by focusing on the dynamic process of technological learning and the firm's role in absorbing and creating technology in the marketplace (on this issue, see also Nelson, 1993; and Wang, 1998). This book distinguishes itself not only from static accounts but also from narrowly focused analyses. Indeed, realizing that there are many actors and interactions in the process, Kim draws on many disciplines, including economics, management and organization theory, sociology cultural anthropology and technology analysis.

It is recognized that the role of the State in the economic development of the Republic of Korea is important, as discussed in part I. The microeconomic studies (case studies) of part II, especially the ones concerning the *chaebols*, offer insights into the workings of transnational corporations as well as of the overall economic environment. In part II, the micro approach is combined with, and enriched by, meso as well as macro approaches.

Imitation to Innovation should be of great interest to enterprise managers and policy makers. The lessons provided are particularly valuable to latecomers to the technology trajectory. In this connection, Kim's position as president of the influential Science and Technology Policy Institute of Korea enables him to put into practice numerous policy recommendations contained in part III of the book. For example, his influence is noticeable in the Republic of Korea's five-year plan for scientific and technology innovation, 1998-2002, in the creative research promotion programme just launched, and in international cooperation activities with the Organisation for Economic Co-operation and Development (OECD) and other countries, such as the Russian Federation and China.

At the same time, in drawing lessons from the experience of the Republic of Korea, as expounded by Kim, care must be exercised in interpretation and application. First, while the process of "imitation to innovation" is a valid generalization, it should not imply that it is unidirectional in all cases. Much depends on the relative position and comparative advantage in a particular case. For example, a Silicon Valley high-technology firm may start with innovation, but as competitors excel in the field, it may not have much choice but also to imitate, including original equipment manufacturing or licensing. Moreover, the dividing line between imitation and innovation is often unclear. Imitation frequently requires adjustments to special situations that are truly innovative, especially in the light of innumerable cases of straightforward transplantations of technology that are inappropriate. Furthermore, most innovations are not earthshaking breakthroughs but small improvements such as the introduction of paper, the zipper or the post-it note.

The interaction between imitation and innovation is all the more evident if the concept is extended from hard to soft technology. The best recent example is provided by social engineering in transitional economies. The single-minded imitation of models of advanced market economies without innovative adaptations to situations where the institutional framework is totally different has resulted in disasters. In such cases, innovation is needed from the very early stages of imitation. ■

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JUST PUBLISHED

World Investment Report 1998:
Trends and Determinants

(Sales No. E.98.II.D.5) ($ 45)

The *World Investment Report 1998: Trends and Determinants* is the eighth in an annual series. It documents the continuing growth of foreign direct investment (FDI), which reached new record levels in 1997. Apart from the standard chapters featuring trends on the global and regional levels, the *World Investment Report 1998 (WIR 98)* covers policy developments and lists the 100 largest transnational corporations worldwide and the 50 largest transnational corporations in developing countries. Special attention is paid to the impact of the financial crises in Asia on FDI flows to and from that region; success stories in terms of attracting FDI in Africa; the interrelationship between FDI, exports and the balance-of-payments in Latin America and the Caribbean; and the absorptive capacity for FDI in Central and Eastern Europe. In addition, *WIR 98* highlights the host country determinants of foreign direct investment flows. As in the past years, the *Report* offers a broad range of empirical information and policy analysis for decision makers in government and business and researchers in academia alike.

World Investment Report 1998: Trends and Determinants. Overview

(UNCTAD/WIR/98(Overview))

Available free of charge in Arabic, Chinese, English, French, Russian and Spanish.

The Financial Crisis in Asia and Foreign Direct Investment: An Assessment

(Sales No. GV.E.98.0.29) ($ 20)

This book assesses the implications for foreign direct investment of the turmoil that erupted in the financial markets of some countries in East and South-East Asia in the second half of 1997. It concludes that, unlike net private foreign bank lending and portfolio equity investment, foreign direct investment remained positive and continued to add to the existing investment stock.

ProInvest, vol. 10, no. 2

ProInvest, which replaces *Transnationals*, is a quarterly newsletter drawing on the results of research and technical cooperation activities undertaken by the UNCTAD Division on Investment, Technology and Enterprise Development. It is available free of charge upon request.

Books received on foreign direct investment and transnational corporations since April 1998

Bellak, Christian and Michael Pfaffermayer, *Fusionen und Übernahmen 1997* (Vienna: Kammer für Arbeiter und Angestellte für Wien, 1998), 182 pages.

Bora, Bijit and Christopher Findlay (eds.), *Regional Integration and the Asia-Pacific* (Melbourne: Oxford University Press, 1996), 260 pages.

Buckley, Peter J., Fred Burton and Hafiz Mirza (eds.), *The Strategy and Organization of International Business* (Houndmills and London: Macmillan, 1998), 272 pages.

Meyer, Klaus, *Direct Investment in Economies in Transition: New Horizons in International Business Series* (Cheltenham and Northampton, Mass.: Edward Elgar, 1998), 308 pages.

Rojec, Matija, *Restructuring with Foreign Direct Investment: The Case of Slovenia* (Ljubljana: Institute of Macroeconomic Analysis and Development, 1998), 87 pages.

Sevón, Guje and Kristian Kreiner (eds.), *Constructing R&D Collaboration: Lessons from European EUREKA Projects* (Copenhagen: Copenhagen Business School Press, 1998), 136 pages.

Toh Mun Heng and Tan Kong Yam (eds.), *Competitiveness of the Singapore Economy: A Strategic Perspective* (Singapore: Singapore University Press and World Scientific Publishing, 1998), 354 pages.

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B. **Footnotes** should be numbered consecutively throughout the text with arabic-numeral superscripts. Footnotes should not be used for citing references; those should be placed in the text. Important substantive comments should be integrated within the text itself rather than placed in footnotes.

C. **Figures** (charts, graphs, illustrations, etc.) should have headers, subheaders, labels and full sources. Footnotes to figures should be preceded by lower-case letters and should appear after the sources. Figures should be numbered consecutively. The position of figures in the text should be indicated as:

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E. **Abbreviations** should not be used, except for FDI (foreign direct investment) and TNCs (transnational corporations).

F. **Bibliographical references** in the text should appear as: "John Dunning (1979) reported that ...", or "This finding has been widely supported in the literature (Cantwell, 1991, p. 19)". The author(s) should ensure that there is a strict correspondence between names and years appearing in the text and those appearing in the list of references.

All citations in the list of references should be complete. Names of journals should not be abbreviated. The following are examples for most citations:

Bhagwati, Jagdish (1988). *Protectionism* (Cambridge, Massachusetts: MIT Press).

Cantwell, John (1991). "A survey of theories of international production", in Christos N. Pitelis and Roger Sugden, eds., *The Nature of the Transnational Firm* (London: Routledge), pp. 16-63.

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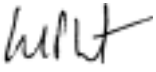

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TRANSNATIONAL CORPORATIONS

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