The growing interdependence between transnational corporations and Governments*

John M. Stopford**

The rapid growth of foreign direct investment has brought the transnational corporation centre-stage in the international political economy. Foreign direct investment has significantly increased the economic interdependence of nations and has made key factors of production more mobile. These developments challenge the traditional assumption of comparative advantage. Rather than concentrating on natural endowments, attention needs to be focused on *created assets*. This article, using the concept of "triangular diplomacy", argues that a greater degree of partnership in wealth creation between transnational corporations and nations is possible, provided that both parties understand each other's requirements more fully. In particular, the article argues the need to consider policy and policy coordination in terms of a positive-sum game, not the zero-sum game that has dominated so much Western thinking.

The optimism that greeted the fall of the Berlin Wall has proved to be short-lived. The hope was for an acceleration of progress towards a liberalized world economy, in which the beneficial impetus to world growth from intensifying global competition could be given free rein. Instead, the removal of the common threat of communism has had the perverse effect of releasing pent-up economic rivalry in the form of increasingly bitter trade fights. The long delay in completing the Uruguay Round of Multilateral Trade Negotiations, combined with symptoms of a world of adversarial trade blocs, suggest a new mood of national self-interest.

Trade frictions are caused in part by the fact that the pace of building an increasingly interdependent world economy through investments is continuing

* An earlier version of this article was presented at a symposium in Stuttgart, Germany, sponsored by the Carnegie-Bosch Institute, April 1993. The author acknowledges with gratitude the support of that Institute.

** Professor, London Business School, London, United Kingdom, and Stockholm School of Economics, Stockholm, Sweden.

at an unprecedented rate. Mobile investments and intensifying global competition affect the source and nature of the associated trade flows. How to capture more of the benefits within a country has become a pressing issue for Governments. What national policies can induce firms — both domestic and foreign — to invest for production and exports and thereby increase national wealth? Within the past two years, this question has emerged centrally in the political debate in Sweden, the United Kingdom, the United States and, more recently, Germany. There, the Solidarity Pact talks among politicians, trade unions and industry have been aimed at ensuring the competitiveness of Germany as an investment location in the 1990s. Regional issues are taking a back seat in the national debates. The same debates have taken place in many developing countries, as a prelude to adopting far-reaching policies of liberalization and privatization.

Yet, Governments' responses to international economic developments are inherently ambiguous. They want the benefits of foreign direct investment (FDI) and are increasingly prone to intervene to increase their share, but fear the consequences when other nations do the same. They also fear possible losses of national sovereignty. For example, some policy makers in the United Kingdom see no inconsistency in simultaneously espousing the cause of market forces and opposing European integration on issues that threatened the country's ability to determine its own future. Those fears are most acute in high-technology industries, such as aircraft, semi-conductors, supercomputers, high-definition television and the like, regarded by many as crucial for their national security and for the strength of their national industries.[1] How Governments resolve the dilemmas bred of ambiguity is a matter that no transnational corporation (TNC) can afford to ignore.

This article argues that managers need to look beyond their products and markets when calculating their global strategies. They need to develop a greater understanding of the forces driving change in the "global political economy" if they are to be spared surprise. What game is really being played, under whose rules? The answers involve more than the effect of domestic political influences on individual project negotiations. The rules of the game are, in effect, determined by the outcomes of a three-way tug of war: domestic political imperatives pull one way; international economic imperatives can pull in another; and firms' global competitive imperatives can add a third dimension. Conventional perspectives and calculations do not readily capture the dynamic interactions at work and may blind many to the reality of new sources of risk.

[1] An eloquent statement of the threat to one nation from other Governments' interventions in high-technology industries is provided in Tyson (1992).

In particular, risks are created as two quite different perspectives about how to build competitiveness come increasingly into conflict. Though rather over-simplified, firms can be regarded as being engaged in a race to create and accumulate new resources that change the structures of competition and fuel further interdependence across borders. This dynamic perspective on a positive-sum game of wealth creation is shared by many Governments in Asia. By contrast, Governments of countries in Europe and North America can be regarded as espousing more static policies to promote and protect indigenous firms. Their actions can directly affect the location of production and thus the welfare of nations in a "beggar-thy-neighbour" zero-sum game.

To make the case, the evidence on growing economic interdependence and the central role of TNCs in that process is summarized first. Then, some of the political and policy issues are explored that are involved in the building of a simple model of triangular diplomacy that illustrates the form of interactions affecting both States and firms. Because Government calculations are often made on the basis of static and increasingly out-dated notions of the Ricardo/Heckscher-Ohlin theory of comparative advantage, some attention to theory will help explain why frictions in policy choice are likely to continue.[2] The aim is to illuminate the sources of friction and risk and to suggest that firms should raise their voice in influencing the policy debates.

Growing economic interdependence

Is the world moving towards the "ideal" state of a global economy in which growth is fuelled by close economic interdependence among the leading nations in trade, investment and cooperative commercial relations, combined with relatively little restriction on cross-border transactions or discrimination against foreign-owned entities? There are two parts to this depiction of an ideal: economic interdependence, as well as harmonization of policy among leading nations. If one looks only at the first part, the evidence might be used as support for K. Ohmae's (1990) claim that strategy should be based on the presumption of a "borderless world" and that Governments' powers to dictate terms to the market are in terminal decline.[3] Discussion of the second part provides an alternative conclusion, but that is deferred until after considering why Ohmae and others are making the claims they do.

[2] For an excellent summary of the theory and economists' subsequent modifications, see Findlay (1991).

[3] This sense that economic determinism was eroding Government power was foreshadowed by Raymond Vernon (1971) in his classic treatise, *Sovereignty at Bay*, though he later modified his position.

Growing economic interdependence can be seen in the evidence that world trade has been growing faster than world GDP. Even more impressively, FDI has been growing four times faster than trade since 1982, despite a downturn during the recent recession. Deregulation of capital markets has fuelled an equal boom in cross-border financial flows. Daily transactions across the foreign-exchange markets now routinely exceed $900 billion, a figure that dwarfs national accounts of annual current account deficits or surpluses.

Central to this growth has been the role of TNCs in reshaping the world economy (Caves, 1982; Dunning, 1993). Their expansion has four notable features, some of which are indicated in table 1:

- First is the growth of output of TNCs. At some point during the 1970s, the output from assets located in one country, but owned and controlled in another, exceeded the volume of world trade for the first time. That output is highly concentrated: just 420 of the largest of the 37,000 or so parent TNCs account for over half of the total output.[4] The implications for Governments are far-reaching, for it is much harder to control foreign investors within a country than to control trade flows at the border. And controlling large firms and harnessing their resources effectively demands particular skills and resources that few nations possess in large quantities.
- A second feature is the growing share of TNCs in exports, both from their home countries and from many of their host countries. Transnational corporations manage about three quarters of world trade in manufactured goods, over a third of which is inter-affiliate trade. For example, United States-owned affiliates abroad now sell more than twice what the whole of the United States exports. Leading the impetus for the North American Free Trade Agreement (NAFTA), Mexican-based affiliates of United States firms already account for over 40 per cent of Mexico's trade with the United States, its largest trading partner (UNTCMD, 1992).
- A third indicator of the significance of TNCs relates to technology. Transnational corporations are the primary source of privately funded research and development and dominate the international trade in technology payments that is estimated to exceed $30 billion a year. The vast bulk of this trade is in the form of transfers among affiliates in the same group. Understanding the decisions of TNCs about where to

[4] For details, see Stopford (1992). John H. Dunning (1993) has challenged the UNTCMD (1992) estimate of 37,000 parent TNCs and proposed a lower, but still substantial, population estimate.

Table 1. Foreign direct investment and selected economic indicators, 1981-1991 (Billions of dollars and percentage)

Indicator	Value, 1991 (Billion dollars, current prices)	Annual growth 1981-1985 (Per cent)	Annual growth 1986-1990 (Per cent)	Annual growth 1990-1991 (Per cent)
FDI outflows	180	4	24	–23
FDI stock	1900	5	11	11
Foreign sales of TNCs	5500[a]	2[b]	15	n.a.
GDP at factor cost	22300[b]	2	9	–6[c]
Gross domestic investment	5100[b]	1	10	n.a.
Exports	3800	2	10	4

Source: UNCTAD, DTCI (1993).

[a] For 1990.

[b] For 1982-85.

[c] Estimate.

locate their innovation effort deserves more attention than has been given so far.[5]

- A fourth indicator of the importance of TNCs is the growth of both strategic alliances among these firms and of other non-equity forms of collaboration with local firms. Alliances can change the structures of competition and challenge the powers of national and regional competition regulations: the economic unit of competition can become wider than that defined by the legal boundaries of a single firm. Moreover, the constantly evolving bargains within an alliance underscore the dynamism of the race to acquire resources. As one study concluded, "companies that are confident about their ability to learn may even prefer some ambiguity in the alliance's legal structure. Ambiguity creates more potential to acquire skills and technologies" (Hamel, Doz and Prahalad, 1989, p. 139).

The growth of local, contract-based collaboration has far-reaching, often subtle implications for the transfer of technology and other resources. For example, General Motors' policies of collaboration with local parts suppliers in Brazil have required hundreds of engineers to spend long periods in Brazil and to incur costs that far exceed the formal value of their assets there. Yet, neither alliances nor contracts are well recorded in the official statistics of FDI. In other words, the official indicators of the reach of TNCs are understated and ignore many other, hidden aspects of growing and deepening economic interdependence.

Firms' motivations to pursue growth vary considerably, but can be grouped in three, well-known basic categories. One is market-seeking growth to gain greater returns on the resources, technical or managerial, already developed. Another is resource-seeking, to gain access to natural resources or the human and technical resources in other countries. The third — efficiency-seeking — is growing fastest at present, as firms seek new ways to link together previously separate operations so as to both lower total system costs and increase their abilities to respond to changes in demand anywhere in the world. In some cases, all three motivations guide policy choices simultaneously in different parts of a single enterprise.

These motivations have taken various forms that have reflected the delicate balance that needs to be struck between gaining scale efficiencies from global integration on the one hand and maintaining responsiveness to local differences

[5] One exception is Cantwell (1993).

on the other. As C. A. Bartlett and S. Ghoshal (1989) demonstrated, firms are attempting to create a variable geometry of organization that is both appropriate to their strategies and capable of being managed effectively.[6] For the purposes of this argument, one can depict the evolution of the strategies of many TNCs as a combination of market and resource-seeking policies occurring within regions where there are efficiencies to be gained by specialization of production and trade in products. Simultaneously, they are building world-scale efficiencies in functions such as technology and information systems, and their trade across regional boundaries is growing in the intangibles of knowledge and finance.

The effect of these developments is to transform some firms' structures in the way depicted in figure 1. The implication is that at least some TNCs have already developed their strategies in ways that provide them options for responding to possible trade wars among the trade blocs of NAFTA, the European Union and in East Asia. The implication is also that they are becoming much harder to control within any one nation.

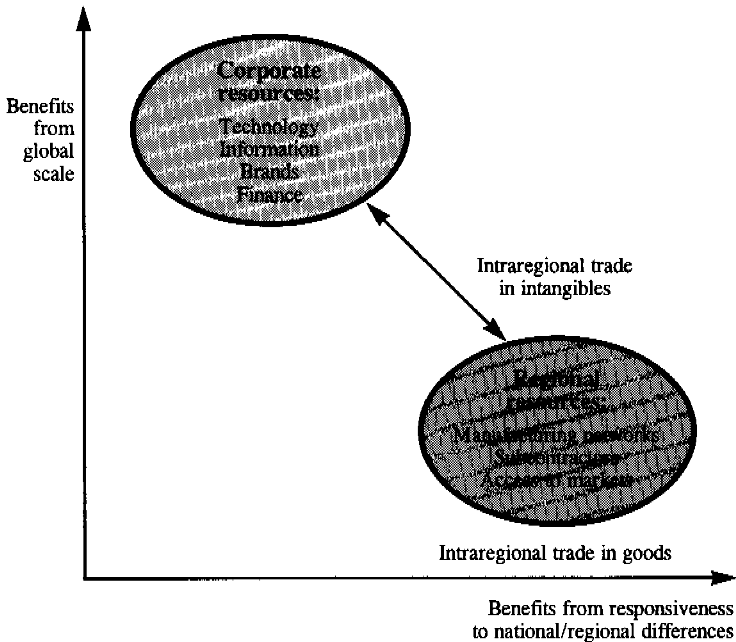
Government responses

Given that investment is one of the keys to economic growth, Governments are motivated to seek as many sources of new investment as possible. Small wonder that so many have been putting out the welcome mat to TNCs and fattening the incentive packages on offer to bias firms' location decisions. Within Europe, there are constant contests both among nations and among regions within nations to attract mobile wealth-creating capital. More generally there has been a general liberalization of investment policy in many, especially developing, countries. And the pace of liberalization has accelerated. Of 82 policy changes adopted by 35 countries during 1991, 80 reduced restrictions on foreign investors. Furthermore, 64 bilateral investment treaties for the promotion and protection of FDI were signed during the first 18 months of the 1990s, compared with 199 such treaties signed during the 1980s (UNTCMD, 1992, p. 3). Privatization and deregulation of communications, as well as of financial markets, have also helped extend the sense of greater mobility of critical resources.

One needs, however, to put the investment contribution of TNCs into context. Inward FDI — a form of transfer of world savings — is only a marginal proportion of total national capital formation. There is, of course, wide variation in this figure. Some of the poorer nations, especially in Africa, attract virtually no foreign capital. At the other end of the scale, Singapore relied on TNCs for over 35 per cent of its capital formation during the period 1986-1989

[6] For equivalent evidence that few TNCs have become global in all functions, see Morrison *et al.* (1991).

Figure 1: The differentiated global network



(UNTCMD, 1992). In the same period, that figure was over 12 per cent for the United Kingdom and 7 per cent for the United States. In almost all countries, these shares have risen significantly above the levels obtained in the early 1970s (UNTCMD, 1992). Though relatively small in value, the composition of inward FDI can be crucial. The United Kingdom, for example, relies on TNCs for infusions of new technologies in industries such as electronics (including consumer electronics) and automobiles.

Enhancing the investment function by promoting inward FDI is, however, a double-edged sword. It can create growth and add needed skills, but it can also hinder growth.[7] Moreover, there are growing concerns about trade consequences. Many foreign affiliates import much more than local firms. For example, in the United States, they import twice as much per worker in the same industry, thus partially or wholly offsetting export gains (Krugman, 1990, p. 127). Such

[7] Some data from developing countries indicate that as much as 30 per cent of foreigners' investment projects can inhibit growth. See Encarnation and Wells (1986).

evidence has led to calls to revise the generally liberal trade policy of the United States and has added to the sense of ambiguity in the general policy response.

There are added concerns that inward FDI can create strategic vulnerability. One example is the European debate about the growth of alliances in politically salient industries such as electronics. As one Olivetti executive put it,

> "In the 1990s, competition will no longer be between individual companies but between new, complex corporate groupings. A company's competitive position no longer (solely) depends on its internal capabilities; it also depends on the type of relationships it has been able to establish with other firms and the scope of those relationships" (*Financial Times*, 29 May 1990).

The electronics industry in Europe is not, therefore, the same as the European electronics industry. Calculations of an appropriate response have sparked a prolonged debate. Some argue that Europe should focus on creating conditions that enhance its value-adding capability regardless of ownership. Others disagree and argue that ownership matters, because it shapes future prospects in any one region: firms give preference to the home territory, making the burden of adjustment to adverse trading conditions fall at the periphery of the system.

Similar fears of dependency and vulnerability have been voiced in the United States, coupled with a more general concern that the United States is losing out in the race to accumulate resources (Reich, 1991; Thurow, 1992). Government persistence in supporting local, high-technology players in Japan, Europe and some developing countries like the Republic of Korea, Taiwan Province of China and Brazil has sparked serious trade frictions with the United States. The reasons are not hard to find. These are industries in which the returns from technical advance create beneficial spill-over effects in related industries and create new barriers to entry that can protect first movers. These are also industries in which a nation's competitive position is clearly not determined by factor endowments. Instead, the competitive position is created by the strategic interactions among domestic firms and their home Governments and among domestic and foreign firms and Governments.

Oligopolistic competition and these strategic interactions have effectively replaced the invisible hand of market forces and "violate the assumptions of free trade theory and the static economic concepts that are the traditional basis for US trade policy" (Tyson, 1992, p. 3). The growing relationship between trade and FDI has provoked a fierce debate among economists about the welfare effects of free trade. Some analyses have suggested that free trade is not

ideological preference for lending the invisible hand a bit of administrative guidance to other, similarly inclined, neighbours.

Japanese firms enjoy access to official support from at least two sources. One is the Japanese International Development Organisation, set up in 1989 by the Keidanren (an association of large Japanese employers), with about one fifth of its capital supplied by the Government. This agency provides financial assistance for investment in developing countries, especially in Asia. The other source is the Japanese aid programme that concentrates on infrastructure projects and provides over half of all aid to the Association of South East Asian Nations and to China. Though official policy is that there are no ties between the public and the private purse, critics point to outcomes that seem more than coincidental. For example, Japanese firms won over a third of the aid contracts in the year up to 31 March 1992. The link between public and private capital is well illustrated by China's Liaoning Province, where Japanese investment was modest until 1988, when $145 million was pledged to finance a dam. "This spurred a flood of private cash. The biggest project was a $155 million cement plant . . . and . . . half of the foreign investment in Liaoning now comes from Japan" (*The Economist*, 24 April 1993, p. 80).

The possibility of ties is also suggested by apparent biasses in the direction of Japan's outward FDI in Asia that cannot be wholly explained by market forces alone. Matsushita, for example, now relies on Asia for 59 per cent of all its overseas production, up sharply from the beginning of the 1990s. Already one tenth of Matsushita's Asian production is exported to Japan, and that proportion is growing. The simultaneous drives for both market-seeking and efficiency-seeking investments seem enhanced by tacit Government support. The resulting advantages in such products as air-conditioners and compressors, as well as in consumer electronics, will increasingly affect trade elsewhere in the world.

The export of administrative guidance could have repercussions far beyond the region, with serious consequences for Western investors. Consider, for example, the impact on world financial markets as Asia continues to grow at much faster rates than elsewhere. Asia commanded 14 per cent of central bank reserves in the early 1980s, a share that has now risen to 43 per cent. One forecast is that the growing interconnections in the region could boost the emerging Asian bond market to the scale of the Eurodollar market. The most favourable terms exist for Asian countries and for Western countries operating in those countries. Capital availability for the United States and others could become increasingly dependent on Asian sources, and on Asian terms.[10] The implica-

[10] Data and forecast provided by Ken Courtis, Senior Economist, Deutsche Bank Capital Markets Asia, at a Business Week conference, Palm Beach, April 1993.

tions for corporate strategy are clear and at odds with much recent corporate behaviour, for many United States firms have reduced, relatively or absolutely, their investments in the region since 1985.

A further manifestation of triangular diplomacy is that, when Governments clash in one industry, the repercussions can be felt in others. One example can serve to make the point. While the fourth round of negotiating the terms and conditions of the Multi-Fibre Arrangement was taking place, the United Kingdom unilaterally reduced its import quota for Indonesian T-shirts. Looking for retaliation against "perfidious Albion", Indonesia embargoed a chemical project that was being built locally by a United Kingdom firm. A value of 100 million pounds of assets were put at risk because of a conflict over less than 5 million pounds of annual trade. Who in the plant construction business would routinely track developments in the textile trade? Yet, a close understanding of all the principal influences on a Government might have given better advance intelligence of looming problems and, perhaps, might have suggested some measures to protect the project.

Ricardo revisited

One symptom of a Government clinging to Ricardian notions of comparative advantage is when it measures national competitiveness primarily in terms of trade performance, as shown in the balance of payments (particularly the current account), and the presumed effect on the exchange rate. For long, in many Western countries, trade and money have been considered central. Where TNC behaviour and influence on trade performance appeared at odds with received wisdom, they were dismissed as a curiosity worth at best a footnote. Those footnotes, however, are now appearing in the main text. Ricardian notions cannot explain why Sony (Japan) exports televisions from the United Kingdom while national producers have all but disappeared, or why Malaysia is one of the world's largest exporters of semi-conductors.

The problem is that the central tenet of the theory — the immobility of assets across borders — no longer holds true. Not only does capital move in the place of goods, but also other factors of production, especially the created, intangible assets of technology and organizational skill, are increasingly mobile within firms. The growth of intra-industry trade and investment reflects such mobility. Moreover, it is increasingly apparent that costs at the level of the firm are not the same as those for the nation and that foreign investors can enjoy new advantages as they transfer their systems of production across borders. The lean production systems of the Japanese automobile producers give their transplant assembly operations an edge over local firms and allow for greater exporting

rules that shape the form of the deepening economic interdependence of nations.

Transnational corporations as diplomats?

If TNCs are truly moving more centre-stage in affecting the emerging rules, then the question naturally arises as to whether their influence is helpful to the cause of policy coordination or a hinderance. The corollary is to ask how the managers of these enterprises are responding to their new responsibilities and whether they may be expected to change their behaviour in ways that might add impulses for further change in the underlying relationships.

Relationships between States and TNCs are necessarily based on bargaining, for there are mutual hostages to be exchanged. But when the rules are in flux, one must ask such questions of managers as "Can they afford to wait for Governments to sort out new rules, domestically and internationally?" or "Should they actively intervene in the debates?". The available evidence suggests that the answers are diverging according to the position of individual firms, but in roughly predictable ways. The difficulty for Governments, though, is that these responses are often hard to decode, for firms hold quite different attitudes as to the nature and extent of their engagement in the public debate. Some seem unwilling to engage in the debate at all, fearful of attracting criticism that they are intervening in politics. Others openly espouse the cause of greater liberalization of the rules for managing cross-border transactions of all kinds. Yet others are busily lobbying Governments for greater degrees of protection.

If one looks behind the façade of these debating positions one can discern that much of the response has to do with the economics of the business involved. Those United States managers whose international business is primarily through FDI have tended to greet the debate with a big yawn (Wells, 1992). The same has been true for many Europeans in the same sorts of industries. Both appear to consider that their configuration of invested assets gives them adequate insurance against continuing trade frictions. Those whose international business is primarily through trade take the opposite view. They are deeply concerned to have some voice in the debate, for they have more at stake.

There is, however, an added consideration affecting the response: the competitive strength of the business. Those who are relatively weak are more prone to invoke the support of home or regional Governments.[14] Consider, for example, the European automobile industry. Some executives, like M. Calvet of

[14] For a fuller exploration of the combined effects, see Stopford (1992), from which some of the general arguments presented here are drawn. See also Milner (1988) for an exploration of TNC influence on the politics of international trade.

Peugeot (France), argue passionately that a liberalization of investment and trade restrictions should be delayed for as long as possible for fear of destroying the existing European producers. There is an alignment of interests between the Government of France and French producers for deep integration of local policy, but also for protectionism at the borders to impede international integration. That sense of alignment is not, however, shared by the United Kingdom, which has argued equally strongly that a liberalization and integration of markets is essential if the United Kingdom is to retain its share of world automobile production. For them, the local presence of United States and Japanese producers is vital in the aftermath of the failure of British Leyland (now the Rover Group).[15]

The weakness of the European electronics industry creates a similar diversity of views and introduces dilemmas that seem incapable of solution by rationality alone. None of the obvious options is wholly satisfactory. Further protection shows no sign of arresting the decline and would merely maintain higher prices. Besides, the consequential inward FDI flows would threaten the incumbents more directly. The dilemma of existing protection is illustrated by Regulation No. 288/89 [OJL 33, of 4 February 1989] that requires the diffusion process for semi-conductor manufacturing to be located in a member State to guarantee free circulation within the European Community. Many think that this restriction will create inefficiency and hurt local buyers. Selective encouragement for some segments does not appear to have helped in the past, because of technical changes that have eroded the protectability of the segment boundaries. Moreover, mergers to gain greater scale do not provide a clear solution. Rather than encouraging any Europe-wide administrative guidance, the dilemmas mean that it is a case of *sauve qui peut.*

The sense of dilemma can cause leading industrialists to make inconsistent statements. For example, one top official in Philips, the troubled leader at the centre of the storm, reaffirmed his support for free trade, but then went on to argue for policies that would oblige Governments to buy European (Van der Klught, 1986). Moreover, Philips successfully argued for European price protection for video tape recorders to maintain inefficient local production. The extra margins awarded to the Japanese had the perverse effect of adding to their cash-low capability to fund the development of next-generation products faster than the protected Europeans could achieve.

[15] The sale of 80 per cent of Rover to BMW, its German competitor, in early 1994 has upset the arrangements with Honda (Japan) and has created another round in the endless speculation about whether the consolidation of the world automobile industry will proceed along continental lines, heavily influenced by Government support policies, or whether a few individual firms will transcend continental borders to build a truly global oligopoly. Speculation about such structural dynamics is beyond the scope of this article.

To whom then should Governments listen? The evidence from many industries indicates there is a growing divergence in positions taken by leading TNCs from the European Union in responding to shifts in global competition and regionalization. There is a dilemma in the sense that industry's voice in the debate is likely to be one-sided. Weak firms are much more vociferous in lobbying both their national Governments and the European Community than are most of the strong players. Strong leaders in investment-intensive industries have been relatively silent, reflecting perhaps their confidence and sense of indifference to changes in trade policy. Few have gone as far as British Petroleum, which stated in 1990 that "as an international company, BP's commercial success is crucially dependent on . . . the maintenance and enhancement of the GATT-based multilateral trading system".

If firms fail to rise to the challenge of acting more as diplomats and continue to act on the basis of short-run perceptions of shareholder requirements, they may provoke policy responses that are the opposite of longer-run shareholder interests. The short-termism debate, especially as it affects the workings of the capital markets, cannot be excluded from the debate. But the issue of time perspective in managing adjustments in a turbulent global economy introduces further dilemmas for States and firms alike. Though TNCs (and, indeed, the official position of the European Union) may, in general, resist protectionism, there are so many special cases of weakness, especially in trade-oriented industries, that the fears of a "Fortress Europe" developing selectively may prove to be justified. Precisely the same effect could develop within NAFTA and across East Asia.

Is partnership possible?

All of the foregoing suggests at least two alternative scenarios for future development. The optimistic scenario is that the silent majority of strong TNCs will have a crucial and more overt role in nudging Governments towards adopting policies that reflect more appropriately the present competitive realities. Should that happen, one might see faster progress towards the twin ideal of a liberalized global economy with growing economic interdependence, matched by moves to erode, or even eliminate, domestic distortions to the terms and conditions of operating across borders in developing and developed countries alike. One recent forecast of possibilities in this scenario is for is a fourfold real increase in FDI flows by the year 2020, with the fastest growth occurring in developing countries, where the marginal returns to fresh capital transfers are likely to be greatest (Julius, 1993). As DeAnne Julius (1993, p. 7) argued, "to bring about such a scenario requires long-term commitment. Companies must commit their [resources] to develop distant markets. Governments must commit to continuing the politically difficult process of economic liberalisation . . . If

such commitments can be made and kept, then together we can reap the growth potential from building an increasingly integrated world community."

The pessimistic scenario is that weaker Western firms will continue to be tempted to bargain for political solutions for their troubles. The effect might be to add further muddle to an already confused set of signals to Governments at regional and national levels. If, simultaneously, Governments preserve outdated notions of static comparative advantage, it is unlikely that North America and Europe will pay sufficient attention to building jointly the created assets needed for future competitiveness.

Of the many possible shocks that could move the world towards this pessimistic scenario, the impact of FDI and further economic interdependence on welfare — both within and across countries — stands out as a cause of dangerous instability. Transnational corporations are not the benign engines of growth the United Nations is now suggesting (UNTCMD, 1992). The growing concentration of investment flows within the Triad markets of the United States, Europe and Japan — for quite understandable competitive reasons — affects the international division of labour and makes it more difficult for latecomer countries to break into the charmed circle of development. The expected rapid growth of population in poor countries is storing up trouble for the next generation. Already, the phenomenon of economic refugees is causing trouble on some frontiers, and could add further pressures for States to strengthen their policies of national self-interest. Even within countries, the wealth effects of inward FDI are skewed in their distribution. Wholly market-based competition does not necessarily promote social justice.

It is perhaps the sheer pace of change that makes it so hard for many States to develop the administrative capacity needed to manage the multiple dimensions of the task simultaneously. How to train officials to comprehend the new realities adequately and to abandon old shibboleths? How to build internal resources as fast as competing States? How to harness TNC skills and resources in durable bargains? Very few nations have the political will to build indigenous resources ahead of demand, as the Republic of Korea has done in its long sustained policies of education, technology enhancement and institution building. Yet even the Republic of Korea is finding that, to maintain its momentum of growth, it has to change and accord foreigners a greater role than hitherto.

To support the development of such national capacity for intelligent bargaining and to provide some form of insurance against welfare and other shocks, the global economy needs a stronger international polity to foster greater clarity, consistency and credibility in policy development. Progress will only be made possible by strong States that understand the new competitive

lishment of rules that reduce the scope for the adoption of discretionary and discriminatory policies with respect to FDI by the signatory Governments, as well as rules of origin that encourage North American value-added activity in several industries.[3]

While NAFTA's investment provisions are meant to contribute to a less discriminatory North American investment environment, they also reflect the protectionist demands of several powerful North American industries. Numerous exceptions to the investment provisions serve to protect regionally based producers from foreign competition through the targeted "grandfathering" of discriminatory measures that were in place before the Agreement came into effect, as well as through the establishment of a few new discriminatory measures. In addition, the rules of origin are highly restrictive in some industries and are therefore likely to result in trade and investment diversion in these cases.

The next section describes NAFTA's new investment rules. The Agreement's discriminatory measures and their potential impact upon intra- and inter-regional investment patterns for particular industries are examined in the section that follows. The last section concludes with a summary of the main findings and some observations concerning the viability of NAFTA as a model upon which investment agreements in other regional forums might be based in the post-Uruguay Round era.

Investment provisions of the North American Free Trade Agreement

The North American Free Trade Agreement can affect FDI regimes in North America through two types of provisions. The first type deals explicitly with FDI issues. These appear in chapter 11 of the Agreement (in which the basic rules for the treatment of FDI and the resolution of disputes between investors and States are outlined), chapters 12 and 14 (in which investment issues related to the provision of services and financial services are dealt with, respectively), and chapter 17 on intellectual property rights. The second type consists of investment-related trade measures. These include the rules of origin and measures related to duty drawback and deferral.[4]

The investment measures

The investment and services chapters

The national treatment provisions (articles 1102, 1202, 1405 of the

[3] For a theoretical analysis of the impact of NAFTA investment provisions on the strategic behaviour of TNCs operating in North America, see Rugman and Gestrin (1993).

[4] For an overview of the theory of TNC activity and the relationship between environmental factors and TNC behaviour, see Dunning (1993), Rugman (1981) and Rugman and Verbeke (1990b).

Agreement) stipulate that each party[5] must accord to investors and investments from the other NAFTA parties "treatment no less favorable than that it accords, in like circumstances, to its own investors" (article 1102.1). The national treatment provisions constitute the conceptual cornerstone of NAFTA. Several provisions of the Agreement, however, move beyond national treatment either by establishing common norms for the treatment of FDI among the three signatories (e.g., articles 1105 and 1110, described below), or through the adoption of measures based upon reciprocity (e.g., the so-called "tit-for-tat" reservations in the annexes, also explained below).

The most-favoured-nation treatment provisions (articles 1103, 1203, 1406) stipulate that each signatory must accord to investors from the other signatories to NAFTA "treatment no less favorable than that it accords, in like circumstances, to investors of any other Party or of a non-Party" (article 1103.1). The most-favoured-nation provisions confer upon foreign investors based in North America the best possible treatment among all foreign investors in instances where one of the parties has chosen to hold a reservation against the national treatment provisions. Under the terms of the United States-Canada Free Trade Agreement, this added security was not available.

The minimum standard of treatment provisions (article 1105) mainly reflect the concerns of United States and Canadian firms that the national treatment and most-favoured-nation provisions might not provide adequate protection in Mexico. Article 1105 attempts to commit the parties to a performance "floor", reflecting the unique concerns arising from the negotiation of an economic agreement between economies at such disparate levels of development. Similarly, the expropriation and compensation provisions (article 1110) also seek to establish a minimum North American standard. The acceptance of these articles by Mexico is historically significant in so far as these represent a weakening of the Calvo doctrine.[6]

The performance requirements provisions (article 1106) contain a list of requirements that the parties may not impose upon investors of other parties or of non-parties with respect to the establishment or operation of an investment. These include export requirements; domestic-content requirements; import requirements; trade-balancing requirements; the linking of domestic sales to export levels or foreign-exchange earnings; technology-transfer requirements (except when required to remedy violations of domestic competition laws); and

[5] The term "party" is hereafter used to refer to the signatory Governments to NAFTA.

[6] The Calvo doctrine was enunciated in 1868 by Carlos Calvo (1824-1906) of Argentina. The doctrine stipulates that foreign investors will be subject to domestic laws and that disputes can only be resolved in domestic courts (Power, 1993, p. 12).

trade and investment.[19] Trade and investment have been administered through the 1965 Automotive Agreement between Canada and the United States; a series of voluntary export restraint agreements[20] on Japanese automotive products beginning in 1981; five Mexican Automotive Decrees beginning in 1963; and, to a lesser extent, the Caribbean Basin Initiative of 1982 (establishing a 35 per cent local-content requirement for products entering the United States).

The main features of NAFTA automotive provisions from an investment perspective are the complete opening up of the Mexican automotive industry to North American investment over the Agreement's first ten years, the establishment of tighter rules of origin and tracing requirements to encourage more regional sourcing, and various advantages conferred upon "incumbent" producers.

In terms of opening the Mexican automotive industry to North American investment, NAFTA phases out the numerous performance requirements and investment restrictions left over from the 1989 Automotive Decree by 1 January 2004. The North American Free Trade Agreement allows for full foreign participation in the automotive parts industry, eliminates all sourcing restrictions on the five existing Mexican assemblers,[21] and completely phases out the trade-balancing requirements for parts and finished vehicles.

The opening of the Mexican automotive regime, however, has been accompanied by a tightening of the rules of origin. For automobiles and light trucks and their engines and transmissions a regional value content requirement of 62.5 per cent applies under NAFTA. Automobile producers, unlike producers in other industries, cannot choose between the transaction value and net cost tests — they must use the net cost test (the same restriction applies to the footwear sector). The reason is that the net cost test reflects better regional content when there is extensive vertical integration that largely eliminates market determined prices along the value-added chain for automobiles.[22]

The rules of origin have also been tightened through the introduction of a "tracing" requirement that is intended to deal with the problem of "roll-up". Roll-up occurs when intermediate inputs, containing materials that do not

[19] Two excellent analyses of the impact of NAFTA upon the North American automotive industry are Eden and Molot (1993) and Johnson (1993).

[20] For an analysis of the empirical record of the use of United States trade laws, see Rugman and Gestrin (1991) and Rugman and Verbeke (1990a).

[21] The Big Three automobile producers (General Motors, Ford and Chrysler), plus Nissan and Volkswagen.

[22] In 1982, intra-firm trade in the transportation-equipment industry accounted for 44, 45 and 50 per cent of total trade for that industry in the United States, Japan and the United Kingdom, respectively (OECD, 1992, p. 220).

originate within NAFTA, but that meet the regional value content and change in tariff classification requirements, are treated as if they originate within NAFTA when introduced to the next stage of assembly in another NAFTA member. Tracing seeks to overcome this problem by requiring manufacturers to keep track of materials not originating in NAFTA members that would otherwise "disappear" along the various stages of production as sub-assemblies are granted "originating" status. The ultimate effect of tracing is to raise the regional value content requirement of automotive production, since non-NAFTA originating materials that would otherwise be rolled-up in the absence of tracing now count against regional value content.

Although not explicitly discriminatory, the tightened rules of origin and the new tracing requirement constitute an attempt to promote regional sourcing in the automotive industry. As an instrument of industrial policy, however, rules of origin are extremely blunt and usually costly from an economic welfare perspective. In this case, the greatest efficiency loss to which NAFTA is likely to give rise is associated with the diversion of parts sourcing away from efficient Asian suppliers.

In terms of the effect of these rules upon investment patterns, Peter Morici (1993, p. 247) suggested that, "given the number of stages in the transformation of basic components into automobiles, the use of non-North American parts by transplants should be substantially reduced". In addition, the restrictions which NAFTA places upon duty drawback programmes for new producers suggests that future investments by these companies will be predominantly located in the United States.

Finally, NAFTA, by grandfathering the United States-Canada Auto Pact and the Free Trade Agreement revisions to it, distinguishes between Auto Pact and non-Auto Pact producers and confers specific advantages to the former. Existing producers are defined as those producing vehicles prior to model year 1992. That distinction, and the associated differences in treatment based upon it, runs counter to national treatment. Indeed, article 1 of the automotive annex (annex 300-A) stipulates that "existing" producers must be granted "treatment no less favorable than (is accorded) to any new producer" (article 1, annex 300-A). In contrast to the national treatment provision, which is intended to protect foreign producers, the "foreign treatment" provision of the automotive annex allows for the conferral of advantages on incumbent assemblers. One significant reservation in this regard can be found in Canada's extension of duty waiver programme for the Big Three and Volvo (annex I, p. C-17).

On balance, NAFTA is beneficial for the North American automotive industries. The Mexican automotive and auto-parts industries, in particular,

stand to benefit as investment is expected to increase by over 16 per cent (USITC, 1993, p. x). Furthermore, the North American automotive industry will become more competitive globally as a result of the increased scope for rationalizing production and the heightened regional competition to which NAFTA will give rise. However, these efficiency gains will be partially offset by the trade and investment diversion caused by the extremely strict rules of origin. Asian parts manufacturers stand to lose the most in this regard.

The rules of origin and sectoral adjustment

The North American Free Trade Agreement's rules of origin are intended to discourage the establishment of export platforms within NAFTA and encourage regional production in industries for which the regional value content requirements are high. Although these rules are not discriminatory in the same way as the measures contained in the annexes or in the national security exclusion provisions, they do constitute a form of industrial policy aimed at reorganizing productive capacity along regional lines through administrative and, hence, arbitrary incentives (as in the case of the automotive rules of origin outlined above).[23]

In addition to automobiles, several other industries in North America have been conferred considerable competitive advantages with respect to non-regionally based producers through tighter regional-content requirements (usually in combination with restrictions upon duty drawback and related programmes). These include electronics, textiles and apparel, home appliances and measuring and testing equipment (USITC, 1993, p. 3).

The rules of origin for electronics embody the explicit strategic objective of increasing regional production of high-technology components (USITC, 1993, p. 5-4). For numerous electronic products containing non-NAFTA originating materials, the rules of origin are complex, involving change in tariff classification and regional value content requirements, as well as the requirement that certain sub-assemblies be completely produced in North America. Theses rules have been applied to encourage more regional production of parts related to the production of high-definition televisions, flat-panel displays and printed circuit sub-assemblies, among other products (USITC, 1993, p. 5-3). These products and, especially, the technologies upon which they are based have been at the centre of the current policy debate in the United States over the erosion of its competitiveness in high-technology industries.

[23] The rules of origin do not, strictly speaking, derogate from national treatment unless, as in the case of provisions for the automobile industry, they confer upon established producers preferential rules of origin.

In addition, the rules have also been tightened for more mature technologies. In particular, the rules of origin aim at increasing the regional production of television tubes. Televisions made in North America with regionally produced tubes will enjoy duty-free access into any NAFTA market. Televisions made with foreign tubes are subject to a 5 per cent duty in the United States. Furthermore, duty drawback restrictions increase the duties on Asian tubes that previously entered Mexican *maquiladoras* from 0 to 15 per cent. Thus, the rules of origin in the electronics industries explicitly aim at increasing regional production. The tight rules of origin will encourage an increase in productive capacity for television tubes in the United States, largely at the expense of Asian producers. The latter have been effectively shut out of the North American market. The effects of tighter rules of origin and restrictions upon duty drawback, however, are not always as clear. Indeed, in a few cases, producers might find it in their best interests to move the production of sub-assemblies completely offshore in response to the duty rate differentials created by the combination of the elimination of duty drawback and deferral benefits, tight rules of origin and the level of the external tariff (USITC, 1993, p. 3-5; Peter Morici (1993) also considers this potential problem in greater detail).

The rules of origin for textile and apparel producers are based upon the concepts of "yarn forward" and "fibre forward". To qualify for NAFTA treatment, goods must be made in North America from the yarn and fibre stages onward (the two rules apply to different types of material). These rules have been described as "ultrastrict" by Gary Hufbauer and Jeffrey Schott (1993, p. 44) and as an example of rules of origin "at their worst" by Peter Morici (1993, p. 241). Indeed, they are likely to have significant investment implications. In particular, since NAFTA substantially liberalizes trade in textiles and apparel between Mexico and its NAFTA partners, low-wage producers of apparel for export to North America stand to experience at least some investment and trade diversion to Mexico (to the extent that it is possible to talk about trade diversion at all in an industry in which trade and investment patterns are already highly administrative in nature). The Caribbean Basin Initiative economies are particularly concerned about this possibility (Hufbauer and Schott, 1993, p. 46). The increase in apparel production in Mexico that NAFTA will bring about is also likely to lead to decreases in North American imports from Asia (USITC, 1993, p. 8-2).

The Uruguay Round Agreement's proposed phase-out of the Multi-Fibre Arrangement and the gradual incorporation of the global textile and apparel industry into the GATT of most-favoured-nation-based tariff system mean that global production patterns will be shaped increasingly by market forces. Mexico stands to benefit from the Multi-Fibre Arrangement, as well as from the

enhanced market access afforded by NAFTA. Apparel producers located in Mexico are likely to expand their share of the North American market significantly as a result of the Uruguay Round Agreement and NAFTA.

Machine tools is another industry in which the rules of origin have been tightened. The rules for that industry stipulate that non-NAFTA originating parts may not be used in sub-assemblies, and they impose strict limits upon the use of non-NAFTA originating motors, pumps, electrical control panels, lasers and "major castings, weldments, and fabrications" (NAFTA, article 401, section B and USITC, 1993, p. 6-2). The United States International Trade Commission estimates that the United States machine tools industry might respond to the stringent rules of origin (in combination with the relatively low external tariff on these products) by moving more production offshore (USITC, 1993, p. 6-2).

Conclusions

On balance, NAFTA treatment of FDI is impressive. New ground has been broken in terms of establishing clear rules, enforceable dispute settlement mechanisms and increased transparency in the discriminatory regimes of the signatories. The North American Free Trade Agreement is therefore likely to stimulate FDI and give rise to efficiency gains as TNCs rationalize their operations across the three signatory economies.

This being said, the Agreement is not simply an exercise in trade and investment liberalization. It establishes discriminatory measures for particular industries and practices at the national and regional level. At the national level, each member of NAFTA has chosen to exempt particular industries from various investment provisions (usually some combination of the national treatment, the most-favoured-nation and the performance requirements articles). The most notable exemptions are the energy industry in Mexico, the maritime industry in the United States and the cultural industries in Canada.

At the regional level, the extremely tight rules of origin for particular industries (although technically consistent with national treatment) will probably give rise to some trade and investment diversion and will also serve to disadvantage new producers in North America whose traditional supplier networks are located in other regions. In essence, these rules seek to reduce import competition (on an interregional basis) for automobiles, textiles and apparel, electronics (particularly, television) and certain machine tools. Provisions that distinguish between incumbent and new producers and accord preferential treatment to the former on the basis of this distinction act as protective complements to the rules of origin. While the rules of origin reduce import competition, the preferences accorded to incumbents soften transplant competition. Such use of this type of derogation from national treatment is concentrated in the automotive industry.

The numerous positive precedents set by NAFTA concerning FDI will invariably influence the negotiation of future regional trade and investment agreements (not to mention any extension of NAFTA itself) and will probably serve as benchmarks for future investment-related negotiations in the World Trade Organization. The tight rules of origin in the industries discussed above will not significantly detract from the positive contribution of NAFTA to the FDI regimes in North America, mainly because the United States external tariff on many of these products is already low (which means that the diversion effects of the rules will be low as well).

Rules of origin are necessary for the functioning of free trade agreements. However, as these agreements come to constitute an increasingly significant element in the administrative structure of global trade, especially among developing countries, their potential to serve protectionist goals and a beggar-thy-neighbour type of quest for manufacturing capital and employment should be considered more carefully. Within the context of NAFTA, the rules of origin are extremely tight only in a limited number of industries, such as automobiles, textiles and apparel and electronics. Furthermore, the pernicious diversion effects of tight rules of origin are reduced to the extent that the external tariff on the products to which these rules apply is already low in the biggest NAFTA market — the United States. The 2.5 per cent tariff for automobiles and most auto-parts into the United States, for example, is helpful in this regard (although the failure of the Uruguay Round to have this rate further reduced is a disappointment). Unfortunately, NAFTA, in addition to all of the positive precedents it establishes in the area of international investment, also sets a dangerous example for future regional trade agreements in its limited, but obvious, use of rules of origin to support particular industries. ■

References

Dunning, John H. (1993). *Multinational Enterprises and the Global Economy* (Wokingham, United Kingdom and Reading, Mass.: Addision Wesley).

The Economist (1994). "Uncle Sam's helping hand", 331 (2 April), pp. 77-79.

Eden, Lorraine and Maureen Appel Molot (1993). "The NAFTA's automotive provisions: the next stage of managed trade", *C. D. Howe Institute Commentary*, 53, November (Toronto: C. D. Howe Institute).

Gestrin, Michael and Alan M. Rugman (1993). "The NAFTA's impact on the North American investment regime", *C. D. Howe Institute Commentary*, 42, March, (Toronto: C. D. Howe Institute).

Graham, Edward M. (1991). "Foreign direct investment in the United States and U.S. interests", *Science*, 254, 20 (December), pp. 1740-1745.

________ and Michael Ebert (1991). "Foreign direct investment and U.S. national security: fixing Exon-Florio", *World Economy*, 14, pp. 245-268.

________ and Christopher Wilkie (1994). "Multinationals and the investment provisions of the NAFTA", *The International Trade Journal*, 8, 3 (Spring), forthcoming.

Hagen, Daniel, Steven Henson and David Merrifield (forthcoming). "Impact of NAFTA on energy markets", in Alan M. Rugman, ed., *Foreign Investment and NAFTA* (Columbia, University of South Carolina Press), pp. 228-248.

Hufbauer, Gary Clyde and Jeffrey J. Schott (1993). *NAFTA: An Assessment* (Washington, D.C., Institute for International Economics).

Johnson, Jon R. (1993). "NAFTA and the trade in automotive goods", in Steven Globerman and Michael Walker, eds., *Assessing NAFTA: A Trinational Analysis* (Vancouver, Canada, The Fraser Institute), pp. 87-129.

Morici, Peter (1993). "NAFTA rules of origin and automotive content requirements", in Steven Globerman and Michael Walker, eds., *Assessing NAFTA: A Trinational Analysis* (Vancouver, Canada, The Fraser Institute), pp. 226-250.

Organisation for Economic Co-operation and Development (1993). *Economic Surveys: United States* (Paris, OECD).

________ (1992). *Technology and the Economy: The Key Relationships* (Paris, The Technology/Economy Programme, OECD).

Ostry, Sylvia (1990). *Governments and Corporations in a Shrinking World: Trade and Innovation Policies in the United States, Europe, and Japan* (New York and London, Council on Foreign Relations Press).

Plourde, Andre (1993). "Energy and the NAFTA", *C. D. Howe Institute Commentary*, 46, May (Toronto: C. D. Howe Institute).

Power, Michael E. (1993). "Foreign investment protection agreements: a Canadian perspective", Working Paper Series No. 14 (April), mimeo.

________ (1992). *The Work of Nations* (New York, Vintage).

Rugman, Alan M. (1981). *Inside the Multinationals: The Economics of Internal Markets* (New York, Columbia University Press).

________ (1990). *Multinationals and Canada-United States Free Trade* (Columbia, University of South Carolina Press).

________ and Michael Gestrin (1991). "U.S. trade laws as barriers to globalization", *World Economy*, 14, 3, pp. 335-352.

________ and Alain Verbeke (1990a). *Global Corporate Strategy and Trade Policy* (London and New York, Routledge).

________ and Alain Verbeke (1990b). "Multinational corporate strategy and the Canada-U.S. Free Trade Agreement", *Management International Review*, 30, 3, pp. 253-266.

________ and Michael Gestrin (1993). "The strategic response of multinational corporations to NAFTA", *Columbia Journal of World Business*, 28, 4 (Winter 1993), pp. 18-29.

________ and Mark Warner (1994). "Competitiveness: an emerging strategy of discrimination in U.S. antitrust and R&D policy?", *Law and Policy in International Business*, forthcoming.

Tyson, Laura D'Andrea (1993). *Who's Bashing Whom? Trade Conflict in High Technology Industries* (Washington, D.C., Institute for International Economics).

UNCTAD Division on Transnational Corporations and Investment (1993). *World Investment Directory 1992, Volume III, Developed Countries* (New York, United Nations), United Nations publication, Sales No. E.93.II.A.9.

United States International Trade Commission (1993). *Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement* (Washington, D.C., United States International Trade Commission), publication 2596.