

World Investment Report 1995

Transnational Corporations and Competitiveness

Overview

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Experts from within and outside the United Nations system provided input for *WIR 95*. Major input was received from Stephen Guisinger, John M. Kline and Terutomo Ozawa. Input was also received from Thomas Andersson, Magnus Blomström, Gonzalo Cid, Michel Delapierre, Gunnar Fors, Edward M. Graham, Anna Joubin-Bret, Friedrich von Kirchbach, Ari Kokko, Donald J. Lecraw, Robert Lipsey, Michael McDermott, Christian Milelli, Trevor Nuttall, Yumiko Okamoto, Robert D. Pearce, Peter Peterson, Eric D. Ram-

stetter, Robert Ready, Frank Sader, Marjan Svetlicic, Alejandro Vera Vassallo and Gerald T. West. A number of experts were consulted and commented on various chapters. Comments, including during expert group meetings, were received from Manuel R. Agosin, Jamuna P. Agarwal, David B. Audretsch, Zoltan Bodnar, Peter J. Buckley, Elisabeth Bukstan, Alvaro Calderon, John Cantwell, Calvo de Celis, Edward Dommen, Peter Enderwick, Arghyrios A. Fatouros, A. V. Ganesan, Tom Ganiatsos, David Gold, Murray Gibbs, William Geoffrey Hamilton, Sirj Haron, Fabrice Hatem, Hal Hill, Kurt Hoffman, David Holland, Ann Houtmann, Jan Huner, DeAnne Julius, Shamsuzzakir Kazemi, Eui-Soo Kim, Gabriele Koehler, Peter Koudal, Jesse Kreier, Nagesh Kumar, Sanjaya Lall, Marc Legault, Roland Lempen, Linda Low, Carl McMillan, Hafiz Mirza, Lynn K. Mytelka, James Clark Nuñez, Jr., Alan Nymark, Herbert Oberhänsli, Maurice Odle, Adrian Otten, John Henry Postmus, Pedro Roffe, Matija Rojec, Yehia Soubra, William Stibravy, Erich Supper, Graham Vickery, Louis T. Wells, Mira Wilkins, John Williams and Stephen Young. The Report benefited from overall comments and advice from John H. Dunning, Senior Economic Adviser.

Numerous officials in Central Banks, statistical offices, investment promotion agencies and other government offices concerned with foreign direct investment also contributed to *WIR 95*, especially through the provision of data and comments, including, in particular, Franklin Chow, Ana de la Cueva, Erich Dandorfer, Johannes Dumbacher, Asbjorn Enge, Betty Gruber, Diwa C. Guinigundo, Airi Heikkilä, Dato J. Jegathesan, Thomas Jensen, H. K. Lee, G. Mellis, Andrew Norman, C. U. Omamogho, David Priest, R. P. Sparling, Beatrice Stejskal-Passler, Benech Sylvie, Soitsu Watanabe, René Weber, Inger Wikström and Jocelyn Young. The advice of Ray Mataloni and Obie Whichard was particularly important.

Finally, executives of a number of companies extended their cooperation by providing information and insights.

A financial contribution by the Government of Sweden is gratefully acknowledged.

Enabled by increasingly liberal policy frameworks, made possible by technological advances, and driven by competition, globalization more and more shapes today's world economy. Foreign direct investment (FDI) by transnational corporations (TNCs) now plays a major role in linking many national economies, building an integrated international production system—the productive core of the globalizing world economy. Transnational corporations deploy their tangible and intangible assets (capital, research-and-development capacity and technology, organizational and managerial practices, trade links), with a view towards increasing their competitiveness and profitability. At the same time, the deployment of these assets by firms strengthens the resource base of countries and their capacity to produce, to reach and expand markets for their products and to restructure their economies—in brief, to improve their overall economic performance. To link the increased competitiveness of TNCs to the economic performance of host and home countries as closely as possible poses a challenge for policy makers. These developments and issues are the particular theme of the *World Investment Report 1995*.

Part One of the *World Investment Report 1995* examines recent global and regional trends in FDI, with a special emphasis on the emergence of TNCs from developing countries and on changing forms of international transactions. Part Two focuses on the role of TNCs in influencing countries' access to resources and markets and in facilitating economic restructuring. Part Three discusses policy issues, from an inward and outward FDI perspective. The annex contains statistics on FDI trends.

Global and regional trends

International production by TNCs—now some 40,000 parent firms and some 250,000 foreign affiliates—increasingly influences the size and nature of cross-border transactions. In the process, it shapes the nature of the world economy. Outward FDI stock and global sales of foreign affiliates—two generally accepted proxy indicators of international production—now stand at \$2.6 trillion (1995) and \$5.2 trillion (1992), respectively (see table 1). In the 1990s, the rate of growth of FDI stock has substantially exceeded that of

world output (GDP) and world exports. The size and scope of international production are amplified further by the activities of TNCs in forms other than FDI, such as subcontracting, licensing and franchising, through which markets for goods, services and factors of production can be reached and international production organized. Global sales in international markets associated with this more broadly defined international production amounted to an estimated \$7 trillion in 1992, compared to some \$3 trillion in arm's-length trade. In fact, in the case of TNCs headquartered in the United States, four out of five dollars received for goods and services sold abroad by these firms are actually earned for goods and services produced by their foreign affiliates or sold to them. The various forms of international production may be substitutes or complements for each other, depending on the strategies of TNCs. All of them are aimed at ensuring access both to markets for goods and services and to markets for tangible and intangible factors of production, in a quest to convert globally inputs into outputs for global markets as efficiently and profitably as possible.

Table 1. Selected world FDI, economic and financial indicators, 1981-1993

Indicator	Value at current prices, 1993		Average annual growth rates	
	1981-1993 ^a	1981-1993 ^a	1981-1993 ^a	1981-1993 ^a
FDI outflows	222	0.8	28.3	5.6
FDI outward stock	2 135	5.4	19.8	7.2
Sales of foreign affiliates of TNCs ^a	5 235 ^b	1.3 ^c	17.4	-2.6 ^d
Current gross domestic product at factor cost	23 276	2.1	10.6	3.3
Gross fixed capital formation	5 351	0.7	9.9	3.2
Exports of goods and non-factor services	4 762	-0.1	14.3	3.5
Royalty and fee receipts	38	-0.7	21.8	13.0

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Estimated by extrapolating the worldwide sales of foreign affiliates of TNCs from France, Germany, Italy, Japan and the United States on the basis of the relative importance of these countries in worldwide outward FDI stock. However, the data on sales of foreign affiliates for France are included only after 1988 because of unavailability of the data prior to that year. For Italy the sales data are included only in 1986, 1988, 1990 and 1992.

^b 1992.

^c 1982-1985.

^d 1991-1992.

The diverse nature of international production suggests that international policy discussions about market access have to deal not only—as they currently do—with trade in goods and services but also with FDI as a modality to access markets. Beyond that, FDI is also a modality to access factors of production. Such a broader perspective also raises the question as to the extent to which specific government policies may introduce a bias in favour or against any specific modality of international transactions and, therefore, distort the way in which firms undertake and organize their international activities. The importance of such distortions would become clearer if governments paid greater attention to the interrelationships between investment, trade and other forms of international transactions in their dual function of accessing markets for goods, services and factors of production and organizing international production.

Partly in response to globalization, progress in coming to grips with the nature of international production is already being made. National, regional and international agreements are paying more attention to FDI. Although for a number of countries there is still an imbalance between the degree of liberalization of FDI and trade regimes (with progress achieved for the latter, furthermore, bound in multilateral agreements), FDI regimes at the national level are rapidly being liberalized: continuing a trend of earlier years, 101 out of 102 legislative changes made in 1993 in 57 countries were in the direction of a more liberal FDI framework; in 1994, 108 out of 110 legislative changes made in 49 countries were in the same direction. In fact, only 5 out of a total of 373 FDI regulatory changes during 1991-1994 were *not* in the direction of greater liberalization (see table 2). Such unilateral measures have been accompanied by the conclusion of bilateral investment agreements, primarily between developed and developing countries, but increasingly also *among* developing countries. Of the more than 900 treaties that existed by mid-1995 between 150 countries, nearly 60 per cent date from the period since the beginning of 1990, 299 from 1994 alone. Another dimension has been added to the liberalization process at the regional level, with the strengthening of free trade agreements which, increasingly, also liberalize FDI flows (and, therefore, properly ought to be called free trade and investment agreements). In fact, the OECD countries began negotiations in September 1995 on a Multilateral Agreement on Investment, with a view to reaching such an Agreement by May 1997 as a free-standing treaty open also to non-OECD countries. Finally, a proposal has been made to negotiate an investment agreement in the World Trade Organization. All this means that the enabling framework for FDI is being strengthened, thus giving further impetus to the process of globalization.

Table 2. Liberalization measures, 1991-1994
(Number)

	1991	1992	1993	1994
Number of countries that introduced changes in their investment regimes	35	43	57	49
Number of changes	82	79	102	110
Of which:				
In the direction of liberalization or promotion	80	79	101	108
In the direction of control	2	*	1	2

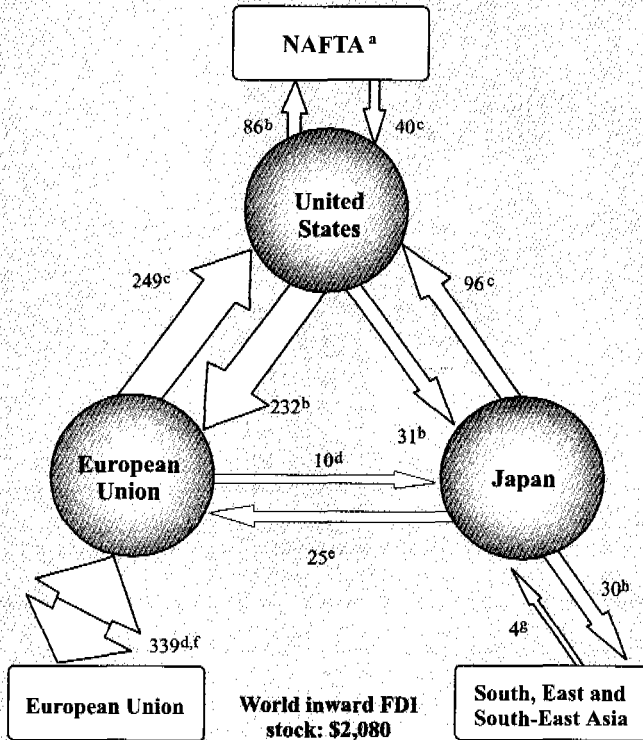
Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

International production by TNCs is boosted by the continuing recovery from the FDI recession ...

International production, as reflected by the FDI stock accumulated by TNCs, has been growing at a rapid pace since the early 1980s, a growth that only briefly slackened during the FDI recession of the early 1990s. Investment stocks and flows remain concentrated primarily in the developed world and particularly in the Triad (the European Union, Japan and the United States), both as far as their origin and destination are concerned (see figure 1). This distribution of inward FDI stock mirrors market size, with the developing countries accounting for between one-fifth and one-quarter of both world GDP and global inward FDI stock. However, the FDI stock in developing countries is highly concentrated: the 10 largest developing host countries account for about two-thirds of the total stock in developing countries, more than would be expected from their share in developing country output or trade. As far as outward stock is concerned, firms from developing countries generated only six per cent of the world FDI stock in 1994, reflecting the superior competitiveness of Triad firms, based on their ownership-specific advantages. As with inward investment, the outward developing country FDI stock is largely accounted for by firms from only a handful of developing countries.

As far as FDI flows are concerned, the share of developing countries in world inflows is now higher than their share in world imports (about 30 per cent in the early 1990s). The volume of FDI flows reflects the strength

Figure 1.
FDI stock among Triad members and their clusters, 1993
(Billions of dollars)



Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Canada and Mexico.

^b United States outward FDI stock.

^c United States inward FDI stock.

^d Outward FDI stock of Austria, Finland, France, Germany, Italy, Netherlands, Sweden and the United Kingdom. Data for Austria are for 1991 and data for France and the Netherlands are for 1992.

^e Data from inward FDI stock of Austria, France, Germany, Italy, Netherlands and United Kingdom. Data for Austria and France are for 1991 and data for Italy and the Netherlands are for 1992.

^f For Sweden, the data reflect FDI to and from all European countries. Intra-European Union FDI, based on inward stocks, is \$225 billion.

^g Data are based on approvals/notifications and represent those from countries other than those in North America and Europe.

^h Estimated by multiplying the values of the cumulative flows to the region according to FDI approvals by the ratio of disbursed to approved/notified FDI in developing countries.

Table 3. FDI outflows from the five major home countries, 1982-1994

(Billions of dollars and percentage)

Year	France	Germany	Japan	United Kingdom	United States	Total (5 countries)	AB countries
Value (Billions of dollars)							
1982-1986	3	6	7	10	11	37	57
1987-1991	20	18	35	28	25	127	195
1989	20	18	44	35	26	143	218
1990	35	29	48	19	27	157	243
1991	24	23	31	16	33	127	199
1992	31	16	17	19	39	123	191
1993	21	17	14	26	69	146	222
1994 ^c	23	21	18	25	46	132	222
Share in total^d (Percentage)							
1982-1986	5	10	13	18	19	65	100
1987-1991	11	10	18	14	13	65	100
1992	17	9	9	10	21	64	100
1993	10	9	7	13	34	66	100
1994 ^c	11	10	9	12	23	59	100

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Not including reinvested earnings. In the case of France, reinvested earnings are not reported after 1982.

^b Excluding outflows to the finance (except banking), insurance and real estate industries of the Netherlands Antilles. Also excludes currency-translation adjustments.

^c Based on preliminary estimates.

^d Calculated on the basis of FDI flows expressed in millions of dollars.

of countries' current locational advantages for inflows and the strength of firms' current ownership-specific advantages for outflows. In terms of FDI outflows, the developing-country share is about a half of their share in world exports.

If the value of sales associated with inward FDI is compared with the value of imports, this suggests that, for developing countries as a group, inward FDI rivals imports when it comes to obtaining what they need from the rest of the world, while they still rely much more on exports than on outward FDI when it comes to delivering goods and services to foreign markets. The implication is that, although developing countries are becoming more fully integrated into the world economy through inward FDI, this integration is asymmetric and does not yet apply to outward FDI. There are,

however, significant differences in the experiences of various groups of developing countries (see below).

By the end of 1993, FDI outflows had largely recovered from the FDI recession (reaching \$222 billion) and, in 1994, maintained this level. Preliminary estimates for 1995 (\$230 billion) suggest that the recovery has been further consolidated. The recovery is partly a cyclical phenomenon: as the major home countries came out of a period of recession, their firms embarked upon expansion plans that included investing abroad. Over and above this cyclical movement are structural factors—in particular the pressures of growing international competition, coupled with advances in communications technology that allow better coordination of cross-border activities—which make it essential for firms to invest abroad in order to be competitive internationally. Furthermore, the liberalization of the regulatory frameworks for FDI, trade and technology and the privatization of state-owned enterprises create additional opportunities for foreign investors.

*... in the developed countries
(led by the United States) ...*

The recovery of FDI flows has been due primarily to an increase in FDI activity by firms from developed countries. A repositioning took place among the top five home countries, together accounting for nearly 70 per cent of global outflows, with the United States reasserting its lead once more as the principal home economy for FDI, accounting (with \$610 billion) for a quarter of the world's stock and (with \$46 billion) one-fifth of world outflows in 1994 (table 3). The vigorous FDI expansion experienced by the United States has not been matched by other Triad members. Although Japan's outward investment rose by nearly one-third (to \$18 billion) in 1994, it remained way below earlier peaks (\$48 billion in 1990). As economic growth in France, Germany and the United Kingdom resumed or gathered momentum, TNCs based in those countries again became more active abroad.

Most of this activity remained concentrated in the Triad. Out of an estimated \$235 billion of world inflows in 1995, inflows to developed countries as a group are projected to be \$138 billion, compared to \$129 billion in 1993 and \$135 billion in 1994. The United States resumed its position as the single largest FDI recipient (\$49 billion in 1994), while flows to Japan remained negligible (with less than \$900 million in 1994, about the same order of magnitude as flows to the Czech Republic). Although Western

Europe continues to be the largest FDI recipient, a number of countries in the region (such as the Netherlands and the United Kingdom) have not yet emerged from the FDI recession. The region's recovery in terms of inflows has been slower than its recovery in terms of outflows, reflecting partly the more dynamic performance of other parts of the world.

While outward FDI flows from European countries have regained their momentum, South, East and South-East Asia—the most dynamic region in the world—continues to be neglected by them as a host region. Perhaps pre-occupied with regional integration, European Union firms have only some four per cent of their stock and about three per cent of their flows directed to this region. The region's share of European Union exports is not much larger, about five per cent. Japanese TNCs have invested four times more in this region, and United States TNCs two-to-three times more than their European Union competitors. Country level data illustrate this further: for instance, Germany's FDI stock in developing Asia (excluding West Asia) is about half the size of her stock in Spain, and Germany's flows to that region during 1990-1993 were less than Germany's flows to Austria. In the case of the United Kingdom, the country's FDI stock in developing Asia is about the same as in Australia, while flows are about the size of flows to Sweden. However, there are signs that European Union firms are changing course, as reflected in their increasing outflows to Asia. With South, East and South-East Asia being the fastest growing region in the world, FDI competition there is set to intensify, both in terms of countries seeking to attract FDI and in terms of TNCs competing for investment opportunities. Firms from the region itself have actually acquired a leadership role in this competition.

***... and the enduring growth of FDI flows
to developing countries ...***

In spite of the renewed attractiveness of the developed countries, developing countries have succeeded in attracting growing investment flows, reaching \$84 billion in 1994 to account for 37 per cent of world FDI inflows (see table 4). This is a continuation of a trend that began in 1990 and has propelled developing countries to become a major force in world FDI. (If intra-European Union flows are excluded, the share of the developing countries in world FDI flows rises from 35 per cent in 1993 to 44 per cent in 1994.) To a large extent, the successive annual increments to FDI flows into these economies reflect the growing attractiveness of a single country, China. With some \$34 billion in inflows, China was the second largest

Table 4. FDI inflows and outflows, 1982-1994

(Billions of dollars)

Year	Developed countries		Developing countries		Central and Eastern Europe		All countries	
	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows
				Value				
1982-1986	43	53	19	4	0.02	0.01	61	57
1987-1991	142	183	31	12	0.6	0.02	174	195
1989	172	202	29	15	0.3	0.02	200	218
1990	176	226	35	17	0.3	0.04	211	243
1991	115	188	41	11	2.5	0.04	158	199
1992	111	171	55	19	4.4	0.02	170	191
1993	129	193	73	29	6.0	0.08	208	222
1994 ^a	135	189	84	33	6.3	0.07	226	222

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Based on preliminary estimates.

NOTE.—Here and in other tables, the levels of worldwide inward and outward FDI flows and stocks should balance; however, in practice, they do not. The causes for the discrepancy include differences between countries in the definition and valuation of FDI; the treatment of unremitted branch profits in inward and outward FDI; the treatment of unrealized capital gains and losses; the recording of transactions of "offshore" enterprises; the recording of reinvested earnings in inward and outward FDI; the treatment of real estate and construction investment; and differences in the equity threshold between inward and outward FDI. The size of the world FDI discrepancy has declined over the past years.

Table 5. FDI inflows and stock in developing countries, by region, 1981-1994
(Billions of dollars and percentage)

Region	Annual average inflows			Inflows		Stock	
	1981-1985	1986-1990	1991-1993	1993	1994	1993	1994
Developing countries^b							
Value	19.6	26.2	56.3	73.4	84.4	500.9	583.6
Share of the world total	34.1	16.5	31.5	35.2	37.4	24.1	25.2
Africa							
Value	1.7	2.8	3.1	3.0	3.1	50.2	53.1
Share of the world total	3.0	1.8	1.7	1.4	1.4	2.4	2.3
Share of developing-country total	8.7	10.8	5.5	4.1	3.6	10.0	9.1
Latin America and the Caribbean							
Value	6.8	8.5	17.6	19.9	20.3	167.6	186.2
Share of the world total	11.9	5.3	9.8	9.5	9.0	8.1	8.0
Share of developing-country total	34.9	32.3	31.3	27.1	24.0	33.5	31.9
West Asia							
Value	6.0	0.9	1.4	1.3	1.4	33.1	34.5
Share of the world total	10.5	0.6	0.8	0.6	0.6	1.6	1.5
Share of developing-country total	30.7	3.5	2.5	1.8	1.7	6.6	5.9
East, South and South-East Asia							
Value	4.9	13.8	33.6	48.5	59.1	246.0	305.1
Share of the world total	8.5	8.7	18.8	23.3	26.2	11.8	13.2
Share of developing-country total	24.9	52.5	59.7	66.1	70.0	49.1	52.3

Table 5. FDI inflows and stock in developing countries, by region, 1981-1994 (*continued*)
(Billions of dollars and percentage)

Region	Annual average inflows			Inflows		Stock	
	1981-1985	1986-1990	1991-1993	1993	1994 ^a	1993	1994 ^a
The Pacific							
Value	0.1	0.2	0.3	0.3	0.3	2.4	2.7
Share of the world total	0.2	0.1	0.2	0.1	0.1	0.1	0.1
Share of developing-country total	0.7	0.7	0.6	0.4	0.4	0.5	0.5
Memorandum:							
Least developed countries							
Value	0.3	0.6	0.9	0.8	0.9	9.7	10.6
Share of the world total	0.5	0.4	0.5	0.4	0.4	0.5	0.5
Share of developing-country total	1.3	2.2	1.5	1.1	1.0	1.9	1.8
Developing countries excluding China							
Value	18.8	23.4	42.0	45.8	50.6	443.7	492.6
Share of the world total	32.7	14.7	23.4	22.0	22.4	21.3	21.2
Share of developing-country total	95.9	89.1	74.5	62.5	60.0	88.6	84.4

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.IIA.9).

^a Estimates.

^b Includes developing countries in Europe (Gibraltar, Malta and former Yugoslavia).

recipient of FDI flows worldwide in 1994, accounting for some 40 per cent of all flows into developing economies. But, even if China is excluded, FDI flows into developing countries registered an increase of 11 per cent in 1994 (from \$46 billion to \$51 billion). The year 1995 may well register another increase, both for China and all other developing countries as a group, to reach an estimated total of \$90 billion.

A notable aspect of the increase in FDI inflows into the developing world is that, since 1990, these flows have become the largest and fastest growing single component of external finance for this group of countries, taken together. More specifically, FDI flows accounted for seven per cent of domestic fixed capital formation in 1993 and have been larger than official development assistance flows since 1992 for the developing world as a whole. They were also larger than other private flows in some years during the late 1980s and early 1990s. Indeed, for 30 developing economies and four economies in Central and Eastern Europe, FDI inflows in 1993 represented the single largest component of all net external resource flows. The number increases to 81 developing economies and seven economies in Central and Eastern Europe, if only private net external resource flows are considered. The dominant role of FDI flows is not only important because of the productive assets associated with them, but also because of their greater resilience, as compared with portfolio equity investments, to adverse economic shocks and currency depreciations, reflecting the fundamental differences in motivation between these two types of external finance.

The success of the developing countries in attracting FDI lies in an investment climate characterized by growing markets and increasingly favourable regulatory frameworks coupled with the general trend for firms from all countries to invest abroad in order to remain competitive internationally. Naturally, there are significant inter- and intra-regional differences (see table 5):

- Driven by its relatively fast economic growth, the *Asia-Pacific* region as a whole remains the most important host region among developing countries, with some \$61 billion in inflows in 1994. That region now accounts for more than 70 per cent of the total developing-country FDI stock. Within Asia, countries have performed unevenly in attracting FDI: China and East and South-East Asia are at the forefront, while the Pacific island economies and some of the South Asian countries are still lagging behind. China remains the largest recipient in Asia, even if allowance is made for the fact that an overvaluation of FDI inflows may have inflated the magnitude of inflows by one-quarter. Moreover, the country is now becoming more cautious in
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terms of appraising FDI projects and more careful in terms of monitoring the fulfillment of contractual FDI commitments. At the same time, China is more selective in terms of the type of FDI that it seeks, and it encourages a greater geographic dispersion of these investments within China.

The success of China in attracting FDI flows has raised the issue of the extent to which this accomplishment has been achieved at the expense of other countries in the region. With the possible exception of export-oriented FDI, there is no evidence suggesting that this has indeed been the case. Profitable opportunities for market-seeking investments abound in other countries in Asia, notably, India, Indonesia, Malaysia and Thailand; such investments are unlikely to have shifted among countries with the emergence of China. Similarly, resource-seeking FDI is location-bound and not likely to be mobile. Hence, only a small part of the FDI attracted by China is likely to have relocated there from other economies in Asia in response to cost and productivity considerations. Indeed, FDI flows into ASEAN have started to grow again since 1994. And India is beginning to attract significant amounts of investment and is likely to attract considerably more if it sustains its liberalization policy. West Asia is still neither a major recipient nor source of FDI, although the prospective success of the Arab-Israeli peace process could boost economic growth and open up new investment opportunities.

- Inward FDI growth in *Latin America and the Caribbean* appears fragile, depending very much on privatization programmes. Flows into Latin America and the Caribbean increased only marginally in 1994, to some \$20 billion, largely shaped by privatization programmes open to foreign investors. The region's resumed economic growth and liberalization of trade and investment regimes are factors that improve prospects for sustained FDI inflows. Experiences across countries vary considerably. Argentina, which was the largest recipient among Latin American countries in 1993 with some \$6 billion in inflows, largely as a result of the implementation of its privatization programme, experienced a sharp decline in 1994 (to some \$1.2 billion). Other countries, notably Peru, with some \$2.7 billion (also very much related to privatization), and Chile, with some \$1.8 billion, experienced a sharp upswing in FDI inflows in 1994. The implementation of MERCOSUR and the possible enlargement of NAFTA may become important factors for the configuration of FDI inflows within the region.

Box 1. The response of TNCs to the Mexican peso crisis

The peso crisis began on 18 November 1994, when shaky investor confidence resulted in a \$1.7 billion one-day run on the peso. On 20 December, the Government devalued the peso by 13 per cent and implemented a series of measures to stabilize the Mexican economy, including the negotiation of a \$38 billion rescue package with the United States and the International Monetary Fund.

The opening of the Mexican economy in the 1980s, and subsequent commitments to further liberalization in the North American Free Trade Agreement, led to its rapid international integration at the level of production geared to the local markets. While the increased amounts of short-term capital inflows that accompanied Mexico's liberalization constituted one of the underlying reasons for the crisis (with volatile mutual funds supplanting commercial banks and international institutions as principal sources of finance), the deeper integration of the economy at the level of production mitigated the adverse impact of the crisis. The automobile industry, which has been particularly active in developing regional production networks, is an example to show that deeper integration can stand such a devaluation crisis.

—The crisis dramatically reduced domestic demand, which in turn has caused TNCs to reduce production. For example, several automotive producers have either stopped or reduced production: Volkswagen initiated plant shutdowns for two weeks each month beginning April; Nissan shut down its operations for two weeks in April and all of May and June; and Ford shut down its production in June. The "Big Five" produced almost 70 per cent fewer vehicles for the domestic market in the first six months of 1995 than they did in 1994.

—Conversely, production destined for international markets has benefited from the crisis. The share of output of the Big Five destined for export markets increased from 55 per cent in the first six months of 1994 to 82 per cent in the same period in 1995 (accompanying table). More significantly, the absolute volume of output destined for export markets increased from 244,000 to 298,000 units over the same periods, an increase of 22 per cent.

In contrast with the crisis of 1981 (when international integration at the level of production was minimal and Mexico's external economic ties were largely limited to financial commitments), the crisis of 1994/95 will probably not have as adverse an impact upon the economy, partly because deeper levels of international integration at the level of production have allowed TNCs in Mexico, first, to become internationally competitive, and second, to compensate for declining domestic sales through exports. For example, whereas automotive production declined by over 30 per cent between 1982 (at the outset of the debt crisis) and 1983, estimates for 1995 are for a decrease in production of only 10 per cent over 1994 levels. Thus, while the impact of the financial crisis on the economy, including the reduction in output and employment, should not be underestimated, FDI and TNC exports have probably helped minimize the cost of the crisis to the economy.

Furthermore, the combination of falling asset prices, increased competitiveness of Mexican exports resulting from the devaluation, and the return of relative stability to the Mexican economy could combine to increase FDI by export-oriented TNCs, including their suppliers. To the extent that TNCs continue to view Mexico as an attractive location for their foreign affiliates, the stability as a host country that integration at the level of production contributed during the crisis will be further enhanced.

The devaluation of the Mexican peso at the end of 1994 and the beginning of 1995 has had a mixed effect on FDI flows (see box 1). On the one hand, it has created new opportunities for export-oriented investment and lowered the cost in foreign currency of purchasing domestic assets; this is likely to boost FDI in Mexico by United States and Canadian TNCs seeking to establish or deepen regional production networks in response to NAFTA, and by non-NAFTA TNCs interested in penetrating the NAFTA market. On the negative side, however, domestic market-seeking investments are suffering from the recession. It is still too early to assess how these two sets of effects will work themselves out, although it is clear that FDI flows have been less affected by the crisis than portfolio flows. Although FDI inflows to Mexico during the first half of 1995 fell to an estimated \$2.6 billion from the level reached in the first half of 1994 (\$3.5 billion)—a drop that can be partly explained by the peso crisis and partly by a post-NAFTA effect (similar to the initial rise and the subsequent drop of FDI flows into the European Union after the implementation of the Single Market programme)—they nevertheless exceeded the levels reached in the first six months of 1992 and 1993 (\$2.2 billion and \$2.1 billion, respectively).

In contrast to Mexico, where rapid FDI-led integration with North America since the mid-1980s had preceded the NAFTA negotiations, the other countries in Latin America and the Caribbean are advancing at a much slower pace as far as such integration is concerned. There are, however, some recent indications that this process is gaining momentum, especially in the case of Chile. Given the already substantial FDI stock in Latin America and the Caribbean accounted for by United States and Canadian TNCs, and the intra-firm trade flows associated with it, the region holds considerable potential for becoming more closely linked to the North American production system and benefiting from the growth it stimulates.

- *Africa* remains marginalized. The FDI boom in developing countries has largely bypassed that continent. Sub-Saharan Africa received FDI flows worth \$1.8 billion in 1994 (the size of flows to New Zealand), while North Africa received \$1.3 billion (comparable to flows to Portugal). Most FDI in Africa continues to be concentrated in a small number of countries endowed with natural resources, especially oil.

Table 6. The top 25 TNCs

Ranking US\$					
Rank	Foreign assets ¹	Index ²	Company	Home country	Industry ³
1	26		Royal Dutch Shell ^c	Netherlands/ United Kingdom	Petroleum refining
2	21		Exxon	United States	Petroleum refining
3	35		IBM	United States	Computers
4	85		General Motors	United States	Motor vehicles and parts
5	95		General Electric	United States	Electronics
6	74		Toyota	Japan	Motor vehicles and parts
7	66		Ford	United States	Motor vehicles and parts
8	87		Hitachi	Japan	Electronics
9	25		Sony ^d	Japan	Electronics
10	68		Mitsubishi	Japan	Trading
11	1		Nestlé	Switzerland	Food
12	32		Mobil	United States	Petroleum refining
13	69		Nissan Motor	Japan	Motor vehicles and parts
14	59		Matsushita Electric	Japan	Electronics
15	46		Elf Aquitaine	France	Petroleum refining
16	5		Asea Brown Boveri ^d	Switzerland	Electrical equipment
17	7		Philips Electronics	Netherlands	Electronics
18	14		British Petroleum	United Kingdom	Petroleum
19	29		Hanson	United Kingdom	Building materials
20	73		Siemens	Germany	Electronics
21	28		Unilever ^d	Netherlands/ United Kingdom	Food
22	89		Mitsui	Japan	Trading
23	60		Alcatel Alsthom	France	Electronics
24	55		Du Pont	United States	Chemicals
25	19		B.A.T. Industries	United Kingdom	Tobacco

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Industry classification for companies follows that in the "Fortune Global 500" list in *Fortune*, 25 July 1994, and the "Fortune Global Service 500" list in *Fortune*, 22 August 1994. *Fortune* classifies companies according to the industry or services that represent the greatest volume of their sales; industry groups are based on categories established by the United States Office of Management and Budget. Several companies are, however, highly diversified. These companies include Asea Brown Boveri, GE, Grand Metropolitan, Hanson, Sandoz, Total and Vebea.

^b The index of transnationality is calculated as the average of foreign assets to total assets, of foreign sales to total sales and of foreign employment to total employment.

anked by foreign assets, 1993

Assets		Sales		Employment		Index ^b
Foreign	Total	Foreign	Total	Foreign	Total	(Per-centage)
(Billions of dollars)				(Number of employees)		
69.4	100.8	45.5	95.2	85 000	117 000	63.1
47.4	84.1	87.7	111.2	57 000	91 000	66.0
44.1	81.1	37.0	64.1	130 655	256 207	54.4
36.9	167.4	28.6	133.6	270 000	756 000	26.4
31.6	251.5	11.2	60.5	59 000	222 000	19.2
d	97.6	41.1	94.6	23 824	110 534	32.3
30.9	198.9	36.0	108.5	180 904	332 700	34.4
d	86.7	16.5	71.8	..	330 637	23.8
d	41.5	26.3	36.3	70 000	130 000	63.2
d	85.2	65.3	168.4	..	157 900	34.2
24.8	30.6	38.4	39.2	203 100	209 800	92.0
23.1	40.7	42.5	63.5	28 600	61 900	56.6
d	68.3	24.2	56.5	34 464	143 916	33.4
22.5	77.2	31.7	64.3	98 639	254 059	39.1
22.4	45.5	14.9	35.5	44 603	94 253	46.0
21.5	24.9	24.7	28.3	..	206 490	89.1
d	23.8	26.6	30.3	200 000	244 400	84.9
19.0	28.1	39.2	52.4	62 600	84 500	72.2
19.0	37.9	7.6	15.4	53 000	71 000	58.1
d	58.4	13.8	50.0	153 000	403 800	32.5
18.0	24.7	16.1	40.0	187 000	294 000	58.8
d	72.5	49.8	172.9	..	11 528	27.3
d	44.2	5.0	26.5	115 500	196 500	38.6
16.4	37.1	16.8	37.1	36 400	114 000	40.5
15.7	50.5	25.3	33.2	175 500	190 308	66.4

^c Foreign sales figures are outside Europe whereas foreign employment figures are outside the United Kingdom and the Netherlands.

^d Data on foreign assets are either suppressed to avoid the disclosure or they are not available. In the case of non-availability, they are estimated on the basis of the ratio of foreign to total employment, foreign to total sales and similar ratios.

^e Data on foreign employment are suppressed to avoid the disclosure.

^f The company's business includes electric power generation, transmission and distribution, and rail transportation. The company was formed by the merger of a Swedish and a Swiss firm. Data on foreign sales and assets are outside Switzerland.

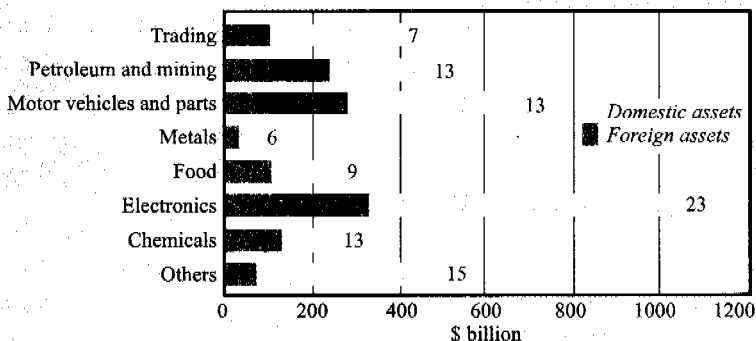
^g Foreign sales, assets and employment figures are outside the United Kingdom and the Netherlands.

In spite of these small investment flows, it is not correct to perceive Africa as a region with poor investment opportunities. The heterogeneity of the region disguises significant differences in FDI performance and potential. It includes a number of countries that do well in terms of attracting FDI, even when compared to the average for all developing countries. Furthermore, key determinants of FDI location, such as the level of development, market size and market growth, suggest that unexploited FDI potential exists in a number of countries. Indeed, an analysis based on the performance of United States affiliates since the early 1980s reveals that profitability in Africa is higher than in certain other developing country areas. Most governments have made considerable progress in undertaking far-reaching domestic policy reforms and improving substantially their regulatory frameworks, especially regarding FDI. But more needs to be done to tap the existing FDI potential. Well-implemented privatization programmes, for example, could be of help here, and in some countries (e.g., Egypt and Morocco) progress is being made in this respect. This underlines further the need to differentiate when considering investment opportunities in Africa.

***... with the countries of Central and Eastern Europe
being drawn into the international production system as well***

The countries of Central and Eastern Europe are not yet major players as regards FDI inflows and outflows. In 1994, total inflows into the region, at \$6 billion, were lower than inflows to Singapore alone, and the region's cumulative stock (of some \$20 billion) was comparable to that of Argentina. Furthermore, inflows remain concentrated in a handful of countries (the Czech Republic, Hungary and Poland) in which privatizations have been an important factor. Elsewhere, FDI flows are lagging behind recovery. Foreign affiliates contribute to the process of transformation, especially in terms of their above-average performance as regards productivity and exports, the provision of specialized services and the stimulation of competition. With more countries creating functioning markets and emerging from the transitional recession, they are likely to attract more FDI. However, care will need to be taken that such factors as excessive expectations, the negative side-effects of privatization and restructuring (such as lay-offs) and sovereignty sensibilities do not lead to a backlash against FDI.

Figure 2. The top 100 TNCs: assets by industry, 1993
(Billions of dollars and number of companies)



Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

As the world's top 100 TNCs are becoming more transnationalized ...

About one-third of the total assets of the world's 100 largest TNCs, as ranked by UNCTAD on the basis of the value of their foreign assets, are located abroad. It is estimated that these TNCs account for one-sixth of world outward FDI stock. Royal Dutch Shell, the biggest of these firms, operates in petroleum extraction and processing activities, but firms in new information industries, such as IBM and General Electric, have been moving up the ladder. Ranking firms by foreign assets is important as it captures the absolute impact that individual TNCs can have on host countries (see table 6 and figure 2). But it does not say anything about either the extent of their transnationalization or about the strategies firms pursue, and especially the role they assign to the various units (including foreign affiliates) that comprise a transnational corporate system. Arranging the top 100 TNCs on the basis of UNCTAD's new composite index of transnationality (which takes into account the respective shares of foreign assets, foreign sales and foreign employment in the corresponding totals but does not, of course, capture corporate strategies and the role of the individual units comprising a TNC system) yields a ranking that gives Nestlé the top position, followed by Holderbank and Thompson Corporation. According to UNCTAD's transnationality index, 40 out of the top 100 TNCs have more than half of their activities

Table 7. The top 25 TNCs based in developing

Ranking by:				
Foreign assets	Index ^a	Company	Home country	Industry ^b
1	8	Cemex S.A.	Mexico	Cement
2	10	Hutchison Whampoa Limited	Hong Kong	Diversified
3	17	Daewoo Group	Korea, Republic of ^b	Electronics
4	40	Samsung Group	Korea, Republic of ^b	Electronics
5	6	Jardine Matheson Holdings Ltd.	Hong Kong	Diversified
6	45	Petroleo Brasileiro S/A - Petrobras	Brazil	Petroleum refining
7	36	Hyundai Motor Co.	Korea, Republic of ^b	Motor vehicles & parts
8	16	Grupo Televisa S.A. de C.V.	Mexico	Media
9	15	Souza Cruz S.A.	Brazil	Tobacco
10	22	Genting Berhad	Malaysia	Diversified
11	4	Dong Ah Construction Industrial Co.	Korea, Republic of ^b	Construction
12	19	Taiwan Co. Ltd.	Taiwan Province of China	Electronics
13	37	New World Development Co. Ltd.	Hong Kong	Diversified
14	25	Keppel Corporation Ltd.	Singapore	Diversified
15	28	LG Electronics Inc. ^a	Korea, Republic of ^b	Electronics
16	5	Acer	Taiwan Province of China	Electronics
17	12	Sime Darby Berhad	Malaysia	Food
18	39	China Steel Corporation	Taiwan Province of China	Metals
19	54	CITIC Pacific Ltd. ^a	Hong Kong	Diversified
20	32	San Miguel Corporation	Philippines	Food
21	13	The Hong Kong and Shanghai Hotels, Ltd.	Hong Kong	Hotel
22	31	Formosa Plastic	Taiwan Province of China	Chemicals
23	47	Yukong Ltd.	Korea, Republic of ^b	Petroleum refining
24	42	Empresas Ica Sociedad Controladora S.A.	Mexico	Construction
25	36	Wing On International (Holdings) Ltd.	Hong Kong	Diversified

Source: UNCTAD, Division on Transnational Corporations and Investment, based on responses to questionnaires and annual reports, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a The index of transnationality is calculated as the average of foreign assets to total assets, of foreign sales to total sales and of foreign employment to total employment.

^b The accounting standards of the Republic of Korea do not require the publication of consolidated financial statements including both domestic and foreign affiliates. The figures provided here are estimates

conomies, ranked by foreign assets, 1993

Assets		Sales		Employment		Index ^b
Foreign	Total	Foreign	Total	Foreign	Total	(Per-centage)
(Billions of dollars)				(Number of employees)		
3 603	8 018	949	2 897	5 171	18 395	35.3
2 743	8 375	815	3 202	9 046	22 489	32.8
.. ^c	44 352	.. ^d	30 893	64 000	156 000	26.6
.. ^c	50 692	.. ^d	51 531	..	191 303	8.0
.. ^c	9 799	5 510	8 424	..	220 000	38.8
.. ^c	20 178	1 037	15 263	17	51 228	4.9
1 105	8 983	1 439	10 544	979	42 306	9.4
948	3 442	208	1 925	..	23 000	27.5
770	1 040	262	3 721	..	12 659	27.5
752	1 541	101	744	..	30 000	21.9
706	2 935	858	1 895	6 366	12 097	40.6
703	3 836	806	3 121	8 564	27 254	25.2
624	6 944	316	1 721	..	28 000	9.3
565	6 948	134	946	2 500	10 707	15.2
485	7 679	1 105	7 565	..	58 800	13.0
467	1 909	1 116	2 010	2 579	6 348	40.2
419	2 829	1 493	2 738	6 500	30 000	30.3
.. ^c	6 215	476	2 355	6	9 601	8.8
366	3 438	599	1 386	1 455	4 500	28.7
359	1 984	198	2 234	2 386	32 832	11.4
339	2 019	43	217	3 048	5 921	29.3
327	1 906	233	1 491	60	3 645	11.5
.. ^c	6 412	300	6 901	4	5 898	3.1
316	3 578	90	1 949	1 569	36 655	5.9
275	1 304	43	399	156	3 175	12.3

consolidated statements as provided by the companies in response to a survey by UNCTAD, Division on International Corporations and Investment. Depending on the availability of the data on foreign components, the data for business group totals are used.

^cData on foreign assets are suppressed to avoid the disclosure or not available. In the case of non-availability of the data, they are estimated on the basis of other foreign component ratios.

abroad, with the average share for the group as a whole being 41 per cent. The index also shows important differences by industry, with chemicals (61 per cent) and food (53 per cent) scoring highest on the transnationality index, and trading the lowest (30 per cent). The index also reveals—not surprisingly—that TNCs from small economies such as Belgium and Switzerland have a strikingly larger proportion of their activities abroad than TNCs from large countries such as Japan or the United States. But even in the case of United States firms among the top 100 TNCs, the transnationalization index reaches an average of 34 per cent.

The universe of TNCs comprises not only large companies. Increasingly, it also includes small and medium-sized firms (i.e., firms with less than 500 employees in their home countries), each of which contributes to the integration of the world economy. UNCTAD's sample of 50 small and medium-sized enterprises from developed countries suggests that these firms can be quite international. Their transnationality index is 27 per cent, with 13 of them scoring over 40 per cent (6 of which even exceeded 50 per cent). In this sample, firms tended to be more transnationalized in terms of employment (44 per cent) than in terms of assets (28 per cent) and sales (26 per cent), pointing to the larger importance of labour-intensive activities for smaller firms—and hence the benefits of seeking out low labour costs abroad.

***... more and more firms from developing countries
are entering the ranks of outward investors***

The globalization process extends, of course, to firms from the developing world as well. While small in the global context, FDI outflows from developing countries as a share of world flows have doubled in importance from 5 per cent in 1980-1984 to 10 per cent in 1990-1994. In 1994, in fact, 15 per cent (or \$33 billion) of world FDI outflows originated in developing countries. Most investments originate from a small number of newly industrializing economies in Asia (and Latin America). Although a growing share is directed to developed countries, most outflows take place in a regional context within Asia and Latin America. Regional flows are increasingly important, especially in Asia: in nine important Asian developing economies, the share in total inward FDI stock accounted for by the same economies rose from 25 per cent in 1980 to 37 per cent in 1993.

Not surprisingly, TNCs from Asia dominate (with 32 entries) the first-ever list compiled of the 50 largest TNCs from developing countries (ranked

by the size of their foreign assets), with the remainder being based in Latin America (see table 7). Asian firms also capture the top seven ranking in terms of transnationality, which reflects the fact that Asian TNCs as a group are more transnationalized (16 per cent) than Latin American TNCs (12 per cent). Although five firms have more than 40 per cent of their activities abroad, TNCs from developing countries as a group, scoring 13 per cent on the transnationality index, are considerably less transnationalized than their developed-country counterparts—an indication that the transnationalization process for these firms is only just beginning. Indicative of this is also the fact that the foreign assets of the leading developing country TNC (Cemex S.A. from Mexico) are barely as large as those of the last firm on the list of the world's top 100 TNCs (R.J.R. Nabisco from the United States).

Foreign direct investment, firm competitiveness and country performance

In today's increasingly open and competitive global economic environment, the performance of countries—best measured in terms of per capita income (as a proxy for welfare) and growth—depends significantly on the links they establish with the rest of the world economy. Key among these are linkages generated through firms that undertake international production, along with flows of trade, technology and capital. Foreign direct investment and non-equity modes of participation by TNCs in international production create opportunities for countries to strengthen their capacities to produce, to reach and expand the markets for their products, and to adapt their economies to changing conditions. Part Two of the *World Investment Report 1995* looks at key aspects of the relationship between FDI and the competitiveness of firms, and the implications of that relationship for the economic performance of host and home economies in which those firms operate.

International competition in a liberalizing and increasingly integrated international economy poses new challenges for TNCs ...

An increasing number of firms in many countries are now subject to integrated corporate strategies that span more than one country and involve not only headquarters but also domestic and foreign affiliates: they constitute parts of transnational corporate systems. Firms comprising these systems are becoming increasingly specialized with product mandates being given to individual firms and a tendency to locate discrete parts of the value-

added chain in any part of the world where it yields the maximum benefit to the system as a whole. The intra-firm international division of the production process has become a necessary—if not imperative—element for firms that wish to compete in the international arena. Given the liberalization of trade, FDI and technology flows, it becomes increasingly difficult for firms to withdraw behind various types of barriers into the safe havens of their home markets. Competition is everywhere. All markets are increasingly being contested by a whole range of international economic transactions. Firms wishing to remain competitive need to maximize their efficiency, drawing on three principal sources: a portfolio of proprietary (or firm-specific) assets; a portfolio of locational assets; and the managerial expertise to exploit these portfolios, with a view towards converting global inputs into outputs for global markets as profitably as possible.

... with significant implications for countries' economic performance

The forces driving TNC systems to enhance their competitiveness have important implications for countries' economic performance. To the extent that these firms bring with them tangible or intangible resources (including capital, research and development, technology and organizational and managerial practices) that increase the capacity of a country to produce a greater quantity or improved quality of goods and services, the performance of the country will be affected positively. Positive effects can also result from the expansion of market access that TNCs can bring about, directly or indirectly, as a result of intra-firm transactions or a greater ability to reach national and international markets, as well as from economic restructuring fostered by TNCs. To the extent that governments make it difficult for firms to develop fully their three principal sources of efficiency, they handicap them in international competition, ultimately harming global welfare and, under certain conditions, their own countries' welfare as well.

Transnational corporations not only create assets and provide privileged access for the individual firms comprising their corporate systems, ...

Capital, innovation, technology, skilled human resources and efficient organizational and managerial practices are all important for the competitiveness of firms and, given an appropriate macroeconomic environment, can help to improve the economic performance of the countries that are host

to them. Transnational corporate systems generate these resources and they disseminate them throughout their cross-border corporate networks in the normal course of their business operations. In fact, a fair share of the worldwide availability of these resources can be attributed to the activities of TNCs:

- *Capital.* Corporate systems generate savings in the form of retained profits. Estimates based on United States data suggest that the total profits generated by foreign affiliates worldwide were some \$175 billion in 1994. The part of those profits that is reinvested is significant—in the case of the United States, it amounts to over half. The remainder is repatriated for distribution to shareholders. In other words, TNC systems also serve as conduits for the circulation of capital (and related payments) among their units via equity flows, intra-company loans and repatriated earnings. Capital generated internally can be deployed anywhere in a TNC system, offering advantages in terms of flexibility in project financing and minimizing transaction costs.
- *Innovatory capabilities, technology and skills.* Corporate systems are an important source of innovation, generating technologies—and, in the process, technological capabilities and skills—that are key to improving a company's competitiveness. Some four-fifths of global civilian research and development is undertaken within TNC systems. The United States, the largest outward direct investor, saw a doubling of research-and-development expenditures by TNC parent firms and an increase by three-and-a-half times in such expenditures by foreign affiliates during 1982-1992. Patent data also suggest that the world's largest industrial firms, most of which are TNCs, account for around half of the world's commercial inventions. And collaborative strategic alliances for the development of new technologies are on the rise.

An increasing share of research and development undertaken by TNCs is accounted for by foreign affiliates, but different indicators give different pictures of the magnitudes involved and the extent to which this trend has gained in importance in recent years. For United States TNCs, the share of research and development performed by (majority-owned) foreign affiliates increased from 9 per cent in 1982 to 12 per cent in 1992 (measured by expenditures). Patent data not only confirm this trend but also suggest that the share of research and development undertaken by foreign affiliates of TNCs from a number of countries may be even higher. While research and development that takes place outside the home countries of TNCs is located largely in developed

economies, increasingly, it is also being located in developing economies and economies in transition. Principal among the forces behind this trend are competitive pressures driving firms to tap into pools of knowledge, expertise and skills wherever they are located, capitalizing on the transnational nature of TNCs. The availability of the requisite talent and capabilities in a number of developing and transitional economies at a much lower cost, combined with the liberalization of regulatory frameworks and (for some industries particularly important) improvements in the protection of intellectual property rights have fostered this trend. There are, however, retarding forces, especially a “stickiness” resulting from an established pattern of locating research at home. But the self-interest logic of a TNC system suggests that research and development (like manufacturing before it) will increasingly be performed where this can be done most efficiently—and that should mean more and more geographical dispersion within TNC systems.

Beyond being conduits for the dissemination of innovatory capabilities, TNC systems offer privileged access to technology for their member units. An estimated four-fifths of global cross-border flows of royalties and fees (a proxy for technology flows) take place within TNC systems. Integrated research-and-development networks with cross-fertilization through two-way flows of information and skills between parent firms and foreign affiliates are, however, prevalent mainly in the developed world where conditions for their operations are more likely to exist. For the majority of developing countries, as well as many developed economies, it is usually a transfer of production technology that takes place, from the parent firm to its foreign affiliates.

- *Organizational and managerial practices.* Transnational corporations are also an important source of organizational innovation and the generation of new and more efficient managerial practices. Drawing upon the ideas of creative individuals within their own corporate sphere and upon knowledge generated outside—e.g., in business schools and management-consulting firms—firms constantly seek to modernize their organizational and managerial practices, in order to gain firm-specific advantages and as a way to improve the efficiency of their operations. The transnational nature of their organizations creates particular demands for sophisticated transnational and cross-cultural management and organization. The very transnational nature of the

corporate system facilitates this, as any part of the system is a potential source of improvements. Moreover, many TNCs typically operate in the forefront of technology and constantly need new practices to respond to the changes in production methods that this requires. The TNC system provides parent firms and foreign affiliates privileged access to any new organizational and managerial practices developed elsewhere in the system, although the actual dissemination of such practices depends upon the characteristics of the individual TNC system concerned.

The role that TNCs have in the generation of these competitiveness-enhancing resources gives these firms a leading edge in the globalizing world economy. And, being part of a TNC system may be necessary for obtaining access to some of these resources.

... but can also provide indigenous firms linked to their systems with advantageous access to the resources available in TNC systems, ...

While the units belonging to TNC systems have *privileged* access to the assets available through these systems, firms linked to them can have *advantageous access* to the same assets. This is particularly apparent—and important—in the area of technology. For example, collaborative agreements between TNC systems and indigenous firms can enhance the competitiveness of all the firms involved, by taking advantage of technological or knowledge complementarities. Similar arrangements may be made between TNC systems and local research institutions. Some foreign affiliates, for instance, sponsor research and development carried out by indigenous firms or institutions. As far as production technology is concerned, backward linkages (including through non-equity arrangements) with TNCs are an important means of acquisition of new or advanced technology by indigenous producers. Such arrangements can contribute substantially to competitiveness and the creation of national technological capabilities, as the experience in several East Asian countries attests.

Even if the resources available in TNC systems are not transferred through linkages, international production can enhance the efficiency of indigenous firms through spillovers, externalities and competition effects—provided that the gap between TNCs and domestic enterprises is not so large that the latter are overwhelmed by the former. For instance, FDI can act as a catalyst for investment by other (including domestic) firms in a host country by signalling investment opportunities. It can also induce technological

change and productivity improvements—through demonstration effects, turnover and hiring of former TNC employees, and increased competition. Key organizational and managerial practices are also spread as indigenous firms imitate the practices of foreign affiliates that compete with them or that they consider better managed. The very presence of foreign affiliates is often sufficient to act as a catalyst for change in management methods, as seems to have been the case with the widespread adoption of quality-control practices. The adoption by many Brazilian companies of ISO standards, viewed as a mark of quality and international competitiveness, is a case in point.

... all of which can contribute to enhancing the performance of host and home countries in which international production is located

It is an advantage of FDI that it provides a *package* of wealth-creating assets that become available directly for use in production activities and hence can enhance the economic performance of countries. Although the wealth-creating assets that are part and parcel of FDI may be acquired separately (provided that countries have the ability to do so), it is precisely because it comes as a package that FDI is increasingly welcomed by all countries.

- *Capital.* For host economies, inward FDI that is greenfield—i.e., that establishes new facilities—adds to the capital stock and increases output and employment. Although FDI flows form a relatively modest proportion of gross domestic capital formation, not exceeding 10 per cent in most host countries, FDI capital is assuming increasing importance for developing countries. The contribution of FDI made through acquisitions or privatizations (rather than the creation of new enterprises)—by far the most common form of FDI in developed countries—is not as obvious. But it, too, may benefit the host economy if the domestic firms that are taken over become more competitive or would have closed down otherwise. Both kinds of FDI can induce a further expansion of the host country capital stock through sequential investments that FDI often triggers, and through associated FDI typically undertaken by firms that are suppliers or distributors for foreign investors.

There seems, however, to be an asymmetry between inward and outward FDI, considered separately, as regards their impact on the capital

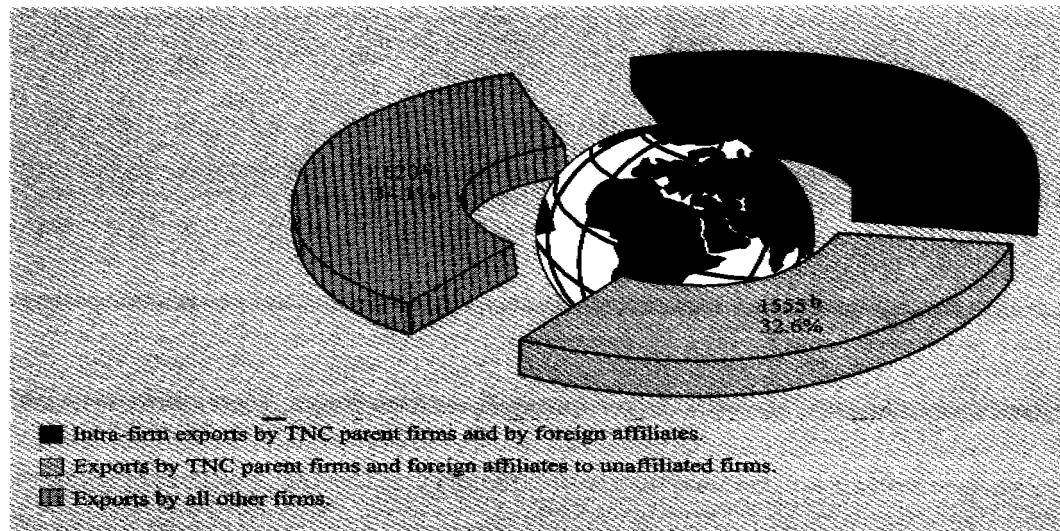
Table 8. Transfer of selected organizational and managerial practices by Japanese TNCs to their affiliates in Western Europe, by industry group, 1992

(Percentage)

Type of practice	All manufacturing	Assembling and processing industries	Parts manufacturing industries	Chemical products industries	Material purchasing industries	Others	Memorandum: design centres and R & D bases
Use of open-space offices	65	75	74	53	47	54	71
Quality-control circles	37	42	46	28	38	19	8
Morning and other regular meetings	35	42	45	15	25	39	17
Internal promotion system	22	32	21	18	17	15	8
Just-in-time system	14	17	21	5	14	8	8
Life-long employment	11	11	8	10	10	15	21
<i>Memorandum:</i>							
Number of affiliates surveyed	406	133	85	61	77	26	24

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

Figure 3. TNCs in world trade: exports of goods and non-factor services, 1993
(Billions of dollars and percentage)



- Intra-firm exports by TNC parent firms and by foreign affiliates.
- ▨ Exports by TNC parent firms and foreign affiliates to unaffiliated firms.
- Exports by all other firms.

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Estimated as in table 9.

^b Estimated on the basis of the assumption based on United States data that arm's-length trade by TNCs accounts for 32.6 per cent of world trade.

^c Derived as the difference between total world exports and estimated exports by TNCs.

Table 9. Forms of international transactions in the world, 1984-1993

(Billions of dollars)

Year	Sales of foreign affiliates ^a	Sales associated with licensing with unaffiliated firms ^b	Intra-firm exports of goods and non-factor services ^c	Exports of goods and non-factor services	Exports of goods and non-factor services excluding estimates of intra-firm exports
1984	2 581	30	816	2 449	1 632
1985	2 400	40	734	2 202	1 468
1986	2 675	50	819	2 458	1 638
1987	3 492	60	971	2 912	1 941
1988	4 090	80	1 109	3 327	2 218
1989	4 640	80	1 202	3 606	2 404
1990	5 089	110	1 399	4 196	2 797
1991	5 373	120	1 482	4 446	2 964
1992	5 235	120	1 646	4 939	3 293
1993	1 587	4 762	3 175

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Estimated by extrapolating the worldwide sales of foreign affiliates of TNCs from France, Germany, Italy, Japan and the United States on the basis of the relative importance of these countries in worldwide outward FDI stock. However, the data on sales of foreign affiliates for France are included only after 1988 because of unavailability of the data prior to that year, For Italy the sales data are included only in 1986, 1988, 1990 and 1992.

^b The share for unaffiliated firms' receipts of royalties and fees worldwide is based on the share of unaffiliated firms in the total receipts of royalties and fees for the United States. Sales are estimated using the assumption that royalties and fees, as a proxy for licensing, are 7.5 per cent of total sales associated with them.

^c Estimated on the basis of the assumption, based on United States data, that intra-firm trade accounts for about one-third of total trade. Some intra-firm exports may be included in the sales of foreign affiliates.

stock of countries. A key question as regards outward FDI is whether the investment takes place at the expense of domestic investment in the home country. If the build-up of foreign affiliates' assets is financed through cross-border flows of capital, and if raising this capital involves the crowding-out of home-country investments, then outward FDI would affect domestic capital formation adversely. There seems to be little evidence, however—at least for major home countries—that such crowding-out takes place. On the other hand, the indirect effects on home-country investment from the remittance of profits or increased demand for exports must also be taken into account. Moreover, domestic factors of production may be released for more produc-

Box 2. TNCs, market access and competitiveness: the experience of China

In the mid-1990s, China has proved that the strategy of harnessing FDI for a more outward looking development pattern is not restricted to small developing countries. From the perspective of TNCs, market access has been the *leitmotiv* for FDI in China (see chapter II). At the same time, China has attracted significant amounts of FDI into labour-intensive manufacturing for export. Foreign affiliates have become major vehicles for China's trade, and close to some 100,000 foreign affiliates and other TNC-related enterprises participated directly in it in 1994. Total trade by these firms reached \$87.8 billion in 1994 (accompanying table). On the export side, TNCs have played a leading role in the expansion of export-oriented processing activities, in particular in the special economic zones. Processing trade—trade under the special customs regime for imports for and exports after processing—has been the most dynamic component of China's foreign trade: exports (after processing) reached 47 per cent of total exports in 1994. Foreign affiliates and other TNC-related firms handled more than half of these transactions, and their share appears to be growing.

Value of international transactions of foreign affiliates
and non-equity joint ventures in China, 1994
(Billions of dollars)

Type of firm	Exports (except processing)	Imports (except processing)	Exports after processing	Imports for processing	Total exports	Total imports
Fully foreign-owned	0.6	4.7	10.7	9.2	11.3	13.9
Equity joint venture	3.2	15.8	14.9	14.1	18.1	29.9
Non-equity joint venture	0.4	4.4	5.0	4.8	5.4	9.2
Total, above	4.2	24.9	30.6	28.1	34.8	53.0
Total, all firms	64.0	68.0	57.0	47.6	121.0	115.0

NOTE.—Exports and imports under the processing customs regime.

The leading export items under processing trade are consumer electronics, textiles and garments and footwear. Typically, processing exports comprise goods in which the activities in China relate to labour-intensive production, whereas product development and international marketing is done elsewhere by TNCs. Accordingly, the large value of processing trade must be seen in conjunction with the net value of exports. Net exports (exports minus imports) were 16 per cent of the export contract value under processing trade; for TNCs, the corresponding value was lower—only 9 per cent. Interestingly, this rate was twice as high for fully foreign-owned firms (12 per cent) as for equity joint-ventures (6 per cent). The contribution of foreign affiliates to other (non-processing) exports is relatively small and has been declining, from 8 per cent in 1993 to 6 per cent in 1994 and 4 per cent in March 1995.

Foreign affiliates have also become a major vehicle for imports into China. In 1994, over a third of China's total imports for the domestic market (imports excluding processing trade) were channelled through foreign affiliates and non-equity joint ventures (table 3). The bulk of these imports consisted of investment goods: initial

investments of foreign affiliates accounted for 83 per cent of all TNC imports for the domestic market in 1994. Imports of machinery represented more than two-thirds of all TNC imports for the domestic market. In fact, TNCs were responsible for 55 per cent of China's machinery imports in 1994. This brings out clearly the contribution of TNCs to the modernization of China's production facilities as well as their participation in the investment boom and growth of domestic market to which as much as two-fifths of China's GDP has been dedicated.

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

tive use when outward FDI takes place, improving long-term economic performance through restructuring.

- *Innovatory capabilities, technology and skills.* Given the dominant role of TNCs in the innovation of new products and processes, inward FDI (and non-equity arrangements with TNCs) are an important source of new and advanced technologies and skills. Foreign direct investment that involves the setting-up of research-and-development affiliates also strengthens the innovative capacities of host countries. At the same time, outward FDI can strengthen home countries by allowing firms to access overseas research-and-development capabilities and technologies that are otherwise difficult to obtain, and to minimize costs of technological development. As research-and-development dispersion by TNC increases, the size of a home country's technology base may shrink and some technological capabilities may diminish or disappear as a result of an international division of labour in research and development. The implications of these changes must be balanced against the returns in terms of repatriated earnings from the worldwide exploitation of the technologies generated and against the effect they have on the competitiveness of the firms involved.
- *Organizational and managerial practices.* The adoption of more efficient organizational and managerial practices by units of TNC systems can improve productivity in an economy directly as well as through the linkages, spillovers and externalities mentioned earlier. The strong competitive position of the United States manufacturing industry in the interwar period and thereafter, as well as the sustained competitive strength of Japanese manufacturing industries in recent decades, can be attributed in some measure to the managerial practices pioneered

Box 3. Revitalizing the United Kingdom automobile industry

In 1975, three years after a production record of 1.9 million cars, the United Kingdom automobile industry was in crisis. Neither United Kingdom membership in the European Community nor the substantial presence of United States TNCs in the industry helped alleviate the crisis. The industry began to turn around in the second half of the 1980s when several Japanese TNCs began to establish automobile factories in the United Kingdom, as an export base to the European Community. At the same time, the decline of British Leyland (which changed its name to Rover)—at that time still the largest producer—was first halted and then gave way to recovery when its collaborative agreement with Honda, dating back to 1979, began to bear fruit. The arrival of Japanese producers led also to a revitalization of the car-components industry. In addition, United States automobile TNCs, which during the 1970s and early 1980s seemed to have lost interest in the United Kingdom, began to increase their manufacturing facilities there. In 1992, General Motors made its largest investment ever in the United Kingdom, \$290 million in an engine factory. From a declining industry, which was regarded by politicians, overseas rivals and even the industry's workers and managers as an industry on its journey to the scrapyard, the United Kingdom automobile industry turned into a highly successful competitive industry. In 1995, it is expected to produce about 1.6 million cars, the highest number for more than 20 years.

The revitalization of the industry became possible because Japanese and other TNCs brought a package of assets needed to restore the industry's competitiveness:

- **Capital.** Between 1986 and 1994, Japanese automobile TNCs invested more than £3 billion in the United Kingdom's automobile industry. In 1994, BMW purchased the Rover Group for another £800 million. New investment by Ford Motor Company in Jaguar Cars Ltd. added another £400 million in 1995. In addition, Ford plans to invest about £300 million in the development in the United Kingdom of a new generation of engines for its small cars. These figures do not include FDI in the components industry.
- **Technology.** With the establishment of new plants, Japanese TNCs brought new, state-of-the-art technology, including technology especially adapted to the organizational and managerial methods that are considered key to their competitiveness (see, e.g., Womack *et al.*, 1990).
- **Organizational and managerial practices.** Honda's cooperation with Rover introduced Japanese organizational practices into the British firm, which became a model of Japanese lean production, based on just-in-time production, close ties with suppliers and quality control (Hoffman and Kaplinsky, 1988), leading to a significant increase in productivity. Similarly, Nissan's success in blending Japanese management practices with local practices resulted in a productivity rate equal to that of Nissan's plants in Japan: about 80 cars per worker a year (compared with a European average of about 45).
- **Skills.** Japanese TNCs give priority to human resource development and allocate substantial funds for training which are essential for the maintenance and improvement of individual and company performance.
- **Markets.** Japanese automobile manufacturers have obtained access to markets previously unavailable to indigenous manufacturers. As a result of the activities of the Japanese affiliates, the export performance of the United Kingdom car industry as a whole has increased from 280,729 units in 1989 to 616,680 units in 1994.

The entry of Japanese firms has influenced the entire industry as it forced other automobile manufacturers to restructure in order to survive. They are now ranked among the most efficient producers in Europe. For example, General Motors reported that its United Kingdom affiliates improved productivity by more than 60 per cent between 1988 and 1992. A similar increase in productivity took place among component suppliers.

A number of lessons can be drawn from the United Kingdom experience with the automobile industry. First, TNCs can assist in restructuring an industry. Second, the positive effects of their activities do not necessarily last forever. When overall economic and industrial conditions in a host country deteriorate and a country loses locational advantages, TNCs will share in the demise of the industry together with local firms. Unlike local firms, however, they can downsize their operations in such a country or leave it altogether. Therefore, adequate government policies that create, enhance and subsequently protect the locational advantages of a country are crucial for the competitiveness of an industry.

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

by the firms of those countries; many of these innovators have been TNCs.

Inward FDI has (along with other channels of transfer of knowledge) acted as a conduit for the spread of Japanese organizational and managerial practices to other countries (see table 8). The comeback of the United States automobile industry and, more generally, the recovery and growth of United States manufacturing productivity is due partly to the successful adaptation of Japanese organizational and managerial practices. Similarly, in developing host countries, foreign affiliates have often acted as conduits for the transfer of, and as catalysts for, the adoption of numerous improvements in organization and management by indigenous enterprises, presumably contributing to a more efficient use of resources and improved performance of the economy as a whole.

Foreign direct investment also affects the competitiveness of firms by helping them get better access to markets, ...

The competitiveness of firms depends not only on their ability to obtain access to assets that complement and enhance their capacities to produce goods and services, but also on their ability to access markets that are large enough to exploit those assets fully and most efficiently. Foreign direct investment strengthens the capabilities of TNCs to reach international markets not only through cross-border trade but also through the sales of foreign affiliates ('establishment trade'). The latter allow TNCs to secure markets

for goods and (especially) services that are impossible to reach without proximity to customers, to expand markets for goods and services that are difficult or costly to service from a distance and to respond rapidly to new or changing customer tastes and market conditions.

Equally important, FDI allows firms to build intra-firm networks of trade that link production units within TNC systems and provide them with privileged access to the rest of the system. These intra-firm activities are estimated to comprise one-third of world trade, or approximately \$1.6 trillion of exports in 1993 (see figure 3 and table 9). The resulting efficiency benefits to the TNC system stem from reduced transaction costs as compared with arm's-length trade and from economies of scale and scope. From a country's point of view, these same arrangements may, however, give rise to concerns over restrictive business practices and transfer pricing which need to be addressed. Beyond such intra-firm trade, TNCs also sell to non-affiliated firms abroad, and such sales are estimated to account for about another one-third of world exports of goods and services. Furthermore, the markets served by establishment trade must also be taken into account.

***... creating or expanding, in the process,
markets for other firms, ...***

The efforts of TNCs to expand their sales and organize their production efficiently create market opportunities for other firms in host and home economies, if these other firms are linked to TNC systems. This applies especially to suppliers of parts and components and of producer services. It also applies to firms that utilize transnational trading corporations, which have played a particularly important role in providing suppliers of primary or manufactured goods with access to international markets. Thus, firms not being members of TNC systems, but being linked to them, can have advantageous access to the sizeable markets worldwide served by TNC systems, an opportunity that may give them a competitive edge over their rivals.

***... with, again, implications for the performance
of host and home countries***

What does this mean for the economic performance of host and home-country economies? For host countries, and especially developing countries, inward FDI not only contributes a package of resources that are often complementary to domestically available resources and hence expand their pro-

Table 10. Structural changes in the manufacturing sector of Japan: output, exports and FDI
(Percentage of manufacturing total)

Year	Labour-intensive light industries				Capital-, assembly- and knowledge-intensive industries			
	Food, beverages and tobacco	Textiles, apparel and leather	Other manufacturing ^a	Total	Chemicals, petroleum and coal products	Basic and fabricated metal products	Machinery, transport equipment and electronics	Total
A. Manufacturing output^b								
1955	42.5	11.9	20.3	74.7	7.2	10.7	7.3	25.2
1970	17.4	7.6	21.4	46.4	14.0	16.6	22.8	53.4
1980	14.4	6.1	18.4	38.9	13.8	16.3	31.1	61.2
1990	9.1	3.5	15.6	28.2	13.7	12.4	45.7	71.8
B. Manufacturing exports								
1955	6.2	37.3	..	43.5	5.1	19.2	..	24.3
1970	3.4	12.5	11.8	27.7	6.4	19.7	46.3	72.4
1980	1.2	4.8	9.5	15.5	5.3	16.5	62.7	84.5
1990	0.6	2.5	9.6	12.7	5.5	6.8	74.9	87.2
C. Manufacturing FDI outflows^c								
First wave 1969-1973	5.0	23.8	14.7	43.5	18.9	14.7	22.9	56.5
Second wave 1978-1985	4.3	5.2	10.5	20.0	16.6	25.2	38.2	80.0
Third wave 1986-1990	5.2	3.3	17.9	26.4	12.2	8.9	52.5	73.6

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Including mostly labour-intensive industries such as toys, table and kitchenware, sporting equipment, travel luggage, etc.

^b Measured by GDP at constant 1985 market prices.

^c Based on approvals and notification.

Table 11. Japanese affiliates in the textile and apparel industry in Asia, 1950-1994

(Number of affiliates)^a

Host country	Before 1971	1971-1975	1976-1980	1981-1985	1986-1990	1994
Republic of Korea	5	19	2	1	3	17
Hong Kong	3	4	1	3	17 ^b	37 ^b
Taiwan Province of China	24	4	—	—	6	18
Singapore	2	1	1	1	—	4
Subtotal	34	28	4	5	26	76
Indonesia	1	16	2	—	—	41
Malaysia	1	7	2	1	2	14
Philippines	—	4	1	—	3	7
Thailand	18	4	2	3	9	50
Subtotal	20	31	7	4	14	112
China	—	—	—	2	15	168
Total	54	59	11	11	55	356

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a Numbers refer to foreign affiliates established in each period except for 1994 numbers which refer to affiliates existing in October 1994.

^b Many of them actually manufacture in China with only marketing functions in Hong Kong.

duction capacities, but also expands the markets for output. Given a competitive environment, and one in which domestic producers are not simply overwhelmed by TNCs, inward investment should thus contribute to raising output of host countries directly as well as through linkage and competition. Where the last of these conditions is lacking, in particular, and one or more industries in a country become exclusively comprised of foreign affiliates, the sharing of the benefits between the host country—i.e., its consumers (through prices), producers (through spillovers and eventual capacity-building), labour and other domestic resources (through wages and other factor returns), government (through fiscal revenues) and TNCs become of particular importance. Maintaining competition becomes key.

A particular contribution by foreign affiliates to markets of developing economies relates to export expansion: there is evidence that foreign affiliates in developing countries often have high export propensities and tend to be more export-oriented than domestic firms, especially in manufacturing. Their high-export propensities are however accompanied, particularly in the

earlier stages of investment, by relatively high-import propensities which can exacerbate foreign exchange shortages in the short run. But, in the longer run, the overall high-trade orientation of foreign affiliates can strengthen the linkages of host countries to the world economy, with benefits in terms of their trade performance as well as output growth (see box 2).

The relationship between outward FDI that strengthens market access for TNCs and the performance of a home economy is less straightforward. This is because outward FDI could, under certain circumstances, displace (actual or potential) domestic investment, and affect output and employment in the home country adversely, particularly in the short- or medium-term. Empirical evidence varies in this regard, although the balance of evidence for FDI in general seems to suggest that the effects of outward FDI on the level of home-country economic activity are marginally positive. In addition, available evidence suggests that outward FDI as a whole has a positive effect on home-country exports, while, in the aggregate, also resulting in increased imports as well as a changing pattern of trade. It contributes, moreover, to income generation for the home economy through repatriated income and strengthens innovatory capacity on account of the abilities of TNCs to finance and sustain high rates of research and development and to keep abreast of technological change. Finally, even in the absence of these effects, home countries would still benefit from outward FDI if that helps their TNCs to retain their markets and, hence, to survive.

Better access to resources and markets also contributes to economic restructuring, facilitated by TNCs, ...

The access to various resources and markets provided by TNCs, and its effects on the economic performance of countries, can produce—in interaction with domestic factors—performance-enhancing effects that go beyond the sum of the individual effects. In particular, TNCs can enhance a country's ability to restructure its economy which, in turn, leads to higher productivity and income. The contributions that TNCs can make in this respect occur simultaneously at the firm, industry and sectoral levels, independently from the level of development of the host and home countries involved (see box 3).

To improve their performance—to be able to maintain or increase welfare through improved productivity over an extended period of time—countries need to restructure, i.e., to change the composition of their economic activities (output, employment, exports, etc.) across sectors, industries

or types of activities within an industry. This is an ongoing process that affects all growing countries. In general, three categories of restructuring can be distinguished:

- Sectoral restructuring of an economy, from the primary sector, especially agriculture, through manufacturing to services.
- Restructuring within a sector, e.g., restructuring of manufacturing industries from low-productivity, labour-intensive (and typically low-technology) light industries to high-productivity (and usually high-technology) knowledge-based industries.
- A shift within an industry—from low-technology, low-value-added goods or services to higher-technology, higher-value-added ones.

Transnational corporations can—and do—facilitate restructuring of home and host countries by introducing new industries or activities that would be unlikely to emerge from purely national enterprises alone or from upgrading existing ones. They can do this because they can supply a package of tangible and intangible assets, reinforced by privileged access to the wider pool of resources residing in their systems as a whole, and by linking their resources with those available in the countries—host or home—in which they are established. Firms can play this role through various forms of involvement, ranging from wholly-owned foreign affiliates through joint ventures to licensing and subcontracting agreements. The central and common characteristics of all these forms is that TNCs retain control over key assets, and hence over key parts of the production or distribution process (or both).

... as exemplified in Asia ...

Nowhere are the phenomena related to the positive role that TNCs can play in industrial restructuring more clearly visible than in parts of Asia, a region undergoing rapid structural transformation. It is a restructuring that involves, to various degrees, TNCs in many of these countries' manufacturing industries. This role can be seen particularly in Indonesia, Malaysia, the Philippines and Thailand, but increasingly also in China and Viet Nam. But even in countries that are considered textbook cases of successful restructuring and development based principally on indigenous capabilities—Japan, the Republic of Korea and Taiwan Province of China—TNCs have played a role.

***... by the restructuring of manufacturing in Japan
by its own TNCs ...***

In the immediate post-war period, foreign TNCs helped turn Japanese light industries into internationally competitive industries, and Japanese automobile makers learned the techniques of mass production in joint ventures with TNCs. This role, however, was short-lived: due to the Japanese ability to develop local capabilities, it soon gave way to looser links with foreign firms in non-equity forms which served mainly as a conduit for technology transfer.

Much clearer and more long-lived has been the role of the country's own TNCs, in terms of helping restructure Japan's manufacturing sector through outward FDI. Japan's success in becoming a highly competitive economy owes much to its ability to restructure its manufacturing sector continuously from labour-intensive industries through resource-based heavy industries and assembly-oriented industries towards high-technology industries. Outward FDI in manufacturing was important at each stage of the restructuring process (see table 10). It accelerated the process of Japan's industrial restructuring, notably by scaling down—through moving abroad—industries or activities losing competitiveness (and thus releasing resources for industries gaining competitiveness), strengthening the existing structure by acquiring abroad assets lacking at home, or lowering the cost of this upgrading by sharing these costs with foreign TNCs. At each stage of the restructuring process, some industries (or activities within industries) came under competitive pressures and had to be restructured at home or relocated abroad, or both.

Some examples illustrate this process. During the 1960s, competition led to the transformation of Japanese small and medium-sized companies in the textile and apparel industries into TNCs: they relocated their production to the (now) newly industrializing economies with (then) an abundant supply of cheap unskilled labour. More recently, Japan's manufacturing FDI is on the rise again, supporting the next round of competitiveness-enhancing industrial restructuring, this time mainly to alleviate the brunt of the yen appreciation by relocating certain types of production to lower-cost countries, mostly in Asia. The activities concerned include parts and components (giving domestic assembly-based industries the benefit of cheaply imported inputs) and low-end final consumer goods such as radios, colour television sets and microwave ovens in which Japan (but not necessarily Japanese firms) has been losing its comparative advantage.

***... and by that in newly industrializing economies
by foreign and their own TNCs, ...***

By relocating assets that were no longer of use at home to neighbouring developing host countries that had a comparative advantage based on an abundance of cheap labour and certain skills—but which could not realize their comparative advantage fully in the absence of these assets—Japanese TNCs (and, for that matter, also United States TNCs) contributed to the building, upgrading and turning around of industries in the countries concerned. In particular, they turned inward-looking industries into export-oriented, internationally competitive industries, thus helping countries realize or enhance their comparative advantages.

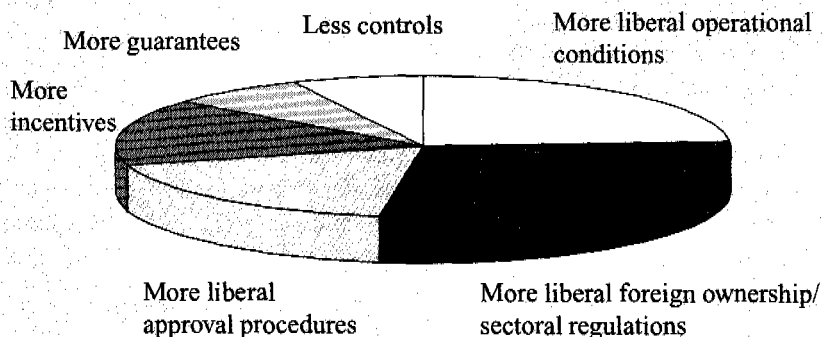
Even the Republic of Korea and Taiwan Province of China used some TNC-controlled assets in the initial phase of industrialization (as illustrated by the case of the textile and apparel industries; table 11), and more when they were moving up the ladder of industrial upgrading (as illustrated by the case of the electronics industry). The reliance on TNC-controlled assets has been higher in countries that have more limited capabilities. If a country wants to pursue an export-oriented strategy (especially at an early stage of industrialization), TNCs can provide key assets (such as access to markets, product design or quality control) that can help to make this strategy a success. Since such key assets can be provided through non-equity arrangements as well, the role of TNCs in economic restructuring is much greater than FDI-based measures would show.

Quite logically, those developing countries in Asia that successfully restructured gave rise, eventually, to their own TNCs; these began to undertake FDI initially in the developing countries of the region and later on also in developed countries. Conversely, the emergence and growth of outward FDI indicates a successful restructuring process. As a result, the newly industrializing economies involved have been taking advantage of both inward and outward FDI as agents of industrial transformation.

***... leading to interactive TNC-assisted restructuring
in the whole region***

The successful restructuring of the first generation of newly industrializing economies created new home countries (and, hence, sources of FDI). Combined with the liberalization of inward FDI policies in the region, this has led to the growing importance of FDI in the restructuring process of

Figure 4.
Types of changes in laws and regulations, 1993-1994
(Percentage)



Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

other developing countries of the region—, first Indonesia, Malaysia, the Philippines and Thailand, and, more recently, China and Viet Nam. Successful restructuring (including in countries relying largely on their indigenous capabilities, such as the Republic of Korea and Taiwan Province of China), moreover, typically leads to a greater role of inward FDI because it involves a movement towards more knowledge-based industries (such as the electronics industry) usually dominated by TNCs.

Furthermore, by shifting assets from home to host countries, Japanese (and United States) TNCs and TNCs from the newly industrializing economies have linked the processes of industrial restructuring within the region, initially between Japan and the newly industrializing economies and later between these countries and other countries in Asia. This has led to an interactive TNC-assisted restructuring process among an increasing number of economies of the region (described by some as a “flying geese” formation). By doing so, TNCs smooth (and speed up) the adjustment process in response to changing patterns of comparative advantage and contribute to economic growth.

The extent of TNC participation—through both equity and non-equity forms—in the industrial restructuring of, especially, East and South-East Asia has been such that TNC activities need to be included among the factors

that explain the above-average economic growth in Asia. The interactive nature of this process, and the impetus it gives to economic development in general, can perhaps be described as “tandem economic development” through interactive TNC-assisted industrial restructuring.

Other regions, too, have the potential to follow Asia's example

Restructuring in Asia has taken place in and among countries that differed greatly as regards the degree of government intervention in the economy, forms of technology acquisition, and the role of FDI. But some conditions have been common to this process:

- The countries involved were at different levels of development, with corresponding factor endowments, cost structures and local capabilities; this provided a wide range of choices for TNCs to match host-country capabilities with their own.
- The governments involved allowed restructuring to happen, including letting some firms or industries be phased out while letting others be phased in, and allowed for the emergence of their own TNCs.
- Restructuring was to be verified by the market.
- An enabling framework was created, permitting TNCs to deploy their assets between the countries involved and to play their restructuring role, at least for the industries targeted by governments for upgrading; this included especially the liberalization of external transactions (particularly FDI and associated trade) and a favourable investment climate.
- There was demand—international or domestic, or both—for the goods (and services) produced by new and restructured industries.

These conditions exist or are being established in other regions as well, including Europe (Western and Eastern) and the Western hemisphere (North America, Latin America and the Caribbean). Both regions include countries at different levels of development. While the high-income countries in these regions have been restructuring (although not always with sufficient speed, especially those in Western Europe), most middle-income countries urgently need to do so. For the countries of Latin America and the Caribbean that already have a large stock of FDI in manufacturing, the challenge is how to make this stock more dynamic, i.e., how to make the foreign affiliates holding this stock internationally competitive. (Or, to apply the

metaphor used earlier: how to turn sitting ducks into flying geese.) For the countries of Central and Eastern Europe, the challenge is how to attract FDI that leads to restructuring. The enabling framework is being created in both regions as a result of the broader market philosophy adopted by the countries of the regions, which is also reflected in the liberalization of trade and investment regimes embodied in a number of regional agreements.

At the same time, however, interactive restructuring in these regions is likely to differ from that in East and South-East Asia, in that it will be more market-driven than Asia's more interventionist approach. If the liberalization of international transactions, combined with differences in relative factor costs among countries, is allowed to work out its logic, TNCs would presumably deploy their proprietary assets in a manner that will contribute to TNC-assisted restructuring in Europe and the Western hemisphere as well. The beginnings of such a process may already be taking place on a limited scale in both regions, as exemplified by the TNC-driven restructuring of the automobile industry in Mexico and restructuring activities of TNCs in Hungary and Poland.

Policy implications

As the trend towards liberalization and facilitation of inward FDI continues, ...

With policy regimes becoming increasingly open and, thus, similar, governments are making extra efforts to attract FDI (see table 2 and figure 4) and to strengthen linkages between foreign affiliates and domestic enterprises, with a view towards enhancing their countries' economic performance.

... governments are fine-tuning their policies to attract performance-enhancing FDI. Targeted promotion is important to attract capital, ...

Governments which actively seek investment also actively seek to improve their countries' image within the investment community as a favourable location for investment. In doing so, they rely heavily on direct contact with prospective investors, especially important ones. In fact, successfully enticing one important TNC to locate in a country can trigger a chain reaction that leads to substantial sequential and associated investment. Examples

abound. During the early 1970s, for example, Malaysia's Industrial Development Authority (MIDA) identified specific companies in the then fast-growing semiconductor sector in the United States; these companies were targeted for discussions between senior government officials and executives of the companies. By 1987, Malaysia was the world's largest exporter and the world's largest producer of semiconductors.

Selecting target firms involves a number of choices: which countries are likely sources, which industries are good candidates and, within those industries, which kinds of firms and activities should be sought. Therefore, successfully targeted investment promotion requires extensive research to determine which firms are likely candidates—not only to invest in the country but also what kind of investment they would bring.

***... and after-investment services are crucial
for upgrading or retaining it***

The most obvious targets are firms already established in a country. Governments can strive to encourage sequential investment (including through reinvested earnings), which can also provide positive demonstration effects for potential new investors: a satisfied foreign investor is the best commercial ambassador a country can have. Policy makers should be concerned when foreign investors leave the host country due to deteriorating local conditions. Emphasis on after-investment and investment-facilitation services for current investors is therefore crucial. This could involve the creation of joint committees consisting of representatives of government, foreign affiliates and local employees to try to resolve problems that could lead to relocation; avoid conflicts; and consider alternative solutions. Also, a business ombudsperson could be appointed to handle complaints about unreasonable delays and demands by government officials on business people. He or she could be given authority to report publicly and periodically on the business climate.

Transfer of technology remains an important issue for most countries, but facilitating the diffusion of research-and-development capabilities is increasingly becoming as important for many, ...

The importance of FDI as a conduit for technology transfer has long been recognized by policy makers. However, today, policies in most countries focus on effective technology transfer, rather than regulating specific

aspects of technology transactions. Consequently, a number of countries have not only liberalized their technology-transfer legislation relating to restrictions on contractual aspects, they have also focused more on improving the capacity to absorb and use new technologies. However, the actual policy instruments used in that regard can vary widely. Much depends on the existing and evolving levels of local skills and capabilities, and on the nature of the technologies concerned. What is desirable for a country such as the Republic of Korea may be inappropriate for Mexico and simply out of the question for a least-developed country. Bearing that in mind, there are, however, two major types of policy instruments that can be said to facilitate technology diffusion.

The first type embraces policy instruments that create an overall attractive environment for technology transfer. They support the institutional base conducive to building local technical skills; a general economic atmosphere that rewards enterprises and innovation; and a dependable legal system, especially intellectual property protection. The second set of policy instruments involves the promotion of linkages between foreign affiliates and local firms, as well as laboratories and research centres. Among the most common factors are workforce mobility; subcontracting and other backward linkages; equipment-supplier systems; user-producer relationships; consultancy services; informal linkages; and strategic alliances that may involve linkages with government, universities, local firms and research-and-development institutions.

... with science parks playing an important role

Of special interest to governments wishing to attract technology-intensive FDI is the establishment of infrastructural facilities to foster technology partnerships and encourage positive agglomeration effects. Science parks play a particular role in this respect. The current usage of these facilities, the extent of awareness of their existence on the part of TNCs, the identification of obstacles to their greater use, and the effectiveness of the available services and facilities are all aspects that need to be carefully assessed. Policies must, however, be consistent with a country's mix of competitive industries, its stage of development, and the capacity of its firms and research institutions. Since not all countries have the resources necessary to develop science parks, regional or subregional initiatives may be useful to pool scarce scientific, technological, financial and institutional resources in specific sectors.

Box 4. Extending trade preferences to FDI

Under the Generalized System of Preferences (GSP), industrial countries offer more favourable treatment to the import of manufactures and semi-manufactures from developing countries, particularly the least developed, thereby providing them a competitive edge in the industrial market (i.e., in terms of a price advantage relative to imports from non-beneficiary countries). The GSP is an agreed departure from the most-favoured nation principle of the GATT. The GSP arrangements are drawn up by individual preference-giving countries, who specify beneficiaries, product coverage and other requirements, principally relating to rules of origin.

In an effort to extend GSP schemes to FDI, industrial countries have begun to apply the "donor country content" rule under which the preference-giving country allows inputs (materials, parts and components) of its manufacture, when supplied to a preference-receiving country and used there in a production process, to be regarded as originating in the preference-receiving country for the purpose of determining whether the finished products qualify for GSP treatment. This facility is granted by Australia, Canada, Japan, New Zealand, several Central and Eastern European countries and, as of 1 January 1995, the European Union. Norway and Switzerland are in the process of introducing the facility. Although the United States does not provide it, TNCs have voiced strong support for it to be included in the new United States GSP scheme.

A number of home countries offer incentives to their firms to invest in the least developed countries. Although these schemes have had only limited impact, they could be coupled with trade preferences through the FDI facility of the GSP to reinforce each other, and constitute a more comprehensive system of investment-trade preferences offered by developed countries to the least developed countries. With business as a new home-country constituency, the erosion of support for trade preferences could also be counteracted. Supportive measures of this type are a necessary complement to the liberalization measures enacted by most least developed countries to attract FDI, which still amounts to less than 1 per cent of the total flow to developing countries.

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

Encouraging the acquisition of skills through training is fundamental, ...

It is indispensable for improved national economic performance that human resources adapt to technical change and contribute to diffusing technology. This requires appropriate training. Lifelong education and retraining are also important, supported by policies that link the educational system to industry and encourage industry's own efforts at training. For that to be effective, however, requires policies that encourage a nexus between pre-work education and on-the-job training. Among other things, this could involve institutional support to promote cooperative arrangements between TNCs and local learning institutions. Such programmes may require fiscal incentives or other public support, but it is also important that TNCs be encour-

aged to contribute to the development of human skills beyond their standard operating procedures. If fiscal incentives or public subsidies are to be granted, they should be differentiated on the basis of the expected benefits of training.

***... but facilitating linkages is necessary
for a further dissemination of skills***

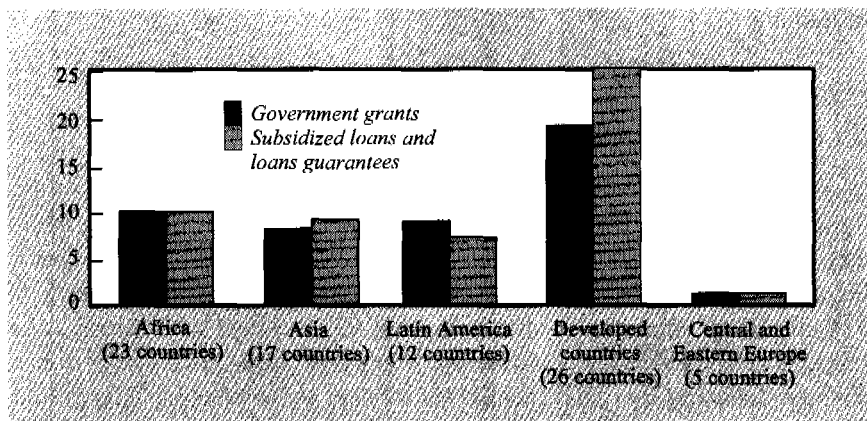
Education and training are, however, only part of the story. One of the most important determinants of a foreign affiliate's impact on the technology and skills in a host country is the extent of its forward and backward linkages with local firms. More technology and skills will be transferred by FDI in linkage-intensive industries than by FDI in industries where such linkages are more difficult to develop. Thus, one policy approach is to encourage industries that lend themselves to local subcontracting through the purchase of parts and components from outside suppliers. Specific consideration might be given to the establishment of an "open school" for small and medium-sized businesses, with seminars in various cities, lectures by TNC specialists, case illustrations, plant visits, etc. Moreover, encouragement could be given to the establishment of centres that provide information and advice on matters such as the availability of courses, teaching materials and training techniques. Since lack of training is usually not the only impediment to a small firm's competitiveness, these centres might offer complementary services such as technological information, market studies, management techniques, and industrial extension services in general, in order to increase their attractiveness to the business world.

Incentives can also be offered to TNCs that have their own training centres to share their facilities and expertise with small and medium-sized enterprises, particularly suppliers and subcontractors. This would give smaller enterprises access to training and make use of subcontracting networks as collective education mechanisms. It could also be useful to co-finance visits to "best-practice" plants abroad by representatives of small and medium-sized enterprises.

***Foreign direct investment can facilitate
access to world markets ...***

Many countries have adopted export-oriented strategies to promote their development. In pursuing such strategies, governments, typically, focus on trade and exchange-rate policies, but tend to neglect the FDI dimen-

Figure 5. Financial incentives for foreign investors, frequency by region, early 1990s



Government grants
 Subsidized loans and loan guarantees

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

sion (see box 4). Few explicitly recognize that inward and outward FDI can be an important means of accessing world markets. Yet, market expansion can be one of the most important contributions that FDI can make towards the performance of host economies, especially developing ones, since foreign affiliates provide privileged access to the large markets within TNC systems and advantageous access to other markets due to linkages with TNCs.

... but this requires policy coherence ...

The implication for policy makers is straightforward: integrated investment and trade policies can facilitate access to international markets. Foreign-direct-investment policy should therefore have a trade component as TNCs are interested in whether a country is suitable for inclusion in their intra-firm division of labour; at the same time, trade policy should have an FDI component, precisely to take advantage of the market access that TNC systems provide. However, while many countries have liberalized their trade and investment policies, the two processes have tended to proceed at a different pace. When FDI policy is more open than trade policy, the type of investment that is attracted tends to take the form of stand-alone production

units geared to the domestic market and often relies on trade protection. Such affiliates have difficulties in benefiting from the resources of their TNC systems, and can also be less subject to the rigours of competition. Generally, FDI should not be encouraged to be either entirely import-substituting (e.g., through tariff incentives) or completely export-oriented (e.g., through export-processing zones). Both introduce inefficiencies and distortions. By contrast, as the recent Latin American experience shows, exposure to international markets is a powerful incentive for managers to cut waste, ensure quality control and upgrade production processes to world standards. And, as the contrasting experiences of export-processing zones and industrial estates also suggests, access to the domestic market stimulates the development of differentiated products and technological capabilities, which are less developed in specialized export units.

... and support for the establishment of local linkages

The market access afforded by TNC systems need not be confined to their member firms. A key policy requirement for the successful establishment of linkages is the availability of local support services to potential small and medium-sized domestic subcontractors. Supportive macro-economic policies are also important, particularly a stable exchange rate that is favourable to the production of tradeables, thereby encouraging local sourcing for TNC systems.

Overall, the various FDI components should be treated as parts of a single package

For analytical purposes, policies regarding the different components of the FDI package can be considered separately. Since FDI is a package, it should be treated as such. The composition of the package that can be attracted very much depends on a country's characteristics, including its level of development. This suggests that each government needs to determine what the role of FDI is in its economy and what the potential is for further FDI; to what extent the regulatory framework in place for FDI facilitates the realization of this potential; and what improvements (perhaps supported, where appropriate, by a technical cooperation programme) are needed to make the regulatory framework more effective. UNCTAD has initiated a series of Investment Policy Reviews, to assist individual governments with these objectives in mind. At the same time, UNCTAD will assist the members of the newly established World Association of Investment-Promotion

Table 12. Menu of policy options for government action on incentives

Level of approach	Voluntary	Voluntary ^a	Binding
Unilateral	National FDI incentives reviews, including the balance between incentives and promotion measures.		
Bilateral		Incorporate language on ceilings and limits into model bilateral treaties on investment and double taxation.	Eliminate or reduce certain incentives conditional on same action by certain other countries.
Regional		Regional FDI incentive reviews.	Agree on ceilings and discontinuation of certain incentives; approval system; review system.
Multilateral		Eminent Persons Group; negative list; check-list of points; "challenge" round pledging reactions.	Strengthen and expand WTO instruments.

Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

^a While voluntary initiatives are unilateral actions that can be reversed easily, a non-binding understanding, being the result of negotiations, would presumably exercise at least a certain amount of restraint.

Agencies (WAIPA) to benefit from each others' considerable experience in this area.

Governments use incentives to attract and retain FDI ...

International competition for FDI has led more and more governments to offer increasingly generous incentives to influence the locational decisions of TNCs (see figure 5). Incentives may be justified to cover the "wedge" between the social and private rates of return for specific FDI undertakings with positive spillovers and to reduce market distortions; they can thus serve a number of development purposes. However, they also involve economic, financial and administrative costs. Moreover, as governments compete for FDI, they may be tempted to offer more and larger incentives than are justified. Competing for FDI with incentives can thus lead to welfare costs exceeding the benefits an investment can bring.

... and, as a result, unavoidably and increasingly compete among themselves, which can lead to waste or distortions

Evidence suggests that the number and range of incentive programmes available to foreign investors has increased over the past ten years. For major investment projects, furthermore, incentives are often provided on an *ad hoc* basis, determined in negotiations with the investor. And as countries are orienting their development strategies towards exports, technology-intensive industries and higher value-added activities, incentives competition is especially strong in these areas. In fact, countries are deliberately changing their FDI-incentives programmes in the light of actions taken by other countries.

Incentives play, however, only a relatively minor role in the locational decisions of TNCs (relative to much more important factors such as market size and growth, production costs, skill levels, infrastructure, political and economic stability and the nature of the FDI regulatory regime). This is not surprising since investment decisions are typically made because they promise to be profitable on the basis of market conditions alone; if incentives are offered, they typically become the “icing on the cake”. Still, the impact of incentives is not always negligible. When all other factors are equal, incentives can tilt the balance in investors’ locational choices. But this logic fails when all countries do the same.

National and international approaches are needed to contain excessive incentive competition

A number of approaches can be pursued to contain excessive incentive competition (see table 12):

- ***National initiatives.*** To rationalize the use of incentives, governments could undertake national incentive reviews to determine, among other things, the complete array of FDI incentive instruments—including discretionary incentives—at all levels of government; whether any of these incentives are redundant; what have been the results obtained from the use of incentives and at what cost for the country; whether some incentives can be eliminated, or a ceiling placed on them; and whether a proper balance is being maintained between investment incentives and undertaking investment-promotion activities. The Investment Policy Reviews mentioned earlier are also meant to include an inventory of FDI incentives, with a view towards helping governments

formulate more effective and efficient incentive policies. A more detailed and systematic review of incentives could be carried out on the basis of a manual prepared for use by governments.

- *Bilateral initiatives.* Some countries have used bilateral investment treaties to curtail the use of performance requirements in host countries; a reduction of these requirements could also moderate the use of incentives that are linked to them. Moreover, in the absence of a multilateral or regional approach, governments could consider investment incentives when negotiating bilateral treaties on investment or double taxation, so that the issue would at least be tabled for discussion. In fact, it might be possible to negotiate a conditional incentives-limitation clause in bilateral agreements that would only become operative if a specified number of countries adopted the same clause.
- *Regional initiatives.* On the basis of incentive reviews similar to those that could be undertaken at the national level, efforts at the regional level to curtail excessive incentives could involve, among other things, agreeing on overall ceilings on investment-incentive packages; criteria to phase out some of the most distorting incentives; and prior approval of incentives packages by the competent regional organization.
- *Multilateral initiatives.* Multilateral efforts to limit incentives competition are in their infancy and could be reinforced and expanded. To assist this process, an International Group of Eminent Persons could hold hearings on FDI incentives, with the participation of the private sector as well as national and international institutions. Based on experiences with the effectiveness of incentives, the Group could explore a wide range of issues, including ways and means of (a) improving transparency regarding FDI incentives; (b) further clarifying and documenting the cost and benefits of FDI incentives; and, on that basis, (c) identifying a limited number of particularly distorting incentives, with a view towards dealing with them first; (d) elaborating a checklist of points that governments should take into account in their incentives policies.

The Group could conclude its work with a “challenge” round of pledges by countries to reduce the level of incentives by some fixed amount over a time period. A demonstration that such a pledge might be feasible could enhance the willingness of governments to seek a multilateral agreement on FDI incentives.

Indeed, just as the international community has begun to deal successfully with subsidies that distort trade, it may be possible, step by step, to make similar progress towards dealing with incentives that shift the benefits of incentives from host-country taxpayers to investing firms.

In an increasingly integrated world economy, governments also need to pay attention to outward FDI

Historically, outward FDI was mostly undertaken by large firms from a small number of developed countries. More firms are however now establishing themselves abroad, including firms from developing countries and a growing number of small and medium-sized enterprises. For many firms, outward FDI has become a strategic option necessary to gain access to markets and resources.

More governments recognize that outward FDI is a strategic option that should be left open to firms, lest they risk impairing the competitiveness of firms located on their territory—in fact, precisely the competitiveness of their strongest firms, namely those that have developed the ownership advantages that would allow them to establish themselves successfully abroad. Governments, too, have recognized that outward FDI can be to their countries' benefit, precisely because of better access to resources and expanded markets and in their interest in economic restructuring and growth. Consequently, a process of liberalization of outward FDI regulations is taking place, although change in this respect has been distinctly uneven between developed and developing countries.

The experience of developed countries ...

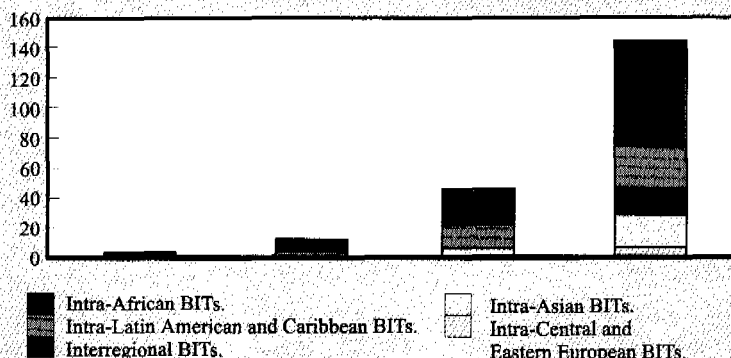
Developed countries have historically permitted and even promoted outward FDI. Where capital flows were restricted, countries used foreign exchange or capital-movement control systems with accompanying licensing or project-approval requirements. The usefulness and effectiveness of national exchange controls was undermined during the 1980s. At the same time, changes in exchange-rate policies—notably the adoption of floating exchange rates—and improved monetary management techniques reduced potential problems that could arise from the lifting of capital-control restrictions. By the end of 1994, only three developed countries maintained (limited) restrictions on outward FDI.

Independent from these liberalization efforts, furthermore, virtually all developed countries have created a variety of programmes to promote outward FDI, particularly to developing countries and economies in transition. They have done this for a number of reasons, including the desire to support the development process of these countries, but also to strengthen their own firms' competitiveness. Promotional policies for outward FDI, thus, have included:

- *Information and technical assistance*, which are provided by government agencies in virtually all developed countries to outward investors. At a minimum, these services include basic information on macroeconomic and business-cost factors, as well as the legal framework and administrative processes relevant to potential foreign investors in host countries. This type of service can be particularly important and cost-effective for smaller prospective investors.
- *Direct financial support*. Financial support was provided in about half of the developed countries during the 1980s, through development-finance institutions. For example, at least eight Japanese agencies sponsor programmes that promote outward FDI, the Export-Import Bank of Japan standing out as a unique institution in this respect. Similarly, the German Investment and Development Company, the United Kingdom's Commonwealth Development Corporation, the European Community's Investment Partners Programme and, on a broader scale, the International Finance Corporation provide both loan and equity financing for FDI projects in developing countries. Other countries' programmes emphasize the link between FDI and exports (e.g., the Canadian Export Development Corporation).
- *Investment insurance*. National investment insurance programmes exist in most developed countries—and at the international level—to provide coverage for expropriation, war and repatriation risks. In the United States, for example, the Overseas Private Investment Corporation has provided financing and political risk insurance since 1971 to support United States investments (worth some \$73 billion) in 140 countries worldwide, generating an estimated \$40 billion in exports and supporting more than 100,000 jobs in the United States. For many firms, the availability of such insurance is important when contemplating investment in developing countries.

With domestic outward FDI policies liberalized, developed countries have sought to supplement their domestic policies with international instruments aimed at protecting and facilitating outward FDI by improving FDI

Figure 6. Bilateral investment treaties among developing countries and economies in transition, by region, 1960s-1990s



Source: UNCTAD, Division on Transnational Corporations and Investment, *World Investment Report 1995: Transnational Corporations and Competitiveness* (United Nations publication, Sales No. E.95.II.A.9).

liberalization standards generally and levelling the playing field among themselves. An expanding network of bilateral, regional and international agreements has been the result, which, eventually, may give rise to a comprehensive multilateral agreement.

... and of developing countries and economies in transition ...

Few developing countries and economies in transition have paid much attention to outward FDI policies; typically these are subsumed under general capital-control policies which, in turn, are normally quite restrictive. The reasons appear self-evident: developing countries typically face a foreign-exchange shortage and are capital-constrained.

In recent years, however, these concerns have been re-evaluated. Governments are seeing merit in their firms and economies are having better access to markets and resources (both material and labour inputs) and benefiting from restructuring—or broader, in becoming part of the emerging international production system.

- Among the Asian economies, the Republic of Korea and Taiwan Province of China already have a long record of liberalizing and in the case of the latter, even encouraging outward FDI. In the case of the Repub-

lic of Korea, “globalization” is the watchword of international economic policy-making, and outward FDI is an integral element of it. Singapore’s history of liberal trade and investment policies has made it one of the first developing countries to pursue a deliberate policy to acquire, through outward FDI, an “external wing”; the country now emphasizes the need to seek overseas investment opportunities and actively supports outward FDI. Malaysia and Thailand, too, seek to ensure the competitiveness of their firms not only by allowing but actively promoting outward FDI, especially in a regional context. India, after allowing outward FDI in the form of equipment and technology exports, has just begun to liberalize outward FDI to help improve international trade competitiveness, substantially relaxing requirements for prior approval. China, since the early 1990s, has embarked on a course to create “world-class transnational corporations”, as part of a broader quest for deeper integration into the world economy; the country’s priorities revolve around securing access to markets and to key natural resources, and acquiring new technology and management skills. Despite retaining constraints on capital exports, China recently became the leading source of FDI from the developing countries, investing in both developed and other developing countries.

- In Latin America, Chile is perhaps most advanced among the principal outward investors in terms of liberalizing outward FDI, rivalled only by Mexico; there are no ceilings on the amount of capital allowed for outward FDI projects, nor are there any restrictions with respect to the financing of such investments.
- Balance-of-payments considerations constrain but do not prevent outward FDI from Central and Eastern Europe, with most countries of that region maintaining various forms of restrictions on outward FDI. Most restructured or privatized state enterprises have sought to retain their existing foreign affiliates, while reform programmes spurred a mini-surge in outward FDI in the early 1990s.

Many of these countries also have incipient promotional policies. Specific programme goals and contents vary widely. Fiscal incentives generally play an important role in supporting outward FDI. Various types of direct financial support and incentives are provided by India, the Republic of Korea, Malaysia, Singapore and Taiwan Province of China. While Thailand does not provide fiscal incentives, the Export-Import Bank of Thailand provides enterprises in Thailand with access to a number of facilities such as long-term loans at preferential rates and equity participation in certain proj-

ects. Investment insurance programmes have so far not been priority concerns for these countries. In any event, the need to provide such insurance has been alleviated by the establishment of the Multilateral Investment Guarantee Agency in 1985, which provides insurance for non-commercial risks for firms from member countries undertaking outward FDI.

The emergence of a number of these countries as home countries is also leading to a change of attitude towards international agreements on FDI. This is most obviously reflected in the growth of bilateral investment protection and promotion treaties signed among developing countries and economies in transition: only two such treaties were negotiated in the 1960s, followed by 12 in the 1970s, 46 in the 1980s, and 154 in the first half of the 1990s (figure 6).

... suggests several approaches—but no single model—for selecting and implementing more liberal outward FDI policies

Once a country has decided to liberalize its outward FDI regime, one option is to do this all at one stroke. More typically, the issue is how to phase in a liberalization programme involving the design of a mechanism to approve desired outward FDI. An approval process enables governments to control directly the purposes, nature and dimensions of outward FDI projects while reducing general restrictions. At the same time, however, such an approach substitutes government decision-making for market signals in determining business responses to global competition, with all the known risks. A minimal procedure, contemplated for example in Hungary's draft foreign exchange law, only examines whether applicants are in good standing in respect to their domestic financial obligations. A related criterion tests the financial soundness of the prospective outward investor, requiring at least a minimum period without bankruptcy or, more positively, a certain level of profitability over a number of years as a measure of managerial ability and the probable success of the new venture. Another approach is to organize the approval or licensing process on the basis of the size of the prospective investment: full assessment would be required only for projects over a certain size. A third approach is to evaluate all proposed outward FDI projects against a list of benefits desired for the home country (e.g., increased exports, inward technology transfers, raw material imports, repatriating earnings). An industry approach is more common when the opposite "negative list" approach is chosen, requiring review and permission only for specified industries. Still another approach is to review and approve out-

ward FDI applications in terms of country or regional destinations or in the light of the existence of bilateral investment or taxation treaties. Broader foreign policy considerations may also influence outward FDI approvals, positively or negatively. Each of these options, individually or in combination with each other, permits countries with restrictive regulations on outward FDI to liberalize their regimes incrementally, if they so desire.

Beyond these broad approaches, where foreign exchange or savings availabilities are a policy concern, there are various possibilities for minimizing capital outflows associated with outward investment:

- *Outward FDI can be financed by foreign borrowing.* This is, in fact, not an uncommon practice (though not recorded in FDI-flow statistics). In the case of a merger or acquisition, the foreign borrowing can be secured by the assets acquired, with the servicing and repayment of the debt being made from profits arising from the new venture. For greenfield enterprises, a guarantee could be issued by the parent firm in the home country, to be replaced by the pledging of the assets once these have been established abroad; unless executed, this guarantee would not appear in the balance of payments of the home country. However, these guarantees would be taken into account when determining the credit available to the country from abroad for other purposes.
- Alternatively, *the government of the home country could provide a guarantee for the loan required*, once an outward greenfield FDI project is approved and a foreign bank has agreed to finance it. In a variation of this approach, host-country financial institutions could issue a bridge guarantee to be replaced by the assets of the foreign affiliate once it is established.
- *Foreign-direct-investment venture capital funds could be established* by investors looking for good projects abroad. Such funds, in turn, could provide finance to FDI projects, including approved FDI projects by firms from countries that restrict capital outflows on account of foreign exchange difficulties. In a variation of this technique, such entities as insurance companies and pension funds could be allowed to diversify their investments. Initial permission for such investments could be linked to the funding of approved outward FDI projects from the same country, thereby utilizing the same foreign exchange draw-off for a dual purpose.

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- *In cases where foreign affiliates already exist, a government could permit the liberal usage of the earnings of these affiliates for (additional) investment abroad, be it for the expansion of an existing venture, or the establishment of a new venture. Such reinvested earnings involve, for balance-of-payments account purposes, simultaneous (off-setting) entries in both the current and capital accounts, i.e., they do not affect the level of foreign reserves.*
 - *In those cases in which outward FDI involves the establishment of sourcing or marketing affiliates in countries that are less developed than the home country, it is possible that the central bank of the home country has assets denominated in the (non-convertible) currency of the potential host country, thus making it easier to authorize outward FDI.*
 - *Some or all of the assets for outward FDI can consist of such intangible assets as intellectual property rights, goodwill or brand names, or such tangible assets as capital equipment or raw materials. Some of these approaches may be particularly suitable for joint ventures.*
 - *The use of non-equity forms of FDI. Management contracts, licensing arrangements, franchising and the like provide, for parent firms, many of the advantages of reaching foreign markets and factors of production, without involving any foreign exchange outlays.*

Experience suggests that the availability of substantial foreign exchange reserves facilitates the liberalization of outward FDI policies. But it suggests also that balance-of-payments concerns do not preclude liberalization. Still, there is no denying that countries facing foreign exchange constraints confront a policy dilemma concerning outward FDI policies. The allocation of scarce exchange reserves requires trade-offs among competing objectives (financing imports, servicing debt, servicing of inward FDI, financing outward FDI, etc.). Nevertheless, most countries should be able to develop calibrated and phased liberalization strategies that fit their own conditions and permit enterprises to maintain their international competitiveness through outward FDI.

Going beyond liberalization, careful thought is required before countries—be they developed or developing—choose promotional measures to accompany their regulatory reforms. The promotion options cover a broad range of measures whose costs and potential distorting impacts increase as governments move from providing information services to offering fiscal and financial incentives. Providing basic information on possible FDI loca-

tions is a relatively low-cost promotional technique useful at early stages in outward FDI and of particular interest to small and medium-sized investors. Fiscal or financial incentives involve a subsidization of enterprise operations and is harder to justify on both economic and political grounds. Government-sponsored insurance programmes and bilateral investment protection and promotion treaties can be effective and are less costly.

In conclusion, as countries become more closely integrated in a globalizing economy, the competitiveness of national firms in foreign markets will become increasingly important to overall national performance. The dilemma for national policy makers is that of balancing macroeconomic balance-of-payments considerations with the microeconomic competitiveness requirements of individual firms.

In considering this policy dilemma, governments must recognize that firms which are restricted to invest abroad in today's world economy are being handicapped. Furthermore, if imports and inward FDI are being liberalized, they are doubly handicapped, in that firms must confront foreign competitors at home without a comparable opportunity to realize the benefits from their own overseas investments or from challenging competitors in their home markets. When liberalizing outward FDI, governments can turn this double handicap for their firms into a double advantage for their countries: they can benefit from allowing their own firms to exploit their ownership advantages (and thereby improve competitiveness) by operating in foreign markets; and they can benefit from allowing foreign affiliates in their countries to develop overseas projects. In fact, if governments are not sufficiently flexible in terms of allowing outward FDI, they may actually face the loss of firms, including perhaps of those which could have become competitive internationally. This can occur when the handicapped firms cannot withstand the increased competition in their own markets and, therefore, fail—or relocate their headquarters to another country. Be that as it may, each government needs to decide on its own, in the light of its concrete circumstances, the precise modalities of liberalizing its outward FDI regime.

Towards a multilateral agreement on FDI?

Inward and outward FDI policies were considered separately in the preceding analysis and, typically, are considered separately by governments. In reality, however, they interact, being joined, in particular, by the overrid-

ing desire of all countries to improve their economic performance and restructure their economies towards higher income-creating activities, and the contribution that FDI can make in this regard. As more countries become more important both as home and host countries, the interrelationships between inward and outward FDI will become more apparent as well, as will be the interests of countries in stable, predictable and transparent international investment relations.

In fact, given the growing importance of FDI and international production for linking national economies and improving national economic performance, and given the transnational nature of this investment, it is almost unavoidable that a framework will be sought that provides for stability, predictability and transparency at the multilateral level, to allow firms to contribute to economic growth, while prospering internationally. Elements of a multilateral framework—and the seeds for something more comprehensive—are contained in the Final Act of the Uruguay Round of Multilateral Trade Negotiations, now being implemented by the World Trade Organization. Efforts could furthermore build on achievements at the regional level, in the context of trade-related regimes, especially in the framework of the European Union, NAFTA, MERCOSUR and APEC. Progress is also being sought among the members of OECD which, in September 1995, began negotiations on a binding Multilateral Agreement on Investment; the Agreement, once concluded, would be open to non-members as well. UNCTAD, for its part, is helping in the discussions on an international framework for FDI through activities designed to advance understanding of the issues involved, especially as far as the development discussion is concerned, and to promote consensus building.

Whether or not these efforts will lead in the foreseeable future to a comprehensive and effective multilateral framework facilitating international production, giving due regard to the various forms of accessing markets for goods and services as well as for factors of production, cannot be predicted at this time. What can be said, however, is that, if such a framework were to be established, it could well rival in importance the international trade framework created by GATT some 50 years ago in terms of setting new parameters within which TNCs maintain or increase their competitiveness and countries improve their economic performance. ■