Chapter I

GLOBAL TRENDS IN FOREIGN DIRECT INVESTMENT

A. The increasing importance of foreign direct investment in the 1980s

After having nearly tripled between 1984 and 1987, world-wide outflows of foreign direct investment increased by another 20 per cent in both 1988 and in 1989, to reach an absolute level of $196 billion. By 1989, the total world-wide stock of this investment stood at approximately $1.5 trillion. 3/

The dynamism of foreign direct investment can be best illustrated by comparisons with world exports and world output. Since 1983, foreign-direct-investment outflows have increased at the unprecedented rate of growth of 29 per cent a year, three times faster than that of the growth of exports and four times that of the growth of world output (table 1). This represents a dramatic recovery from the slow growth years of the early 1980s. It was not until 1986, however, that outflows surpassed the previous peak level of $57 billion, reached in 1979. Since 1985, the gap between the growth rate of exports and that of foreign-direct-investment outflows has widened dramatically (figure I), leading one writer to suggest that "as a means of international economic integration, foreign direct investment is in its take-off phase; perhaps in a position comparable to world trade at the end of the 1940s". 4/ Furthermore, the rapid growth of foreign direct investment compared to that of world output suggests that the share of the former in world output is increasing. This has important implications for the competitiveness of countries and regions — both as home and host countries — given the links between foreign direct investment and trade, technology and financial flows, an issue examined in chapter III.

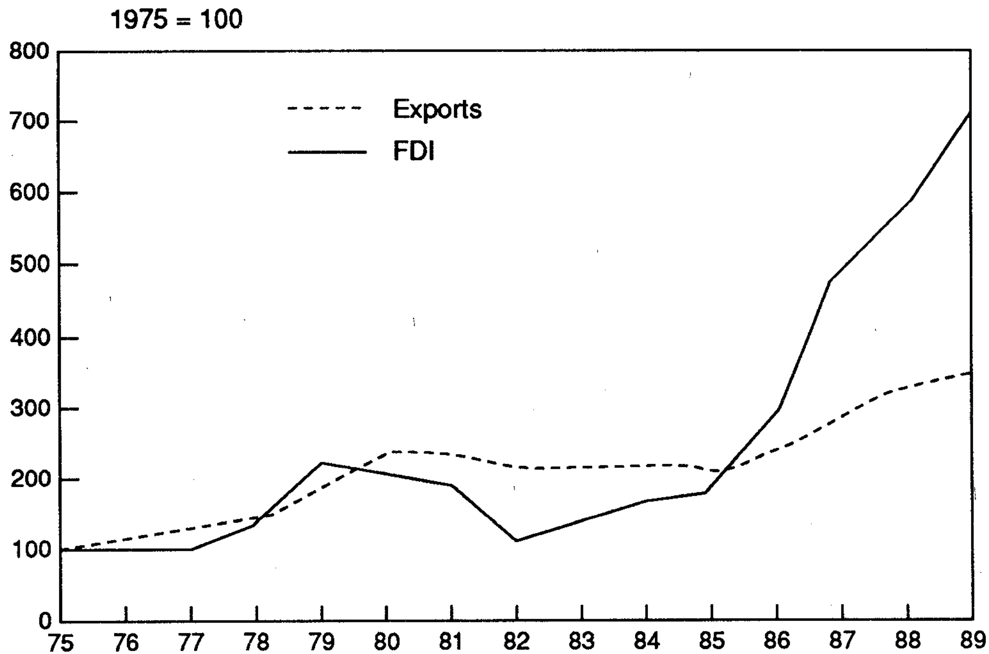
Table 1. Growth in current value of world foreign-direct-investment outflows, exports and gross domestic product, 1983-1989

Item	1983-1989 compound annual growth rate (Percentage)
World foreign-direct-investment outflows	28.9
World exports	9.4
World gross domestic product	7.8

Sources: UNCTC estimates, based on UNCTC, *World Investment Directory* (New York, UNCTC, 1991); International Monetary Fund, *Direction of Trade Statistics, 1990 Yearbook* (Washington, D.C., 1990); *International Financial Statistics, 1990 Yearbook* (Washington, D.C., 1990); United Nations, *National Accounts Statistics: Analysis of Main Aggregates, 1987* (United Nations publication, Sales No. 90.XVII.2); and *World Economic Survey, 1990* (United Nations publication, Sales No. 90.II.C.1).)

The unparalleled growth of foreign direct investment since 1985 may be explained, in part, by the strong recovery of the world economy from the recession of the early 1980s and the ensuing high growth rates in both developed and developing countries. After 1985, the gross domestic product at constant prices grew at an average annual rate of 3.5 per cent in developed countries and 3.4 per cent in developing countries, compared to 2.2 and 1.7 per cent, respectively, between 1980 and 1984. 5/ The improved economic performance of several developing countries in the second half of the 1980s, particularly those experiencing debt-servicing problems, reversed some factors which had been inhibiting foreign investment in the first half of the 1980s, such as the ability of investors to repatriate profits. 6/ Another factor behind the growth of foreign direct investment is that, during the 1980s, the number of developed countries which became significant outward investors increased, eroding the established positions of the United States and the United Kingdom. The most important of the new outward investors was Japan: investments abroad by Japanese transnational corporations increased at an annual rate of 62 per cent from 1985 to 1989. One reason for the rapid growth of foreign direct investment from Japan has been the appreciation of the yen *vis-à-vis* other currencies rendering the acquisition of assets abroad less expensive compared to domestic assets, coupled with large current account surpluses and protectionist forces in its export markets. In addition, a number of newly-industrializing economies, such as Singapore, Hong Kong and Taiwan Province of China, facing current account surpluses, appreciating currencies and rising production costs at home and fearing protectionist

Figure I. Index of current value of exports and foreign-direct-investment outflows, 1975-1989



Sources: UNCTC estimates, based on UNCTC, *World Investment Directory* (New York, UNCTC 1991), International Monetary Fund balance-of-payments tape, retrieved on 10 January 1991; and United Nations, *Monthly Bulletin of Statistics*, October 1984 (ST/ESA/STAT/SER.Q/142) and October 1990 (ST/ESA/STAT/SER.Q/214).

forces in their export markets, have emerged as outward investors.

The growth in the number of cross-border mergers and acquisitions, driven by technological and competitive forces, has contributed significantly to the rise of foreign direct investment. The 1992 programme to integrate the European Community (EC) has led not only to a rise in foreign direct investment into the Community, but also to an increase in investment activity between EC members. Finally, the rise of the services sector in the world economy — mostly products which are difficult to trade — coupled with the liberalization of regulations on the movement of capital flows in that sector has resulted in increased investment activity by transnational service corporations.

As noted earlier, foreign-direct-investment flows have grown faster than output in

recent years, with the consequence that, overall, a larger share of output may be accounted for by foreign direct investment. One indicator of this is the ratio of foreign direct investment to gross domestic capital formation. (The use of this indicator is not without problems; for instance, foreign direct investment reflects both the acquisition of existing assets in the host country, as well as newly-established investments and, as such, it is not totally comparable to gross domestic capital formation, which measures only additions to the existing stock of domestic capital.) According to this indicator, foreign direct investment has increased in importance in most developed and developing countries in the late-1980s, as compared to the early-1980s (table 2). Given the drawbacks associated with the use of this indicator, the focus is on the direction of change. Differences in the relative importance of foreign direct investment among host countries may reflect not only declining levels of foreign direct investment, but also faster growth of domestic investment.

In Latin America and the Caribbean, the ratio of foreign direct investment to gross domestic capital formation declined in 1985-1987 in about half the countries presented in table 2, whereas in East, South and South-East Asia and the Pacific Islands, the corresponding ratio increased in all but two countries. The decline in the ratio observed in most countries in Latin America can be explained by the drop in foreign-direct-investment flows to that region resulting from debt-related economic problems. In contrast, foreign direct investment has become increasingly important in East, South and South-East Asia, with the ratio rising from a low level in many cases. Since domestic investment increased rapidly in that region during the 1985-1987 period, it appears that the rate of growth of foreign direct investment has surpassed that of domestic investment. In Africa, significant increases were registered in the case of the seven reporting countries. Finally, for the most part, foreign direct investment has become increasingly important in developed countries. In all of the five largest outward investors, namely, France, Germany, Japan, the United Kingdom and the United States, the ratio of foreign direct investment to gross domestic capital formation either increased or remained the same.

Overall, the importance of foreign direct investment in relation to domestic investment is significantly higher in developing countries than in developed countries. Among the former, the average ratio of foreign to domestic investment was 6 per cent in 1985-1987; among developed countries the average was 3.4 per cent. Thus, while foreign-direct-investment flows are highly concentrated in developed countries, from a host-country perspective, foreign direct investment plays, on the whole, a much greater role in the economies of developing than in developed countries. The data presented at the bottom of table 2, however, indicate that the gap between the importance of foreign direct investment in developed as compared with developing countries may be narrowing: the average ratio among developed host countries appears to be rising, while among developing host countries the overall ratio has remained unchanged. This illustrates the growing importance of foreign direct investment in developed host countries, as transna-

Table 2. Share of average annual foreign-direct-investment inflows in gross domestic capital formation (percentage)

Region and economy	1980-1982	1985-1987
Developed market economies		
United Kingdom	8.2	8.8
Netherlands	5.8	8.4
Greece	6.3	7.4
Spain	4.1	7.3
Australia	4.9	6.8
Belgium and Luxembourg	7.6	6.6
New Zealand	4.9	4.7
United States	3.5	4.5
Portugal	2.1	4.1
France	1.8	2.7
Sweden	0.9	2.0
Ireland	4.4	1.8
Austria	1.7	1.6
Canada	-2.1	1.6
Italy	0.8	1.3
Norway	2.8	1.1
Finland	0.1	1.0
Denmark	1.1	0.8
Germany, Federal Republic of	0.3	0.6
Japan	0.1	0.1
South Africa	0.8	-1.4
Developing economies		
Latin America and the Caribbean		
Antigua and Barbuda	46.0	23.5
Colombia	4.3	13.2*
Grenada	2.0	11.8*
St. Vincent and the Grenadines	4.4	9.4*
Guatemala	9.0	8.3*
Costa Rica	7.1	8.2*
Mexico	4.3	6.6
Uruguay	5.8	6.6
Honduras	1.0	5.5
Dominican Republic	3.6	4.6
El Salvador	-0.1	3.2
Barbados	2.3	3.1
Chile	7.2	3.0
Ecuador	1.8	2.4
Brazil	4.6	2.1
Panama	-1.2	2.1
Guyana	0.8	1.9*
Paraguay	2.4	1.4
Peru	17.5	0.8
Trinidad and Tobago	11.4	0.7
Venezuela	1.1	0.3
Bolivia	5.4	0.0
Jamaica	0.0	-1.5*
Suriname	5.1	-19.4
Asia and the Pacific		
Singapore	23.4	25.5
Hong Kong	7.1	15.2

/.....

Table 2. (continued)

Region and economy	*1980-1982*	*1985-1987*
Asia and the Pacific (continued)		
Indonesia	11.1	14.4
Papua New Guinea	11.7	12.8
Malaysia	8.2	8.7
Philippines	1.6	3.5
Taiwan Province of China	1.0	3.3
Fiji	9.9	3.1
Thailand	2.6	2.7
Sri Lanka	4.0	2.1
Pakistan	0.7	1.4
Republic of Korea	0.5	1.4
Bangladesh	0.2	0.4
India	0.1	0.2
Africa		
Seychelles	19.2	31.2
Nigeria	0.4	12.1
Egypt	7.4	9.9
Tunisia	11.6	4.1
Mauritius	0.6	2.8
Kenya	2.1	1.9
Ghana	1.5	0.9
Average share, by region and economy		
Developed market economies	2.9	3.4
Developing countries	6.0	6.1
Latin America and the Caribbean	6.0	5.0
Asia and the Pacific	5.9	6.8
Africa	6.1	9.0

Sources: United Nations, *National Accounts Statistics: Analysis of Main Aggregates, 1987* (United Nations publication, Sales No. 90.XVII.2); International Monetary Fund, balance-of-payments tape; UNCTC, *World Investment Directory* (New York, UNCTC, 1991).

Note: A negative share represents negative inflows of foreign direct investment.

* 1985-1986.

tional corporations strive to win competitive positions in the Triad (this trend is examined in detail in chapter II).

Other indicators of the relative importance of foreign direct investment to the economies of the recipient countries are presented in the annex. The share of sales, assets, employment and exports of foreign affiliates, among others, expressed in relation to the respective totals, provides a measure of the relative significance of the activities of foreign affiliates in particular sectors and

industries. The importance of their activities varies depending on the country and industry in question. In Taiwan Province of China, for example, over two fifths of all exports of electrical equipment in 1986 were accounted for by foreign affiliates. In Hong Kong in 1987, about half of total sales in that industry were accounted for by foreign affiliates, whereas the corresponding share for the secondary sector as a whole was less than 20 per cent.

For most of the developing countries shown in the table, foreign direct investment is more important in the manufacturing sector than it is in the primary and services sectors. Within manufacturing, the three industries shown in the table — electrical equipment, motor vehicles and transportation equipment — are among the most important industries for the activities of transnational corporations. Overall, the table underlines the greater importance of foreign direct investment in the economies of developing as compared to developed countries.

B. Regional distribution

1. *Developed countries*

Foreign-direct-investment inflows to developed countries have grown at an average annual rate of 46 per cent since 1985, and reached a value of $163 billion in 1989. The share of developed countries in world-wide inflows increased to 81 per cent in the 1985-1989 period, up from 75 per cent in the 1980-1984 period. The five major home countries (with the exception of Japan) are also among the largest host countries, with an average share of 57 per cent of world flows during the 1980s (table 3).

Foreign-direct-investment outflows from developed countries grew by 38 per cent annually after 1985, and reached $187 billion in 1989. The five major home countries maintained their 70 per cent share of total outflows throughout the 1980s (table 3). The United Kingdom, the United States and Japan were the largest home countries for outflows over the 1980-1989 period; the United Kingdom was the largest home country for the period overall, with average annual outflows of $17 billion (20 per cent of world outflows). Outflows from Japan, however, have exceeded those from the United States since 1986 and surpassed those from the United Kingdom in 1989, such that Japan replaced the United Kingdom as the largest source country of investment flows, accounting for 23 per cent of total world-wide outflows in that year.

2. *Developing countries*

Foreign-direct-investment inflows to the developing countries have increased continuously since 1983, to reach about $30 billion in 1989 (table 4). 7/ Since 1985, those inflows have grown at an annual rate of 22 per cent, compared to 3 per cent during the 1980-1984 period and 13 per cent during the 1975-1979 period. Although the rate of growth of foreign direct investment to the developing countries lagged behind that of the developed countries during the 1985-1989 period, it is significantly higher than com-

Table 3. Outflows of foreign direct investment from five major home countries, 1985-1989

Home country	1985	1986	1987	1988	1989	1980-1984	1985-1989
	(Billions of dollars)					(Percentage)	
France	2.2	5.4	9.2	14.5	19.4	6.0	8.0
Germany, Federal Republic of	5.0	10.1	9.2	11.2	13.5	7.4	7.8
Japan a/	6.4	14.5	19.5	34.2	44.2	8.9	18.8
United Kingdom	11.1	16.5	31.1	37.0	32.0	19.4	20.2
United States b/	8.9	13.8	28.0	13.3	26.5	28.1	14.3
Total	33.7	60.2	97.1	110.2	135.6	69.8	69.1
Developed countries	52.1	84.7	132.6	155.4	187.1	98.4	96.8
Developing countries	1.2	1.7	2.4	5.9	8.9	1.6	3.2
All countries	53.3	86.5	135.0	161.3	196.1	100.0	100.0

Source: International Monetary Fund, balance-of-payments tape, retrieved on 10 January 1991.

a/ Data for Japan do not include reinvested earnings.

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

parable rates of earlier periods. The highest growth of inflows was experienced by East, South and South-East Asia, where it reached a rate of 37 per cent per annum during the 1985-1989 period. 8/

In spite of a near doubling of average annual flows to the developing countries between 1980-1984 and 1985-1989, their share in world-wide inflows between those two periods fell from 25 per cent to 19 per cent. Ten developing economies maintained a share of about three fourths of total inflows to developing countries throughout the 1980s. The ten and their respective shares of the $16 billion in average annual inflows to developing countries and territories over the 1980-1989 period (excluding tax havens) are: Singapore (12 per cent), Brazil (12 per cent), Mexico (11 per cent), China (10 per cent), Hong Kong (7 per cent), Malaysia (6 per cent), Egypt (6 per cent), Argentina (4 per cent), Thailand (3 per cent) and Colombia (3 per cent). 9/

While the shares of Africa and East, South and South-East Asia in total world-wide inflows remained stable over the periods

Table 4. Inflows of foreign direct investment to developing regions, by region, 1980-1984, 1985-1989 and 1988-1989

Host region and economy	Annual average inflows (Billions of dollars) 1980-1984	1985-1989	1988-1989	Shares (Percentage) 1980-1984	1985-1989	1988-1989
All countries	49.70	119.00	173.00	100.0	100.0	100.0
Developing countries	12.50	22.20	29.20	25.2	18.6	16.9
Africa	1.20	2.60	3.20	2.4	2.2	1.9
Latin America and the Caribbean	6.10	8.30	10.00	12.3	7.0	5.8
East, South and South-East Asia	4.70	10.70	15.20	9.4	9.0	8.8
Oceania	0.13	0.14	0.20	0.3	0.1	0.1
West Asia	0.37	0.40	0.54	0.8	0.3	0.3
Other a/	0.04	0.03	0.05	0.1	0.0	0.0
Ten largest host economies	9.01	14.31	19.26	18.1	12.0	11.1
Argentina	0.44	0.73	1.09	0.9	0.6	0.6
Brazil	2.10	1.59	2.53	4.2	1.3	1.5
China	0.53	2.49	3.29	1.1	2.1	1.9
Colombia	0.40	0.56	0.39	0.8	0.5	0.2
Egypt	0.56	1.23	1.40	1.1	1.0	0.8
Hong Kong	0.68	1.65	2.04	1.4	1.4	1.2
Malaysia	1.13	0.83	1.28	2.3	0.7	0.7
Mexico	1.50	2.02	2.42	3.0	1.7	1.4
Singapore	1.39	2.50	3.29	2.8	2.1	2.0
Thailand	0.29	0.72	1.40	0.6	0.6	0.8
Least developed countries	0.19	0.15	0.17	0.4	0.1	0.1

Source: UNCTC estimates, based on International Monetary Fund balance-of-payments tape, retrieved on 10 January 1991; OECD estimates; and UNCTC, *World Investment Directory* (New York, UNCTC, 1991).

a/ Includes Malta and Yugoslavia.

1980-1984 and 1985-1989, the share of *Latin America and the Caribbean* in world inflows declined from 12 to 7 per cent, although in absolute terms average annual inflows to Latin America increased. As a share of inflows to only developing countries, Latin America also experienced a substantial decline, from 49 to 38 per cent, while the corresponding share of South-East Asia increased from 37 to 48 per cent.

In spite of the increase in annual average inflows, foreign-direct-investment flows to Latin America and the Caribbean in 1989 fell by $2.8 billion from their 1988 level of $11.4 billion. Although most of this decline can be accounted for by Bermuda — the exclusion of which reduces the fall in the inflows to $ 0.8 billion — continued debt-related problems in Latin America are in some measure behind the decade-long decline in the region's share of both world-wide inflows and flows to developing countries. Initiatives for economic integration in the potential extension of the United States-Canada free trade area to Mexico, and the Asunción agreement to create a common market between Argentina, Brazil, Paraguay and Uruguay (Mercosur), are likely to encourage foreign direct investment, since transnational corporations will be able to reap the benefits of economies of scale and access to a wider market.

Foreign-direct-investment flows to *East, South and South-East Asia* increased steadily after 1985. In 1986, that region surpassed Latin America and the Caribbean for the first time as the largest host region for foreign-direct-investment inflows in the developing world. In the period 1988-1989, over half of all foreign-direct-investment flows to developing countries went to that region. This sustained increase can be partly attributed to the continuous attractiveness of the newly industrializing economies, to the growth of investment opportunities in several ASEAN member countries and to the emergence of China as an important host country in the region, in spite of the small increase in foreign-direct-investment flows to the latter between 1988 and 1989. In addition, intra-regional foreign direct investment became increasingly important for East, South and South-East Asia in the latter half of the 1980s, as the newly industrializing economies emerged as important investors, seeking new low-cost production locations in neighbouring countries in order to maintain their competitiveness in export markets. One implication of this trend may be the continuation of the overall increase in foreign direct investment in East, South and South-East Asia even if total flows from developed countries decline or are diverted to other regions.

The share of *Africa* in total average annual inflows to developing countries increased from 9 per cent in the 1980-1984 period to 12 per cent in the 1985-1989 period, with oil exporting countries in Africa accounting for the bulk of the increase. In absolute terms, inflows to Africa reached $4.3 billion in 1989, two times the level reached in 1988. Egypt and Nigeria, both oil-producing countries, accounted for about 86 per cent of that amount. Foreign direct investment in sub-Saharan African countries also increased significantly, although Nigeria was the main recipient of those flows. For the non-oil-exporting sub-Saharan African countries, foreign-direct-investment inflows have remained below $0.5 billion since 1981, with some year-to-year fluctuations. Despite the increasing openness towards transnational

corporations in sub-Saharan Africa, deteriorating business conditions and political instability in many of those countries have been contributing factors to the persistently low levels of foreign direct investment.

The *least developed countries* accounted for only 0.7 per cent of average annual inflows to developing countries in the 1985-1989 period, down from 1.5 per cent in the 1980-1984 period, reaching about $200 million in 1989, one fourth of what Austria received in that year. The marginalization of least-developed countries, most of which are located in Africa, is likely to continue, since flows to developing countries are highly concentrated in newly industrializing and resource-rich countries.

Overall, net resource transfers through foreign direct investment to developing countries have shown a reversal from -$1.0 billion in the 1980-1984 period to $3.1 billion in the 1985-1988 period (table 5). 10/ That shift is due to a decrease in repatriated dividend and profit payments, coupled with increased foreign-direct-investment inflows. As indicated in table 5, for developing countries in South and South-East Asia and, to a lesser extent, in Africa, the reversal is more pronounced. In contrast, Latin America has experienced a relative decline in the transfer of net resources through foreign direct investment in the 1985-1988 period, compared to the 1980-1984 period. The positive transfer on account of foreign direct investment contrasts with negative transfers exceeding $30 billion in both these periods on account of private credit.

It should be noted that net resource transfer, as defined here, is not a very meaningful indicator of the economic impact of foreign

Table 5. Net resource transfer through foreign direct investment by region, for 96 capital-importing developing countries, 1980-1984 and 1985-1988 (Billions of dollars)

	Average	
Region	*1980-1984*	*1985-1988*
Africa	-0.74	0.52
Latin America and the Caribbean a/	2.07	1.36
Europe b/	0.02	0.01
West Asia	-0.04	0.33
East, South, South-East Asia	-2.39	0.91
Oceania	0.00	0.01
Total	-1.08	3.14

Source: International Monetary Fund, balance-of-payments tape, retrieved on 27 February 1991.

a/ Excluding Bermuda, the Netherlands Antilles and the Cayman Islands.
b/ Malta and Yugoslavia.

direct investment. For example, outflows in the form of a repatriation of profits are directly related to past investments, the economic benefits of which (employment, technology transfer etc.) are not reflected in the figure for resource transfer. Nevertheless, data on the direction and the magnitude of resource transfer are of interest to policy makers, largely because of their implications for the balance of payments.

3. *Central and Eastern Europe*

By the end of 1990, virtually all countries in Central and Eastern Europe had passed legislation encouraging foreign direct investment, and several countries had passed privatization laws. An important development in 1990 has been the allowing of 100 per cent foreign ownership of enterprises in the USSR and of profit repatriation. As a result, most of the countries of the region (and especially the USSR) are potentially quite attractive to foreign investors: they represent large domestic markets with relatively high purchasing power and consumer demand, as well as considerable untapped business opportunities; in addition, skill levels are high and, particularly in the USSR, natural resources plentiful. At the same time, the transition from centrally planned to market economies creates, at least in the short run, major economic uncertainties in an environment which, in any event, has an underdeveloped business infrastructure (for example, regarding telecommunications, transport, the financial and retail system and other basic business services).

The number of registered joint ventures in Bulgaria, Czechoslovakia, Hungary, Poland, Romania and the USSR grew rapidly in 1990, reaching 13,120 by the beginning of 1991, compared to 3,287 at the beginning of 1990, with Hungary surpassing the USSR in terms of number of registrations. 11/ In Yugoslavia, the number of registered joint ventures was about 3,000 at the beginning of 1991. Estimates of the value of foreign investment in joint ventures registered in Czechoslovakia, Hungary, Poland and the USSR range from about $3.5 billion to $5 billion, half of which occurred in the course of 1990. 12/ Nevertheless, only a few of these ventures have actually commenced operations; it has been reported that, for example, less than 10 per cent have done so in the USSR. 13/

Foreign equity capital in joint ventures with domestic partners is concentrated in the manufacturing sector. In Poland and Hungary, foreign capital in the manufacturing sector accounted for over 60 per cent of the total foreign capital during the past few years. Foreign capital in the services sector, which accounts for the overwhelming majority of the remaining share, is mostly in finance, trade, transport, storage and communication and in other business activities. In the USSR, foreign equity capital in the manufacturing sector accounted for about 60 per cent of the total foreign statutory capital by the end of 1990. 14/ The majority of foreign capital in services was in hotels and restaurants and in wholesale and retail trade, which may be explained by the small size of initial capital required for investment, by the short duration between setting-up and beginning to operate those joint ventures and by the increasing demand for such services by both domestic and foreign enterprises. In all countries, the number of joint ventures and the amount of foreign equity participation in the primary sector is very small.

More than half of the total number of joint ventures and foreign equity participation in Central and Eastern Europe originate from countries in Western Europe, particularly the European Community and Austria and, to a lesser extent, the United States. These home countries are likely to remain the largest investors over the next few years, although several Japanese companies in a recent survey have indicated that they plan to invest considerable amounts in Central and Eastern Europe. 15/ However, the rapid growth in the number of new joint ventures by the beginning of 1991 is likely to decline in the course of the year, given the possible disillusionment of foreign investors after an initial burst of euphoria, once they are confronted with a deteriorating economic situation and inadequate infrastructure in Central and Eastern Europe.

C. Sectoral pattern of foreign direct investment

1. Shifts among sectors

The rapid increase of foreign-direct-investment flows in the 1980s has been accompanied by a transformation in the sectoral composition of both the flows and stocks of this investment. During the 1950s, foreign direct investment was concentrated in raw materials, other primary products and resource-based manufacturing; today, it is mainly in services and in technology-intensive manufacturing. 16/

The shift towards services accelerated during the 1980s (table 6). As a result, while services represented around a quarter of the total world stock of foreign direct investment at the beginning of the 1970s, by the late-1980s, the share of services in world stock of foreign direct investment was close to 50 per cent, and services accounted for some 55 to 60 per cent of annual flows.

Table 7 shows recent sectoral changes in the stock of foreign direct investment for the seven major home countries which largely determine the global geographical and sectoral patterns of foreign direct investment. Although, in absolute terms, foreign direct investment in all three sectors has been growing, investment in services grew the fastest in *all* countries, followed by manufacturing and the primary sector.

Trends in the sectoral distribution of foreign direct investment generally conform to long-term changes in the structure of economic activities in both home and host countries, in which the role of the primary sector in gross national product has declined while that of the services sector has increased. In addition, changes in the policies of many developing countries with regard to the ownership of their natural resources contributed to the decline in foreign direct investment in the extractive sector. By the middle of the 1970s, ownership by transnational corporations of facilities producing — and, to a lesser extent, processing — petroleum, natural gas, non-fuel minerals and agricultural export commodities had been reduced to a great extent through nationalizations by host countries. 17/

Table 6. Sectoral distribution of foreign-direct-investment outflows for five major home countries, 1981-1984 and 1985-1989 (Millions of national currency and percentage)

Country	*1981-1984*	*1985-1989*	*1981-1984*	*1985-1989*
	Average annual flows		*(Percentage share)*	
United States a/				
Services	5 981	10 289	52	57
Non-services	5 435	7 804	48	43
Total	11 416	18 093	100	100
France				
Services	8 031	29 213	41	49
Non-services	11 468	30 790	59	51
Total	19 498	60 004	100	100
Japan b/				
Services	5 280	26 723	61	73
Non-services	3 448	9 770	39	27
Total	8 727	36 493	100	100
United Kingdom c/				
Services	1 396	5 699 d/	35	38 d/
Non-services	2 650	9 360	65	62
Total	4 046	15 059	100	100
Germany, Federal Republic of e/				
Services	8 415	6 160 d/	55	64 d/
Non-services	6 865	3 455	45	36
Total	15 280	9 615	100	100

Source: UNCTC estimates, based on UNCTC, *World Investment Directory* (New York, UNCTC, 1991).

a/ Excluding outflows to the finance (except banking), insurance and real estate sectors of the Netherlands Antilles. Data for 1985-1989 exclude currency translation adjustments. Other industries have been broken into services and non-services. The petroleum industry, a portion of which includes services (for instance, trading activities) is included in the non-services category.

b/ In dollars.

c/ Data prior to 1984 exclude investments by oil companies.

d/ Covers 1985-1988.

e/ Calculated from changes in outward stocks between consecutive years.

Table 7. Changes in the sectoral composition of the stock of outward foreign direct investment of major home countries
(Percentage share and compound annual growth rate)

Country	Period	Sectors: Primary	Secondary	Tertiary	Total
Canada					
Composition	1975	21.1	50.5	28.4	100
	1987	13.2	43.3	43.5	100
Growth rate	1975-1987	12.1	15.1	16.6	16.4
France a/					
Composition	1975	22.1	38.2	39.7	100
	1988	15.0	36.6	48.3	100
Growth rate	1975-1988	22.6	26.0	28.3	26.3
Germany, Federal Republic of					
Composition	1976	4.5	48.3	47.2	100
	1988	2.8	43.4	53.7	100
Growth rate	1976-1988	7.6	10.7	12.9	11.5
Japan					
Composition	1975	28.1	32.4	39.5	100
	1989	6.7	26.1	67.2	100
Growth rate	1975-1989	10.0	19.9	26.5	21.8
Netherlands					
Composition	1975	46.8	38.6	14.6	100
	1988	36.4	24.7	38.8	100
Growth rate	1975-1988	5.9	4.2	16.5	7.9
United Kingdom b/					
Composition	1981	..	..	35.6	100
	1987	26.9	34.4	38.6	100
Growth rate	1981-1987	..	..	12.3	11.3
United States c/					
Composition	1975	26.4	45.0	28.6	100
	1989	16.7	40.9	42.3	100
Growth rate	1975-1989	4.7	7.4	11.4	8.2

Source: UNCTC estimates, based on UNCTC, *World Investment Directory* (New York, UNCTC, 1991).

a/ Based on cumulative flows of direct investment from 1972.

b/ Data for primary and secondary sectors are not available separately for 1981. The combined growth rate of the two sectors for the 1981-1987 period was 10.3 per cent.

c/ The vertically-integrated petroleum industry is included in the primary sector in 1975. In 1989, only the extractive portion of the industry is included in the primary sector, with processing included in the secondary sector and marketing and distribution in the tertiary sector.

2. *The growing importance of services*

The growing importance of services foreign direct investment has resulted from a number of factors related to the pattern of economic development, policy changes, technological advances and the strategies of both services and industrial transnational corporations. The most important among those factors are the following:

- Services have become the largest sector in the world economy, growing continuously in most countries. During the past two decades, total demand for services has grown because of the growth in demand for consumer services resulting from a rise in real income per capita mainly in developed countries, and because technological advances have increased the demand for intermediate services, while the externalization of producer services have increased their supply.
- The expansion of services would not have been possible without the profound qualitative changes which many services have undergone during the past decade. In particular, the technological, information and knowledge component of most services has vastly increased. Telecommunications, not long ago based on simple electro-mechanical technology, has become a sophisticated set of activities employing the most modern technology and is closely linked to development in computers, micro-electronics, fibre optics and satellites. As a result, telecommunication services are now more widely in demand. New uses have emerged for accounting as a tool for management information and control; changes have also occurred in financial services and transportation, and tourism has exploded. The growth of demand for producer services is also due to the fact that many goods have become technically more complex, and are sold under much more competitive conditions than a decade or two ago. As a result, the value of goods consists increasingly of various service inputs, ranging from design to marketing, and decreasingly of direct production costs and material inputs. For instance, IBM is a service company, although it appears annually on the list of the United States' largest industrial firms. 18/
- Transnational corporations, relative to other firms, have been particularly well placed to benefit from those developments. Previously, the competitive advantages of foreign transnational corporations seeking to establish a local presence in many service industries were not as great as those of domestic companies or were insufficient to compensate for the additional cost of serving a foreign market. 19/ In addition, Governments of both developed and developing countries strictly controlled the extent and form of non-resident involvement in such strategically, politically and culturally sensitive industries as transport, telecommunications, banking, advertising and community services (for example, education, health and public utilities) and, by a variety of fiscal instruments or direct measures, favoured production by indigenous companies. Qualitative changes which have taken place in most service industries and, most importantly, the technological and information revolution, have redefined those parameters. The

pattern of competitive or ownership-specific advantages have shifted to favour corporations which have been in the forefront of change. Also, they have forced Governments to revise their protectionist policies with regard to many service industries; as a result, many countries have set in motion a process of liberalizing domestic and international policies and have relied more on competition as a tool to increase efficiency. 20/

- While transnational corporations in manufacturing usually have many options in serving foreign markets, ranging from exports to the establishment of wholly-owned foreign affiliates, the range of options available to service corporations is often limited, since many services are not tradable. This helps to explain the much faster expansion of foreign direct investment in services than that of services trade, along with the slower growth in foreign direct investment in the manufacturing sector compared to growth in the services sector. Those trends have been accelerated by a combination of a growing demand for services and the opening up of markets. The trend towards services foreign direct investment has been reinforced by industrial corporations, which have increasingly established service affiliates abroad, particularly in finance and trade-related areas, where investments appear to be designed to strengthen and internalize corporate functions, rather than diversify into services *per se*. 21/
- The opening of developed-country markets in some service industries encourages transnational service corporations to exploit their advantages in new markets. It also leads to increased investment, as competing transnational corporations follow each other into important markets to protect or strengthen their international market position *vis-à-vis* their competitors. 22/ The industries most affected by these strategic considerations include banking and other financial services (which, along with wholesale and retail trade, constitute the bulk of services foreign direct investment) and, in selected locations, other services, such as management consultancy, advertising, air transportation and hotels.
- The increasing importance of those developments has led to a diversification of home countries undertaking services foreign direct investment. In the second half of the 1980s, Japan and the European Community became the largest sources of services foreign-direct-investment flows, with average annual investments in services three times and almost two times larger, respectively, than those of the United States. 23/ Japanese and Western European transnational service corporations are catching up with United States corporations in many important industries and markets, including those of the United States, a country which has been one of the most dynamic areas for the expansion of transnational service corporations. Also, transnational corporations based in a few newly industrializing countries have emerged in such industries as trading, banking, construction and hotels.
- The single most important destination for services foreign direct investment during the second half of the 1980s was the

European Community; growth in that region alone accounts, to a considerable extent, for the rapid expansion of world services foreign direct investment during that period. From 1984 to 1988, cumulated investment flows (excluding reinvested earnings) in services in the European Community by both third countries and firms from the Community, exceeded by far those in all other sectors and amounted, respectively, to ECU 28 billion and 16 billion for third countries and ECU 34 billion and 21 billion for intra-Community foreign direct investment. 24/ The creation of the Single Market has provided a powerful inducement for both Community and non-Community transnational service corporations to invest in the Community. This is not surprising, given that services will be greatly affected by the Single Market programme. While the European Community started dismantling its internal barriers to trade and foreign direct investment in goods some 30 years ago, obstacles to foreign direct investment and trade in services remained untouched until the late 1980s when the 1992 project began. The mere announcement of the Single Market and the process to remove those obstacles has led to a massive reorganization of service industries in the Community and has created a substantial interest on the part of transnational service corporations from all major home countries which rapidly started positioning themselves in the large and dynamic Community market. As a result, the share of services in total foreign direct investment in the European Community by both third-country and Community transnational corporations rarely fell below 60 per cent in each of the years during the 1984-1988 period (see table 8).

Although services foreign direct investment has rapidly increased in absolute terms in both developed and developing countries, it has done so much faster in the former than in the latter. As a result, by the mid-1980s, some 84 per cent of the stock of foreign direct investment in services was located in developed countries, compared with 75 per cent of all foreign direct investment. 25/ The structure of transnational-corporations-related service activity in developed countries is very different from that in developing countries. In the former, intermediate services, such as financial, business and professional services, and services competing for the discretionary income of consumers play a much more important role. In developing countries, there is a higher proportion of investment in trading, construction, tourism and basic financial services. That discrepancy underlines the locational advantages of developed countries *vis-à-vis* developing countries stemming from large and dynamic markets for modern and efficient services which, together with more liberal policies towards transnational service corporations, constitute compelling locational inducements for transnational service corporations. Exceptions include a few developing countries offering fiscal incentives to induce tax-haven and flags-of-convenience-related activities, as well as such capital-intensive projects as the construction of hotels. That pattern of locational advantages is, however, rapidly changing. Developing countries increasingly emphasize the efficiency of services as a principal policy objective and, in that context, seek a greater role for transnational corpora-

Table 8. Share of services in total foreign-direct-investment flows a/ from, into and within the European Community, 1984-1988 (percentage)

Direction of flows	*Share of services in total flows* 1984	1985	1986	1987	1988	*Share for the period 1984-1988*
A. Outward investment from the EC	35	51	43	44	26	37
B. Inward investment in the EC						
By third countries	60	57	71	56	62	60
By the EC (intra-EC)						
• Reported by investing country	-7 b/	53	44	66	75	57
• Reported by country of investment	70	78	60	68	53	62

Source: Eurostat, "Les investissements directs de la Communauté Européenne" (Luxembourg, August 1990).

a/ Excluding reinvested earnings.
b/ Negative figure is due to disinvestment.

tions in the provision of services. 26/ It remains to be seen, however, whether policy changes alone will prove to be sufficient to attract increased investment by transnational service corporations.

All indications are that the internationalization of service industries through foreign direct investment is in its early stages and that the momentum in the growth of services foreign direct investment will be maintained or even increased during the 1990s. For one, demand for modern producer services, supplied mostly by transnational corporations, is growing rapidly in all countries, including developing countries. In addition, the countries of Central and Eastern Europe will need increasingly to make use of such services as banking, insurance and other financial services, telecommunication, accounting and legal services in the transition towards a market economy. Countries also realize that the provision of many of those services will not be possible without the participation of transnational corporations. Secondly, the process of liberalization of foreign direct investment in services is a relatively recent phenomenon which is spreading to more countries and more service industries, including capital-intensive infrastructure services, such as telecommunications, transportation and public utilities, in which foreign ownership was previously not allowed by most countries. Thirdly, transnational service corporations as a group are much less transnational than industrial firms, implying that there is con-

siderable potential for rapid growth in services foreign direct investment in the future.

While there is little doubt that these and other factors will lead to an increasing transnationalization of service industries in the near term, technological developments may, in the longer run, alter the ways in which services are delivered to foreign markets. As pointed out earlier, the limited tradability of many services has been a key factor favouring the rapid growth of foreign direct investment rather than trade. The advent of transborder data flows through the convergence of computer and telecommunication technologies changes that situation fundamentally, because transborder data flows permit instantaneous, long-distance interactive transactions via transnational computer-communication systems. 27/ By collapsing time and space, transborder data flows make it possible for certain services to be produced in one place and consumed in another. The result is an increased transportability and, therefore, tradability of certain services, especially information-intensive services. It is conceivable that the increased use of transborder data flows will make a whole range of intangible and non-storable services tradable and, in that manner, either reduce the need for foreign direct investment to deliver those services to foreign markets or change the nature of the investments involved.

On the other hand, the increased use of transborder data flows could lead to further foreign direct investment in services. One implication of such a development is that transnational service firms, like their manufacturing counterparts, may find themselves in a position in which they, too, can split their production processes into parts and allocate certain operations to foreign affiliates — for instance, to take advantage of lower wages and other costs; that would result in both increased foreign investment and intra-firm trade in services. The increased application of data services can also stimulate new foreign direct investment in a wide range of service industries, especially those which are information-intensive. The reason is that the use of transborder data flows makes it easier to establish foreign affiliates abroad by linking them to their parent corporations in an interactive manner via transnational computer-communication systems and allowing them to locate value-added activities in the parent corporation or the affiliate (or both).

In conclusion, technological changes have opened new opportunities in the areas of both trade and foreign direct investment in services. In some cases, those changes may lead, in the long run, to trade replacing foreign direct investment; in others, the result may be an increase in both foreign direct investment and intra-firm trade in services. In still other cases, a potential for new foreign direct investment in services may also emerge. Although the precise nature of the new opportunities and their full implications are still far from clear, there is little doubt that they will act in favour of a continued expansion of foreign direct investment and trade in services.

D. Policies affecting foreign direct investment

In recent years, the area of foreign direct investment has been given increased attention by policy makers at both the international and the national levels. At the international level, OECD and GATT are currently perhaps the two most important forums for crafting and implementing multilateral policies relating to foreign direct investment. Concerning the former, OECD recently took measures to harmonize the treatment of transnational corporations by host countries and to strengthen the OECD Codes of Liberalisation, and it added a chapter on transnational corporations and the environment to its Guidelines on Multinational Enterprises. In the current Uruguay Round of Multilateral Negotiations, two issues stand out as particularly important for the future of a multilateral approach to foreign-direct-investment issues: the creation of a framework to govern international transactions in services, and rules governing the application of trade-related investment measures by member States. In this section, both of these issues, which are two of the most important ones currently being tackled in the international arena, are examined. 28/

In terms of policy developments at the domestic level, privatization, de-regulation and debt-equity swaps have been among the most important policies related to foreign direct investment in many countries. The discussion below draws on the results of an empirical study which examined the impact of liberalization on foreign-direct-investment flows, with the finding that liberalization alone is unlikely to cause a significant change in investment inflows in the absence of favourable conditions in the domestic economy. Thus, while actions are being taken at the international level to encourage the growth of foreign direct investment, the most important foreign-direct-investment policy arena remains at the national level, in the efforts of policy makers to improve the overall competitiveness of their economies.

1. International policy changes

(a) The Uruguay Round and foreign direct investment in services

The establishment of a multilateral framework of rules governing trade in services is likely to have important implications for the volume and pattern of foreign direct investment in services. Such a framework has been under negotiation in the Uruguay Round of Multilateral Trade Negotiations (MTN) since 1986. The Group of Negotiations on Services in the MTN has made significant progress in bringing about a convergence of views among countries as regards the need for an international regime which would facilitate the flow of services among member States of the world community. Thus, provided the negotiations can overcome the difficulties relating to a few remaining issues regarding goods as well as services trade, the emergence of an international framework for services is likely.

The implications of the Uruguay Round for foreign direct investment arise largely out of the importance of foreign direct investment as a vehicle for the delivery of services to foreign markets as described in section C above. Data for the United States indicate that, in at least half of the 22 service activities

for which figures are available, sales by affiliates account for a greater proportion of service firms' total foreign revenues than do direct or cross-border exports. 29/ Particularly in business services such as accounting, advertising, data-processing and software, United States firms serve foreign markets primarily through the establishment of affiliates or other arrangements which allow for the direct relationships between clients and producers that are an essential element of the production process in many services.

The fact that there is a continuum of means, involving varying degrees of direct participation by services producers, for delivering services to foreign markets has been recognized by the negotiations on services in the discussions on a definition of trade in services. Trade in services has been interpreted to include the cross-border supply of services, as well as the cross-border movement of consumers and providers, and the establishment of a commercial presence for the production, distribution, marketing, sales and delivery of a service. Furthermore, although the emergence of a multilateral framework awaits the successful conclusion of the Uruguay Round, many countries, both developed and developing, have begun to anticipate a freer regime for services by opening up their services markets to foreign investors. Those policy changes are likely to consolidate further the prevailing trend towards increasing flows of foreign direct investment in services in the developed countries and to provide a stimulus to increased services foreign-direct-investment flows to developing countries as well. While the comparative advantage in many services lies with developed countries and one would therefore expect investment flows from those countries to expand significantly, the proposed multilateral framework explicitly includes provisions that would increase the participation of developing countries in world trade in services and would expand their exports of services. It also provides for the inclusion of provisions that would promote the strengthening of the efficiency and competitiveness of the domestic services sector in developing countries; affiliates of transnational service corporations in developing countries can influence that process considerably through the transfer of technology and skills.

(b) The Uruguay Round and TRIMs

One of the new issues being discussed in the Uruguay Round concerns trade-related investment measures (TRIMs), such as incentives and performance requirements for transnational corporations wishing to invest in a host country. Local content rules (that a given per cent of a good must be domestic in order to be treated as "local" and, hence, be sold free of duty), trade balancing (that imports must be matched with a given amount of exports) and export-performance requirements are among the most familiar TRIMs, which can take on a variety of forms and degrees of applicability. The United States was instrumental in having TRIMs included in the current round of negotiations; it has been estimated that one half of the latter's foreign direct investments in developing countries were subjected to TRIMs. 30/ However, while TRIMs are more frequently found in developing countries, developed countries — as the larger recipients of foreign direct investment flows — are far more important in terms of the amount of investment actually covered by TRIMs. In that regard, TRIMs

might be seen as an issue primarily between developed countries. Furthermore, among developing host countries there is a wide discrepency between the amount of investment officially subject to a TRIM (between one half and two thirds) and the amount that transnational corporations actually report as being covered by a TRIM (2 to 6 per cent). 31/ This seems to imply that a good portion of TRIMs, while officially legislated, is being imposed on an ad-hoc basis or not at all; and/or that TRIMs are unnecessary, because many transnational corporations are meeting the requirements of their own accord. In either case, the findings on TRIMs suggest that they are more of an international issue in theory than in practice.

Negotiations on TRIMs in the Uruguay Round have not yet resulted in an agreed draft, and there is still a broad spectrum of opinion among members regarding the treatment of those measures by GATT. The United States and Japan hold that a range of TRIMs is trade- and investment-distorting and should be prohibited, and that GATT rules should be elaborated to cover TRIMs explicitly; they also call for disciplines on other investment measures, not necessarily directly trade-related, such as local equity requirements and controlled access to foreign exchange, as those may also lead to trade distortions. The EC countries consider only a limited number of investment measures to have a direct impact on trade and to fall under GATT rules; they maintain that disciplinary action should focus on eliminating the trade-distorting aspect of those TRIMs rather than on their outright prohibition. Developing countries take the view that TRIMs are a legitimate instrument when applied in the broader context of a Government's overall economic development objectives, and that attempts to impose comprehensive restrictions on investment measures go beyond the GATT mandate by limiting a Government's ability to achieve its development goals. They also argue that some corporate behaviour can be trade-distorting (predatory pricing is an example) and that investment measures can be used to offset such negative effects.

Overall, the differences of opinions concerning TRIMs centre on four basic issues: the coverage of a TRIMs agreement (whether it should be extended to measures applied to established firms or only to measures on new investments); the level of discipline to be imposed; the treatment of developing countries (whether they may be granted a special allowance to use TRIMs in the context of their socio-economic development goals); and the treatment of restrictive business practices in the context of restrictions of TRIMs. Negotiations are continuing on those issues.

2. *National policy changes and their impact*

(a) Recent policy developments

During the 1980s, a large number of countries changed their policies and regulations affecting transnational corporations. In many cases, especially in *developed market economies*, those changes were a component of policies aimed at improving the climate for business operations in general, and did not single out the activities of transnational corporations. For example, while the privatization of previously Government-owned or Government-regulated assets in developed market economies frequently meant opening up to both domestic firms and foreign transnational corporations, it appears to

have contributed to a growing presence of foreign transnational corporations in domestic markets previously dominated by state enterprises. Policies involving privatization and deregulation opened to all competitors markets that had previously been restricted to Government-owned or regulated domestic enterprises. In telecommunications, strategic alliances and mergers and acquisitions have served to increase the role of foreign transnational corporations in domestic markets for equipment. Similar changes are occurring in air transport. Early in 1991, for instance, the United States agreed to reduce restrictions on foreign ownership of domestic air carriers, a change that is expected to lead to an increase in equity participation by foreign transnational corporations.

Beyond the issue of privatization, there are indications that some developed countries are treating the expansion of foreign production within their economies as an element fostering national competitiveness. The United Kingdom, for example, has actively welcomed foreign transnational corporations in such industries as computers, consumer electronics and automobiles, to expand purchasing power and employment on the one hand, and to help revitalize domestic industry on the other. In other developed economies, while there are clear signs that attitudes towards foreign production are becoming more tolerant, major policy changes have yet to occur, and policy towards foreign production remains either neutral or mildly restrictive in key sectors. In the EC, for example, the issue of local content requirements has yet to be resolved.

In *developing countries*, policy changes in the 1980s were frequently part of explicit attempts to attract greater amounts of foreign direct investment by transnational corporations and/or to influence the impact of such investment. Some countries have reduced or removed their exchange controls, thus permitting wider currency convertibility and allowing greater repatriation of profits and dividends. Price controls have been eased or lifted, giving greater play to market forces. Conditions restricting the entry of transnational corporations into key industries are more adaptable and new investment codes have been formulated that make regulations more flexible. Those changes contributed to improving the climate for foreign direct investment in a number of developing countries, including the Republic of Korea and China. On the other hand, changes in performance requirements in the 1980s were in the direction of imposing greater restrictions on transnational corporations. In many instances, however, the restrictions implied by performance requirements were linked to investment incentives granted to transnational corporations. Performance requirements, the incidence of which is not high, represent the only major area of policy where changes appear to have been in the direction of greater restrictions.

Furthermore, the growth of debt-equity swaps has enabled a number of heavily indebted countries both to reduce their external debt and expand the inflow of foreign direct investment. A number of debtor developing countries have instituted official mechanisms to convert a portion of their external debt into domestic equity. A foreigner wishing to invest in the host country can purchase debt on the open market at a discount, sell the debt to the host country central bank, and receive local currency with which to make an approved investment. Debt-equity swaps have made a

significant contribution to debt reduction in only one instance, Chile. In other cases, they have become an instrument of policy aimed at expanding and channelling inflows of foreign direct investment. 32/

Data from five debtor developing countries found that debt-equity swaps accounted for between 20 and 80 per cent of inflows of foreign direct investment in the last half of the 1980s (table 9). It is not clear, however, to what extent this represents a net increase in foreign direct investment, since it is not always possible to isolate the effect of a debt-equity swap programme from other important economic changes within host countries and, especially, since it is difficult to ascertain what part of the debt-equity related foreign direct investment is additional to investment that would have been made in any event.

Policy changes in the countries of *Central and Eastern Europe* have been among the most dramatic. As described above, the opening of those economies to allow substantial foreign participation has led to a large increase in the number of agreements, such as joint ventures, involving the participation of foreign transnational corporations, although inflows of foreign direct investment have not as yet grown as sharply. The initial openings have included, or have been followed by, the establishment of stock exchanges and the formulation of new legal and regulatory environments. In addition, there has been a growing attempt to align accounting systems to those prevailing in the major home countries of

Table 9. Foreign direct investment financed through debt-equity swaps in selected developing debtor countries, 1985-1989 (millions of dollars)

Country	*Total foreign direct investment inflows*	*Foreign direct investment through debt-equity swaps a/*	*Foreign direct investment through debt-equity swaps as percentage of total foreign direct investment*
Argentina	3 646	731	20
Brazil b/	7 687	4 529	59
Chile c/	3 947	3 160	80
Mexico	10 098	3 052	30
Philippines	2 306	473	21

Source: UNCTC, "Transnational banks and debt-equity conversions" (E/C.10/1991/5).

a/ Includes only that portion of swaps which corresponds to foreign direct investment.
b/ Excludes informal conversions.
c/ Excludes chapter XVIII transactions.

transnational corporations. While such policy changes will undoubtedly increase the attractiveness of those countries as hosts to international production by transnational corporations, larger inflows of foreign direct investment are not likely to occur until domestic economic environment stabilizes, growth rates increase and the regulatory framework has become stable and predictable.

(b) *The impact of liberalization*

The trend towards reducing restrictions on the activities of transnational corporations in host developing countries is one of the more important policy developments of the past decade. A sample of more than 300 instances of changes in policies and regulations affecting foreign direct investment by transnational corporations covering 46 countries (20 developed market economy countries and 26 developing countries, including five newly industrializing countries) over 11 years (1977-1987) illustrates the scope and direction of the changes. 33/ More than two thirds of the changes in the sample were in the direction of reducing restrictions on the activities of transnational corporations. In the case of the newly industrializing countries, more than three fourths of the changes were in the direction of reducing restrictions on transnational corporations.

Despite such substantial changes in policies, flows of foreign direct investment to developing countries have increased only slightly, and those increases have tended to be concentrated in the largest and most rapidly growing developing countries, as discussed above. Thus, policy changes may have a limited impact by themselves.

The sample of over 300 policy changes was analysed statistically to assess the relative importance of policy changes and economic variables in explaining changes in flows of foreign direct investment to host countries. For most countries, and especially for the developing countries, the policy changes explained very little of the observed changes in foreign-direct-investment flows. For the developing countries in the sample, except for the newly industrializing countries, the policy changes explained almost none of the flows of foreign direct investment. Instead, the size of host country markets was the most important determinant in the analysis. In the sample of newly industrializing countries, extensive policy liberalization was accompanied by a significant augmentation of foreign-direct-investment inflows, indicating that policy changes enhanced the growing economic attractiveness of those countries as hosts to foreign direct investment.

Statistical analysis of the type undertaken in the research cited above is limited in its ability to provide definitive answers. For example, when a policy change is recorded, it is not always possible to distinguish whether one type of policy change is more important than another. Changes in the implementation of existing policies are not measured, and such changes may be more important than alterations in the policies themselves. It is difficult to measure the lag between when a policy is changed and when market responses occur. In addition, it is easier to obtain measures of some possible explanatory variables than for others. Moreover, the lack of a stronger response may be due to the fact that many countries liberalized more or less simultaneously, offsetting, to some extent, the benefits that might accrue to any one of

them. Future research on this issue may have to explore new data and seek measures that can discriminate among various policy instruments to assess their projected importance.

At the same time, the statistical results are consistent with research on the behaviour of transnational corporations, which indicates that basic economic conditions are the most important determinants of where transnational corporations engage in foreign production, and of how much capital they transfer to their foreign production locations. In developing countries that possess a large and growing internal market or substantial productive resources, and in countries that are in geographical proximity to a major developed country market, changes in policies and regulations can be instrumental in helping attract greater amounts of foreign direct investment. This appears to have been the case in China, the Republic of Korea and recently in Mexico. In general, however, while appropriate policies appear to be a necessary precondition for attracting foreign direct investment, they are not sufficient, by themselves, to improve the ability of host countries to obtain larger inflows of foreign direct investment.