PART ONE

TRENDS

Chapter I

Global Trends: The Expanding International Production System

Foreign direct investment (FDI) flows continue to set new records. In 1999, global inflows reached $865 billion, an increase of 27 per cent over the previous year. FDI flows to developing countries, after stagnating in 1998, seemed set to resume their earlier growth trend. Their value reached $208 billion, an increase of 16 per cent over 1998. The driving force behind the 1999 increase in FDI continued to be cross-border mergers and acquisitions (M&As), accounting for a substantial share of total flows — a higher share in developed and a lower share in developing countries.

This is the short-term picture. The long-term picture is that FDI is playing a larger and more important role in the world economy. International production — production under the common governance of transnational corporations (TNCs) — is growing faster than other economic aggregates. The nature of international production is changing, responding to rapid technological change, intensified competition and economic liberalization. Falling transportation and communications costs are allowing TNCs to integrate production and other corporate functions across countries in historically unprecedented ways. Previous *World Investment Reports (WIRs)* have termed this process "deep integration", which is giving rise to a *cohesive global production system*, with specialized activities located by TNCs in different countries linked by tight, long-lasting bonds. The system is unevenly spread across industries, countries and TNCs, but it is growing rapidly to span many of the most dynamic activities in the world. If it represents "best practice" in international economic activity — and this may be so, given the strong economic rationale behind its growth — then all countries have to come to grips with its dimensions and implications.

A. The growth of international production remains unabated

International production now spans — in different degrees — virtually all countries, sectors, industries and economic activities. While it is difficult to quantify its magnitude because of its many facets, broad indicators show its spread. At the end of 1999, the stock of FDI, a broad measure of the capital component of international production, stood at $5 trillion (table I.1). Sales by foreign affiliates, a broad measure of the revenues generated by international production, reached an estimated $14 trillion in 1999, while their gross product (value added) stood at an estimated $3 trillion. The gross product of all TNC systems together — that is, including parent firms — was an estimated $8 trillion in 1997, comprising roughly a quarter of the world's gross domestic product (GDP).[1]

International production is thus of considerable importance to the world economy. Global sales of foreign affiliates alone were about twice as high as global exports in 1999,

Table I.1. Selected indicators of FDI and international production, 1982-1999

(Billions of dollars and percentage)

Item	Value at current prices (Billion dollars)			Annual growth rate (Per cent)				
	1982	1990	1999	1986-1990	1991-1995	1996-1999	1998	1999
FDI inflows	58	209	865	24.0	20.0	31.9	43.8	27.3
FDI outflows	37	245	800	27.6	15.7	27.0	45.6	16.4
FDI inward stock	594	1 761	4 772	18.2	9.4	16.2	20.1	18.8
FDI outward stock	567	1 716	4 759	20.5	10.7	14.5	17.6	17.1
Cross-border M&As[a]	..	151	720	26.4[b]	23.3	46.9	74.4	35.4
Sales of foreign affiliates	2 462	5 503	13 564 [c]	15.8	10.4	11.5	21.6[c]	17.8[c]
Gross product of foreign affiliates	565	1 419	3 045 [d]	16.4	7.1	15.3	25.4[d]	17.1[d]
Total assets of foreign affiliates	1 886	5 706	17 680 [e]	18.0	13.7	16.5	21.2[e]	19.8[e]
Exports of foreign affiliates	637	1 165	3 167 [f]	13.2	13.9	12.7	13.8[f]	17.9[f]
Employment of foreign affiliates (thousands)	17 433	23 605	40 536 [g]	5.6	5.0	8.3	11.4[g]	11.9[g]
Memorandum:								
GDP at factor cost	10 611	21 473	30 061 [h]	11.7	6.3	0.6	-0.9	3.0[h]
Gross fixed capital formation	2 231	4 686	6 058 [h]	13.5	5.9	-1.4	-2.1	-0.3[h]
Royalties and fees receipts	9	27	65 [h]	22.0	14.2	3.9	6.3	0.5[h]
Exports of goods and non-factor services	2 041	4 173	6 892 [h]	15.0	9.5	1.5	-1.8	3.0[h]

Source: UNCTAD, based on FDI/TNC database and UNCTAD estimates.

[a] Data are only available from 1987 onwards.
[b] 1987-1990 only.
[c] Based on the following regression result of sales against FDI inward stock for the period 1982-1997:
Sales = 636 + 2.71 * FDI inward stock.
[d] Based on the following regression result of gross product against FDI inward stock for the period 1982-1997:
Gross product = 239 + 0.59 * FDI inward stock.
[e] Based on the following regression result of assets against FDI inward stock for the period 1982-1997:
Assets = -714 + 3.86 * FDI inward stock.
[f] Based on the following regression result of exports against FDI inward stock for the period 1982-1997:
Exports = 129 + 0.64 * FDI inward stock.
[g] Based on the following regression result of employment against FDI inward stock for the period 1982-1997:
Employment = 13 287 + 5.71 * FDI inward stock.
[h] Estimates.

Note: Not included in this table are the value of worldwide sales by foreign affiliates associated with their parent firms through non-equity relationships and the sales of the parent firms themselves. Worldwide sales, gross product, total assets, exports and employment of foreign affiliates are estimated by extrapolating the worldwide data of foreign affiliates of TNCs from France, Germany, Italy, Japan and the United States (for sales and employment) and those from Japan and the United States (for exports), those from the United States (for gross product), and those from Germany and the United States (for assets) on the basis of the shares of those countries in the worldwide outward FDI stock.

compared to almost parity about two decades ago. Global gross product attributed to foreign affiliates is about one tenth of global GDP, compared to 5 per cent in 1982. The ratio of the stock of FDI to global GDP has risen from 6 per cent to 16 per cent over this period. The ratio of FDI flows to world gross domestic capital formation was 14 per cent in 1999; this ratio is significantly higher for manufacturing (22 per cent in 1998) (table I.2). [2] In relation to private capital formation, the share varies (for the countries for which data are available) from 0.4 per cent in Japan to 98 per cent in Djibouti.[3] This share is typically higher in developing countries.[4] Global sales and gross product associated with international production have increased faster than global exports and GDP — by 3.2 percentage points and 4.1 percentage points, respectively, during the period 1982-1999 (figure I.1).

Table I.2. The importance of FDI flows in capital formation, by region and sector, 1980, 1990 and 1998

Region/economy	FDI inflows as a percentage of gross domestic capital formation: all industries	FDI inflows as a percentage of gross domestic capital formation: manufacturing	FDI inflows as a percentage of private capital formation: all industries
World			
1980	2.3	9.0[a]	3.4[d]
1990	4.7	14.0[b]	5.4[e]
1998	11.1	21.6[c]	13.9[f]
Developed countries			
1980	2.7	8.5	3.4
1990	4.9	11.9	5.2
1998	10.9	16.6	12.9
Developing countries			
1980	1.2	11.7	3.6
1990	4.0	22.3	6.7
1998	11.5	36.7	17.7
Central and Eastern Europe			
1980	0.1	..	..
1990	1.5	..	0.7[g]
1998	12.9	..	16.2

Source: UNCTAD, based on information from the World Bank, 1999 and 2000b; International Finance Corporation, Economics Department Database, (taken from their web site http://www.ifc.org/economics/data/dataset.htm); OECD, various issues and IMF, 1999.

[a] Based on data for the following economies: Bangladesh (1981), Bolivia (1981), Canada (1984), Chile, Colombia, Costa Rica, Ecuador (1986), France (1987), Germany (1987), Hong Kong (China) (1986), India, Italy (1989), Malaysia (1985), Mexico (1984), Nepal (1987), the Netherlands (1988), Pakistan (1986), Peru (1982), the Philippines, the Republic of Korea, Singapore (1981), Sri Lanka, Sweden (1987), Thailand (1989), Trinidad and Tobago (1981), the United Kingdom (1987), the United States, and Venezuela (1981).

[b] Based on data for the following economies: Australia, Bangladesh, Bolivia, Canada, Chile, Colombia, Denmark, Ecuador, Ethiopia (1992), Finland (1992), France, Germany, Hong Kong (China), India (1991), Indonesia, Italy, Malaysia, Mexico, Mongolia (1991), Morocco (1992), Nepal, the Netherlands, Norway (1994), Pakistan (1988), Peru, the Philippines, the Republic of Korea, Singapore, Spain (1992), Sri Lanka, Sweden (1987), Thailand, Trinidad and Tobago, Tunisia, the United Kingdom, the United States, Venezuela and Zimbabwe (1993).

[c] Based on data available for the most recent year in the economies as follows : 1987 for Sweden; 1991 for Denmark, Mexico and Pakistan; 1992 for Bangladesh; 1993 for Argentina, Germany, the Netherlands and Sri Lanka; 1994 for Bolivia, India, Italy, Mongolia, Norway, Peru, the Republlic of Korea, Thailand and Tunisia; 1995 for Australia, Chile, Colombia, Ethiopia, Finland, Hong Kong (China), Indonesia, Malaysia, the Philippines, Spain, Trinidad and Tobago, the United Kingdom, the United States and Zimbabwe; 1996 for Belgium, Ecuador, France, Morocco, Nepal, Singapore and Venezuela.

[d] Includes only 71 countries (14 developed and 57 developing) for which data are available for 1980.

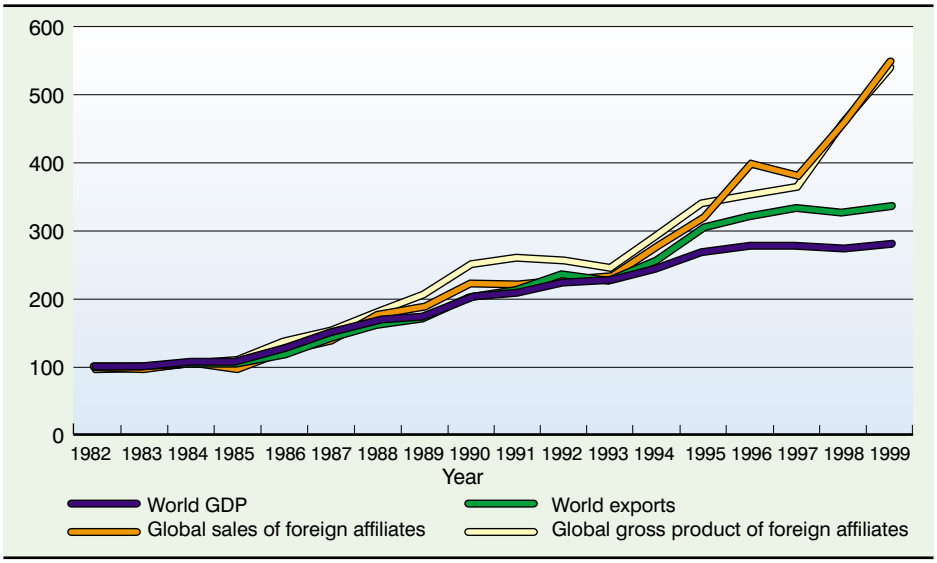
[e] Includes only 100 countries (14 developed, 84 developing and 2 in Central and Eastern Europe), for which data are available for 1990.

[f] Includes only 113 countries (13 developed, 93 developing and 7 in Central and Eastern Europe), for which data are available for 1998 or the most recent year.

[g] Based on data for Bulgaria and Poland.

While there are several reasons behind the expansion and deepening of international production,[5] the ongoing liberalization of FDI (and related) regimes and the recognition that FDI can contribute to firm competitiveness stand out as the principal pull and push factors. They exercised their influence in 1999 in the context of a relatively healthy world economy, including the recovery in Asia.

FIGURE I.1
The growth of sales and gross product associated with international production, GDP and exports, 1982-1999
(Index, 1982=100)



Source: UNCTAD, FDI/TNC database.

B. Countries continue to liberalize FDI regimes

Given the economic importance of FDI, it is not surprising that all countries today seek to attract it and to make their policies more favourable to investors. Of the 140 changes in FDI laws in 1999, 131 liberalized conditions for foreign investors (table I.3) (box I.1); over the period 1991-1999, 94 per cent of the 1,035 policy changes favoured investors.

These changes in national FDI laws were complemented by the conclusion of new bilateral investment treaties (BITs), an increasing number between developing countries. The total number of BITs rose from 1,726 at the end of 1998 to 1,856 at the end of 1999 (figure I.2 and box I.2). These treaties were often accompanied by double taxation treaties (DTTs), which rose in number to 1,982 at the end of 1999, compared to 1,873 at the end of 1998 (see figure I.2 and box I.3).[6] BITs and DTTs together were concluded at a rate of one every two working days during 1999 — an impressive rate of treaty-making. At the regional level, an increasing number of agreements are creating more favourable FDI regimes as well (UNCTAD, 1996b). Thus, during the second half of 1998 and 1999, free trade and investment agreements between Chile and Mexico, and between the members of the European Community and Mexico, expanded and deepened the existing network of agreements (UNCTAD, 2000a). More broadly, investment issues increasingly permeate international economic agreements. For example, many of the free trade, association, partnership and cooperation agreements signed by the European Community with third countries also contain FDI provisions (box I.4).

Table I.3. National regulatory changes, 1991-1999

Item	1991	1992	1993	1994	1995	1996	1997	1998	1999
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76	60	63
Number of regulatory changes	82	79	102	110	112	114	151	145	140
of which:									
More favourable to FDI [a]	80	79	101	108	106	98	135	136	131
Less favourable to FDI [b]	2	-	1	2	6	16	16	9	9

Source: UNCTAD, based on national sources.

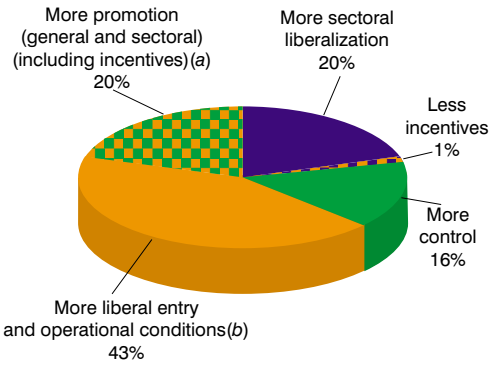
[a] Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.
[b] Including changes aimed at increasing control as well as reducing incentives.

Box I.1. Developments in national FDI frameworks during 1999

Changes in government policies on FDI during 1999 confirm and strengthen the trend towards the liberalization, protection and promotion of FDI. Most new measures by developing and transition economies reduced sectoral restrictions to foreign entry, or liberalized operations in industries earlier closed or restricted to FDI (box figure I.1.1). Notable among them are petroleum, mining, energy, airports, telecommunications, tourism, film making, banking and insurance, retail trading and pharmaceuticals. Other restrictions, such as on the ownership of land and real estate, employment of foreigners and foreign exchange controls, were also reduced or removed. In some countries, legal guarantees on the protection of intellectual property rights and against expropriation and unfavourable changes in legislation, were strengthened. Some incentive regimes were revised and rationalized while additional incentives — mainly tax incentives — were offered to promote investment in priority industries and activities. In most cases, these measures were an extension of changes undertaken in previous years.

Box figure I.1.1. Types of changes in FDI laws and regulations, 1999

(Percentage)



Source: UNCTAD, based on national sources.

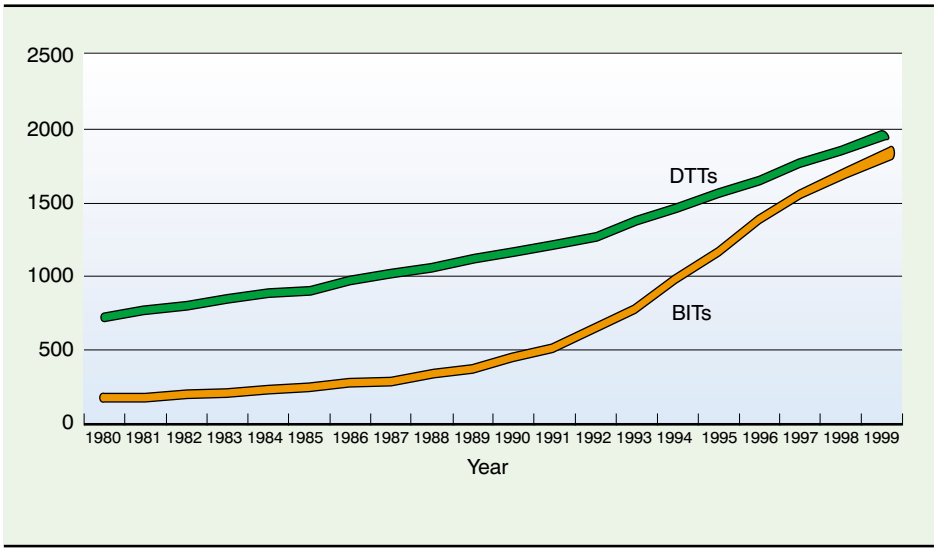
[a] Includes free-zone regulations.
[b] Operational conditions include performance requirements as well as other operational measures.

A number of countries, however, also substantially revised their FDI regimes to make them more attractive, e.g. Cambodia, India, the Russian Federation, Slovenia, the Sudan and Thailand. There was some opening up in the Islamic Republic of Iran after years of restriction. At the same time, there was a noticeable trend in developing and transition economies towards greater consumer and environmental protection and disclosure of financial information.

In developed countries, where FDI regimes are largely open, there was further deregulation of activities where foreign entry had been limited (e.g. electricity, gas and banking). The emphasis of regulatory changes, however, was on strengthening competition laws, corporate governance, consumer and environmental protection. A few countries introduced new incentives targeting, in particular, R&D and investment in underdeveloped regions. Most new fiscal measures, however, were related to the general tax regime.

Source: UNCTAD.

FIGURE I.2
Cumulative number of DTTs and BITs, 1980-1999



Source: UNCTAD, BITs and DTTs databases.

C. Enterprises seek to become more international

The quest of countries to attract more FDI is matched by the desire of companies to enhance competitiveness by spreading activities over different locations — to acquire a good portfolio of "locational assets". Capturing new markets is one important motivation, allowing firms to serve customers better by setting up local facilities. (In many services, where supply necessarily requires a local presence, this becomes the major driver of foreign investment.) Another is the search for new sources of knowledge and skills ("created assets") abroad.

Firms venturing abroad seek to match their competitive strengths ("ownership advantages") with the resources and capabilities in other countries ("locational advantages"). In many cases, where selling firm-specific advantages at arm's length is costly, cumbersome or simply unfeasible, firms expand by internalizing facilities in affiliates they control. Then FDI becomes the preferred way for firms to remain competitive in the new global environment. It is not, however, the only way. Where arm's length arrangements with overseas firms are a cheaper and more efficient way of exploiting ownership advantages, firms also undertake externalized transactions (such as licensing) with firms in other countries. Typically TNCs engage in the whole range of internal and external transactions internationally: the decision on the type of transaction depends on the nature of a firm's advantages, the capabilities of the overseas firm and conditions in the foreign location. Over time, however, as FDI policies have been liberalized, innovation costs have risen and international transaction costs fallen, internalized transactions by TNCs have grown in significance.

As a result, the number of firms that have become transnational has risen exponentially over the past three decades. In the case of 15 developed countries, that number increased from some 7,000 at the end of the 1960s to some 40,000 in the second half of the 1990s (figure I.3). The number of parent firms worldwide is now in the range of 60,000 (table I.4). These parent firms form a diverse universe that spans all countries and industries, and include a large and growing number of small and medium-sized enterprises. More and more TNCs hail from countries that have only recently begun to undertake international production - witness the growth of TNCs from some developing countries and economies in transition (table I.4 and chapter III).

The ownership of FDI, however, remains highly concentrated in both host and home countries. The concentration ratio increased even further in recent years in FDI inflows (UNCTAD, 1999a). A mere one hundred (non-financial) parent firms, based mainly in developed countries, account for roughly one-eighth of the total assets of all

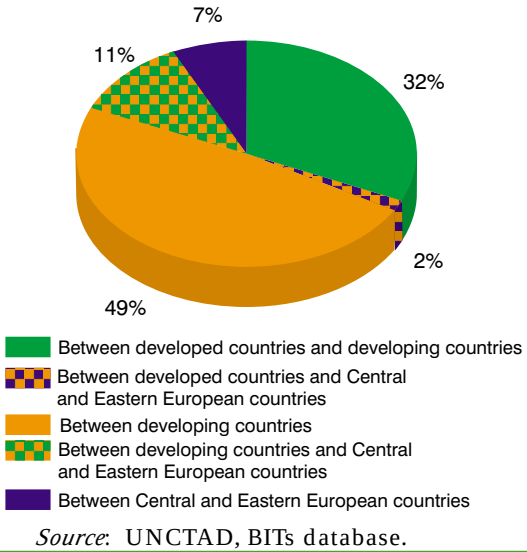
Box I.2. BITs in 1999

During 1999, the number of BITs increased substantially. A total of 96 countries concluded BITs: 30 in Asia, 20 in Latin America and the Caribbean, 13 in Africa, 11 in Central and Eastern Europe, 4 in developing Europe and 18 developed countries. Nearly half the 130 BITs concluded that year were between developing countries, while 43 treaties were concluded with developed countries (box figure I.2.1). The growing expansion of the BIT network between developing countries reflects the growth of outward FDI by developing countries. While free trade and investment agreements aim at liberalizing FDI mainly within regional groups, BITs are the main international instrument for protecting FDI between regions.

Source: UNCTAD.

Box figure I.2.1. BITs concluded in 1999, by country group

(Percentage)



Source: UNCTAD, BITs database.

foreign affiliates (chapter III). This means that the locational decisions of these few companies can have important repercussions for international production in the world economy, as well as in individual host (and, for that matter, home) countries. The extent of concentration by destination is also high as far as the absolute value of FDI inflows is concerned.[7] It is even higher for participation by host countries in integrated global production systems.

The 63,000 parent firms have an estimated 690,000 affiliates (defined in terms of a minimum of equity ownership by parent firms) (table I.4). In addition to these affiliates, TNCs have, as noted, a variety of non-equity arrangements with other firms, such as franchising, licensing, subcontracting and management contracts.[8] Inter-firm agreements like strategic alliances and partnerships also play a growing role, mostly with other large firms with strong ownership advantages. With the rise of the internet, new types of cooperation, such as internet-based procurement systems, are developing, even among fierce competitors. The on-line exchange planned by General Motors, Ford and Daimler Chrysler is an example. To the extent that TNCs can exercise control through non-equity arrangements — at least for the duration of the arrangement — local producers also fall under their common governance, creating interlocking relationships that expand the size and scope of international production.

Transnational corporations adopt a variety of strategies in undertaking international production. These strategies have changed over time. Independent "satellite" production facilities abroad by firms pursuing "stand alone" strategies are being increasingly replaced by integrated production structures by firms pursuing "deep integration" strategies (UNCTAD, 1993a, 1999a). Deep integration can take several forms. It may mean the location abroad of corporate functions like R&D, marketing or accounting. It may mean an integrated production system in which different steps of a production process are undertaken in different countries according to their relative cost and logistic advantages. It may also mean that service functions are broken up into different segments and are located internationally to minimize cost or increase flexibility.

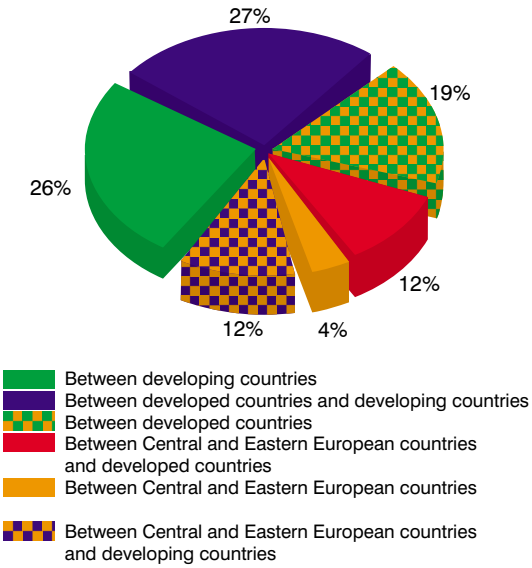
The progress of deep integration is uneven by activity, firm and location. Some activities lend themselves more readily to the division of specialized processes across countries than do others; for example, engineering industries with many discrete processes can be divided more efficiently than heavy process industries. Some TNCs are more likely to locate important functions overseas than are others. Those that do relocate transfer some tasks more than others; for instance, the relocation of top management and R&D activities has proceeded far more slowly than that of other functions. Similarly, some host countries can be integrated into global systems more easily than others, depending on their locational advantages, FDI and other policies, infrastructure, risk and so on. Thus, the overall structure of international production remains fairly hybrid, with deep integration strategies being pursued alongside traditional shallow integration strategies (involving merely the integration of markets). However, with barriers to investment, trade and information falling,

Box I.3. DTTs in 1999

In 1999, 88 countries signed a total of 109 DTTs (box figure I.3.1); 25 developed countries, 28 Asian developing countries, 12 Central and Eastern European countries, 11 countries from Africa, six from Latin America and the Caribbean and 4 from developing Europe.

Box figure I.3.1. DTTs concluded in 1999, by country group

(Percentage)



Source: UNCTAD, DTT database.

it makes economic sense - indeed, there is increased competitive pressure to do so — for TNCs to place any activity (or segment of an activity) wherever it is most economically performed — as long as efficiency, control and responsiveness remain the same. Growing competition and increasing familiarity with different locations should therefore lead inexorably to more deep integration.

Box I.4. FDI provisions in association, partnership, free trade and cooperation agreements of the European Community, March 2000

The European Community and its member States have concluded, since 1966, a number of association, partnership, free trade and cooperation agreements with non-member States. From the start, many of these instruments included provisions dealing with FDI. Thus, for example, article 74 of the 1995 Association Agreement with the Republic of Latvia provides as follows:

"Investment promotion and protection

1. Cooperation shall aim at maintaining and, if necessary, improving a legal framework and a favourable climate for private investment and its protection, both domestic and foreign, which is essential to economic and industrial reconstruction and development in Latvia. The cooperation shall also aim to encourage and promote foreign investment and privatization in Latvia.

2. The particular aims of cooperation shall be:

- for Latvia to establish a legal framework which favours and protects investment;
- the conclusion, where appropriate, with Member States of bilateral agreements for the promotion and protection of investment;
- to proceed with deregulation and to improve economic infrastructure;
- to exchange information on investment opportunities in the context of trade fairs, exhibitions, trade weeks and other events.

Assistance from the Community could be granted in the initial stage to agencies which promote inward investment.

3. Latvia shall honour the rules on Trade-Related Aspects of Investment Measures (TRIMs)."

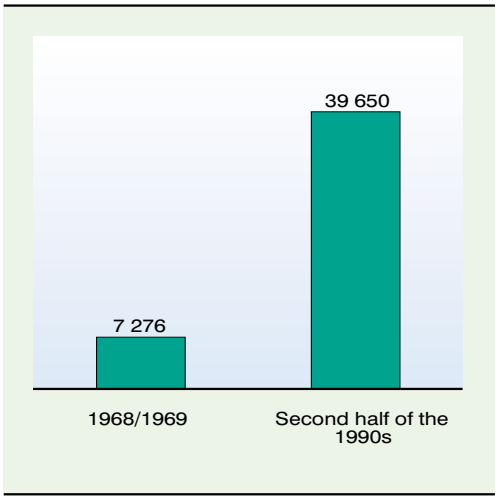
Source: UNCTAD, 2000a, vol. V.

D. M&As take the lead

Over the past decade, most of the growth in international production has been via cross-border M&As rather than greenfield investment (chapter IV). The value of completed cross-border M&As (defined as the acquisition of more than 10 per cent equity share) rose from less than $100 billion in 1987, to $720 billion in 1999 (figure I.4).[9] As a percentage of GDP, the increase was from a negligible proportion in 1987 to 2.4 per cent in 1999. Individual M&A deals can be quite substantial. Take the biggest cross-border deal until early 2000 - the takeover of Mannesmann (Germany) by Vodafone AirTouch (United Kingdom): this nearly $200 billion deal came to 6 per cent of the combined GDPs of the two countries in 1999.

It is not possible to determine precisely the share of cross-border M&As in FDI inflows. M&As can be financed locally or directly from international capital markets; neither is included in FDI data. FDI data are reported on a net basis, M&A data are not. Moreover,

FIGURE I.3
Number of parent TNCs in 15 developed home countries,[a] 1968/1969 and second half of the 1990s[b]



Source: UNCTAD, based on United Nations, 1973 and table I.4.

a Austria, Belgium, Denmark, France, Germany, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

b 1993 for the Netherlands, 1995 for Switzerland, 1997 for Austria, Belgium, Italy, the United States and Norway, 1998 for Denmark, France, Germany, Spain and the United Kingdom, 1999 for Portugal and Sweden. Luxembourg is not included.

Table I.4. Number of parent corporations and foreign affiliates, by area and economy, latest available year

(Number)

Area/economy	Year	Parent corporations based in economy[a]	Foreign affiliates located in economy[a]
Developed economies		**48 791** [b]	**94 269** [b]
Western Europe		**37 580** [b]	**61 594** [b]
European Union		**32 096** [b]	**52 673** [b]
Austria	1997	896	2 464
Belgium/Luxembourg	1997	988 [c]	1 504 [c]
Denmark	1998	9 356	2 305 [d]
Finland	1998	1 200	1 491 [d]
France	1998	1 695	9 494
Germany	1998	8 492	12 042 [e]
Greece	1991	..	798
Ireland	1998	39 [f]	1 140 [g]
Italy	1997	806 [h]	1 769 [h]
Netherlands	1993	1 608 [i]	2 259 [i]
Portugal	1999	1 100 [j]	3 500 [j]
Spain	1998	857 [k]	7 465
Sweden[l]	1999	3 965	3 759
United Kingdom [m]	1998	1 094	2 683
Other Western Europe		**5 484** [b]	**8 921** [b]
Iceland	1999	78	47
Norway	1998	900 [n]	3 100 [n]
Switzerland	1995	4 506	5 774
North America		**5 109** [b]	**23 665** [b]
Canada	1997	1 722	4 562
United States	1997	3 387 [o]	19 103 [p]
Other developed countries		**6 102** [b]	**9 010** [b]
Australia	1999	610	2 539
Japan	1998	4 334	3 321 [q]
New Zealand	1998	217	1 106
South Africa	1998	941	2 044
Developing economies		**12 518** [b]	**355 324** [b]
Africa		**167** [b]	**3 669** [b]
Ethiopia	1998	..	21 [r]
Lesotho	1999	..	411
Mali [s]	1999	3	33
Seychelles	1998	-	30
Swaziland	1999	12	53
Tunisia	1999	142	1 906
Zambia	1999	2 [t]	1 179
Zimbabwe	1998	8	36
Latin America and the Caribbean		**2 019** [b]	**24 345** [b]
Bolivia	1996	..	257
Brazil	1998	1 225	8 050
Chile	1998	478 [u]	3 173 [v]
Colombia	1995	302	2 220
El Salvador	1990	..	225

/...

Table I.4. (continued)

Area/economy	Year	Parent corporations based in economy[a]	Foreign affiliates located in economy[a]
Guatemala	1985	..	287
Guyana	1998	4	56
Jamaica	1998	..	177
Mexico	1993	..	8 420
Paraguay	1995	..	109
Peru	1997	10 [w]	1 183 [x]
Trinidad & Tobago	1999	..	65 [y]
Uruguay	1997	..	123
Asia		**10 332** [b]	**327 310** [b]
South, East and South-East Asia		**9 883** [b]	**317 147** [b]
Bangladesh	1999	..	161 [z]
Bhutan	1997	..	2
Cambodia	1997	..	598 [aa]
China	1997	379 [ab]	235 681 [ac]
Hong Kong, China	1998	819 [ad]	6 247 [ae]
India	1995	187 [af]	1 416
Indonesia	1995	313	2 241 [ae]
Lao People's Democratic Republic	1997	..	669 [ag]
Malaysia	1999	..	15 567 [ah]
Mongolia	1998	..	1 400
Myanmar	1998	..	299 [ai]
Nepal	1999	..	224 [aj]
Pakistan	1998	59	644
Philippines	1995	..	14 802 [ak]
Republic of Korea	1999	7 460	6 486
Singapore	1997	..	24 114
Sri Lanka	1998	..	305 [al]
Taiwan Province of China	1994	666 [am]	2 026
Thailand	1998	..	2 721 [an]
Viet Nam	1996	..	1 544
West Asia		**449** [b]	**1 948** [b]
Oman	1995	92 [ao]	351 [ao]
Saudi Arabia	1989	..	1 461
Turkey	1995	357	136
Central Asia		**-**	**7 663**
Armenia	1999	..	1 604 [ap]
Georgia	1998	..	190 [aq]
Kazakhstan	1999	..	1 865 [ar]
Kyrgyzstan	1998	..	4 004 [as]
The Paciifc		**-**	**552** [b]
Fiji	1997	..	151
Papua New Guinea	1998	..	345 [at]
Solomon Islands	1996	..	56 [au]
Central and Eastern Europe		**2 150** [b]	**239 927** [b]
Albania	1995	..	2 422 [av]
Armenia	1999	..	1 657 [aw]
Belarus	1994	..	393
Bulgaria	1994	26	918
Croatia	1997	70	353
Czech Republic	1999	660 [t]	71 385 [ax]

/...

Table I.4. (continued)

Area/economy	Year	Parent corporations based in economy[a]	Foreign affiliates located in economy[a]
Estonia	1999	..	3 066 ay
Hungary	1998	..	28 772 az
Lithuania	1999	16 ab	1 893
Poland	1998	58 ba	35 840 bb
Romania	1998	20 ba	71 318 bc
Russian Federation	1994	..	7 793
Slovakia	1997	..	5 560 bd
Slovenia	1997	1 300 ae	1 195 az
Ukraine	1999	..	7 362
World		**63 459**	**689 520**

Source: UNCTAD, based on national sources.

a Represents the number of parent companies/foreign affiliates in the economy shown, as defined by that economy. Deviations from the definition adopted in the *World Investment Report* (see section on definitions and sources in the annex B) are noted below.
b Includes data for only the countries shown below.
c Provisional figures by Banque Nationale de Belgique.
d Directly and indirectly owned foreign affiliates.
e Does not include the number of foreign-owned holding companies in Germany which, in turn, hold participating interests in Germany (indirect foreign participating interests).
f As of 1994.
g Refers to the number of foreign-owned affiliates in Ireland which receive assistance from the Industrial Development Agency (IDA).
h Relates to parent companies and foreign affiliates in agriculture and industrial activities (*source*: REPRINT database, Polytechnics University of Milano/CNEL).
i As of October 1993.
j Preliminary estimate. The number of foreign affiliates in Portugal as of 1998.
k Includes those Spanish parent enterprises which, at the same time, are controlled by a direct investor.
l Data provided by Sveriges Riksbank. Includes those Swedish parent companies which, at the same time, are controlled by a direct investor. The number of foreign affiliates relates only to majority-owned firms.
m Data on the number of parent companies based in the United Kingdom, and the number of foreign affiliates in the United Kingdom are based on the register of companies held for inquiries on the United Kingdom FDI abroad, and FDI into the United Kingdom conducted by the Central Statistical Office. On that basis, the numbers are probably understated because of the lags in identifying investment in greenfield sites and because some companies with small presence in the United Kingdom and abroad have not yet been identified.
n Approximation by Norges Bank. The number of parent companies as of 1997.
o Represents a total of 2,618 non-bank parent companies in 1996 and 60 bank parent companies in 1994 with at least one foreign affiliate whose assets, sales or net income exceeded $3 million, and 709 non-bank and bank parent companies in 1994 whose affiliate(s) had assets, sales and net income under $3 million. Each parent company represents a fully consolidated United States business enterprise, which may consist of a number of individual companies.
p Data for 1996. Represents a total of 13,108 bank and non-bank affiliates in 1996 whose assets, sales or net income exceeded $1 million, and 5,551 bank and non-bank affiliates in 1992 with assets, sales and net income under $1 million, and 534 United States affiliates that are depository institutions. Each affiliate represents a fully consolidated United States business entreprise, which may consist of a number of individual companies.
q Only foreign affiliates that have over 20 per cent stake in their affiliates located in Japan, plus the number of foreign affiliates, insurance and real estate industries in November 1995 (284).
r Represents the number of foreign affiliates that received permission to invest during 1992-May 1998.
s As of April 1999
t As of 1997.
u Estimated by Comite de Inversiones Extranjeras.
v Number of foreign companies registred under DL600.
w Less than 10.
x Out of this number, 811 are majority-owned foreign affiliates, while 159 affiliates have less than 10 per cent equity share.
y An equity stake of 25 per cent or more of the ordinary shares or voting power.
z Number of investment projects registered with the Board of Investment.
aa Number of projects approved, both domestic and foreign, since August 1994.
ab As of 1989.
ac Number of registered industrial enterprises with foreign capital.
ad Number of regional headquarters as at 1 June 1998.
ae As of 1996.
af As of 1991.
ag Number of projects licensed since 1988 up to end 1997.

/...

payments for M&As (including those involving privatizations) can be phased over several years (UNCTAD, 1999a, p. 8). It is therefore possible for the ratio of the value of cross-border M&As to total FDI flows — for the world as a whole or for individual countries — to be higher than 1.[10] Taking the extreme case in which all cross-border M&As are financed by FDI (certainly incorrect for developed countries, but less so for developing countries), the share of total cross-border M&As in world FDI flows has increased from 52 per cent in 1987 to 83 per cent in 1999 (figure I.5). This figure varies considerably between developed and developing countries. For the former, the ratio is higher, having risen from 62 per cent in 1987 to more than 100 per cent in 1999.[11] For developing countries, the ratio is lower, but is also rising (figure I.5), with considerable variation among developing regions and countries (figure I.6). While these ratios do not show the exact share of FDI flows accounted for by M&As in any given year, they do suggest that M&As contribute an increasing share of FDI flows to all groups of countries.

This makes it imperative for developing host countries to understand the forces driving M&As and the impact they have on development. Only then will they be able to formulate appropriate policies. The latest M&A wave — especially where it has taken the form of hostile acquisitions or "fire sales" — has heightened concerns on the part of host governments. As the Prime Minister of Malaysia phrased it in his address to UNCTAD X in February 2000:

> "...mergers and acquisitions .. are making big corporations even bigger. Now many of these corporations are financially more powerful than medium sized countries. While we welcome their collaboration with our local companies, we fear that if they are allowed into our countries unconditionally they may swallow up all our businesses" (Mahathir, 2000, p. 6).

The basis of concern is that M&As represent a change of ownership from domestic to foreign hands, while greenfield FDI represents an addition to the capital stock. This leads to such worries as the extent to which M&As (when compared to greenfield FDI) bring resources to host countries that are needed for development; the denationalization of domestic firms; employment reduction; loss of technological assets; crowding out of domestic firms and increased market concentration and its implication for competition.

Table I.4. (concluded)

[ah] May 1999. Refers to companies with foreign equity stakes of 51 per cent and above. Of this, 3,787 are fully owned foreign affiliates.
[ai] Number of permitted foreign enterprises up to end-February 1998.
[aj] June 1999.
[ak] This figure refers to directly and indirectly owned foreign affiliates.
[al] Number of projects approved under section 17 of the BOI law which provides for incentives.
[am] Number of approved new investment projects abroad in 1998.
[an] Data refer to the number of BOI-promoted companies which have been issued promotion certificates during the period 1960-1998, having at least 10 per cent of foreign equity participation.
[ao] As of May 1995.
[ap] Accumulated number of joint ventures and foreign enterprises registered as of 1 November 1999.
[aq] Number of cases of approved investments of more than 100,000 dollars registered during the period of January 1996 up to March 1998.
[ar] Joint ventures and foreign firms operating in the country.
[as] Joint venture companies established in the economy.
[at] Number of applications received since 1993.
[au] Number of foreign investment projects approved in 1996.
[av] 1,532 joint ventures and 890 wholly-owned foreign affiliates.
[aw] The number refers to the registered firms.
[ax] Out of this number 53,775 are fully-owned foreign affiliates. Includes joint ventures.
[ay] As of 15 March 1999. Only registered affiliates with the Estonian Commercial Register.
[az] Data are for the number of investment projects.
[ba] As of 1994.
[bb] Number of firms with foreign capital.
[bc] The number of affiliates established during December 1990-December 1999.
[bd] Includes joint ventures with local firms.

Note: The data can vary significantly from preceding years, as data become available for countries that had not been covered before, as definitions change, or as older data are updated.

Indeed, perhaps the most common concern about cross-border M&As — in distinction to greenfield FDI — is their impact on domestic competition. The sheer size of many of the firms involved, and their large share of global markets, raise fears about growing international oligopolies and market power. Governments therefore increasingly realize that effective competition policy is vital, and a large number of countries have adopted (or are in the process of preparing) competition laws. If anything, this policy instrument will become more important as a global market for firms is emerging, leading to the consolidation of industries on a global scale.

The mode of entry of foreign investors raises therefore important policy issues. What is driving cross-border M&As? How do they perform? Does it matter for developing countries and economies in transition whether FDI comes in the form of M&As or greenfield ventures? What policies help to minimize the negative impacts of cross-border M&As? What policies help to maximize the positive impacts? These and related issues are examined in some detail in the present report.

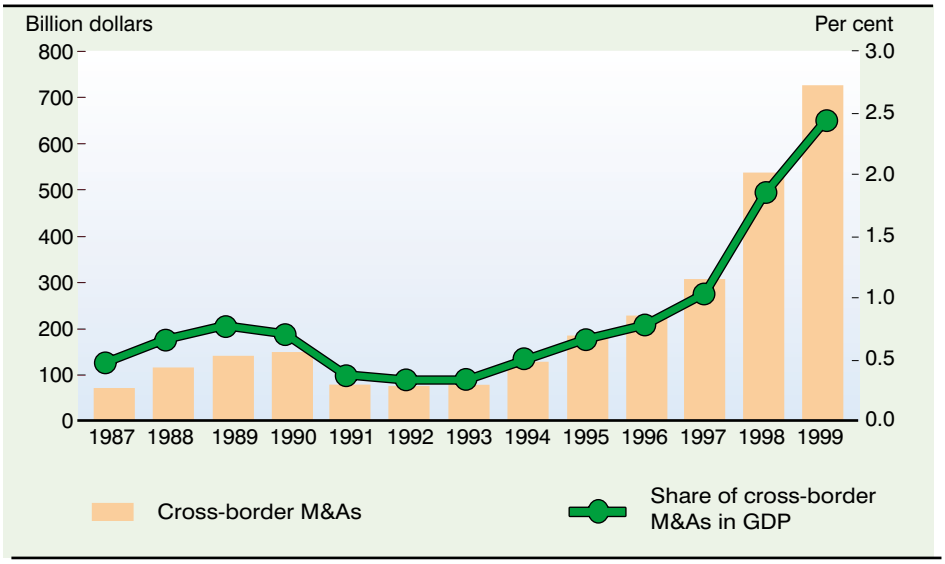
E. International production expands in scope and depth

Regardless of whether the mode of entry into a foreign market is M&As or greenfield FDI, the outcome is still an increase in the extent of international production under the common governance of TNCs. International production involves a gamut of cross-border flows by TNCs. The principal ones are finance, trade and flows of know-how, personnel and technology. The usual way to measure these flows is by its financial element — the value of FDI flows. This is an incomplete measure of the spread of international production; in fact, it does not even measure correctly the value of all investments undertaken abroad by TNCs (because some of them can be financed from local or international capital markets). However, FDI is the only aspect of international production on which comparable data are available at the country level, and this section focuses thereon.

Global FDI flows, as noted earlier, have continued to rise steadily. Inflows of FDI reached $865 billion worldwide[12] in 1999, a new record (figure I.7). The current FDI boom is now in its seventh year (since 1993). It is expected to continue into the year 2000.

Equity capital accounted for 72 per cent of global FDI inflows and reinvested earnings for 8 per cent in 1998 (figure I.8). This distribution has changed little over the past five years. Continuing last year's trend, FDI inflows to developed countries in 1999 rose faster than to other countries and set a new record of $636 billion. Most of this increase reflected cross-border M&As between firms based within the developed world. Flows of FDI, both inward and outward, for the European Union and the United States were at record levels in 1999. For Japan, inward flows quadrupled to reach also a record high, but outflows declined slightly.

FIGURE I.4
Value of cross-border M&As and its share in GDP, 1987-1999



Source: UNCTAD, FDI/TNC database and cross-border M&A database (based on data provided by Thomson Financial Securities Data Company).

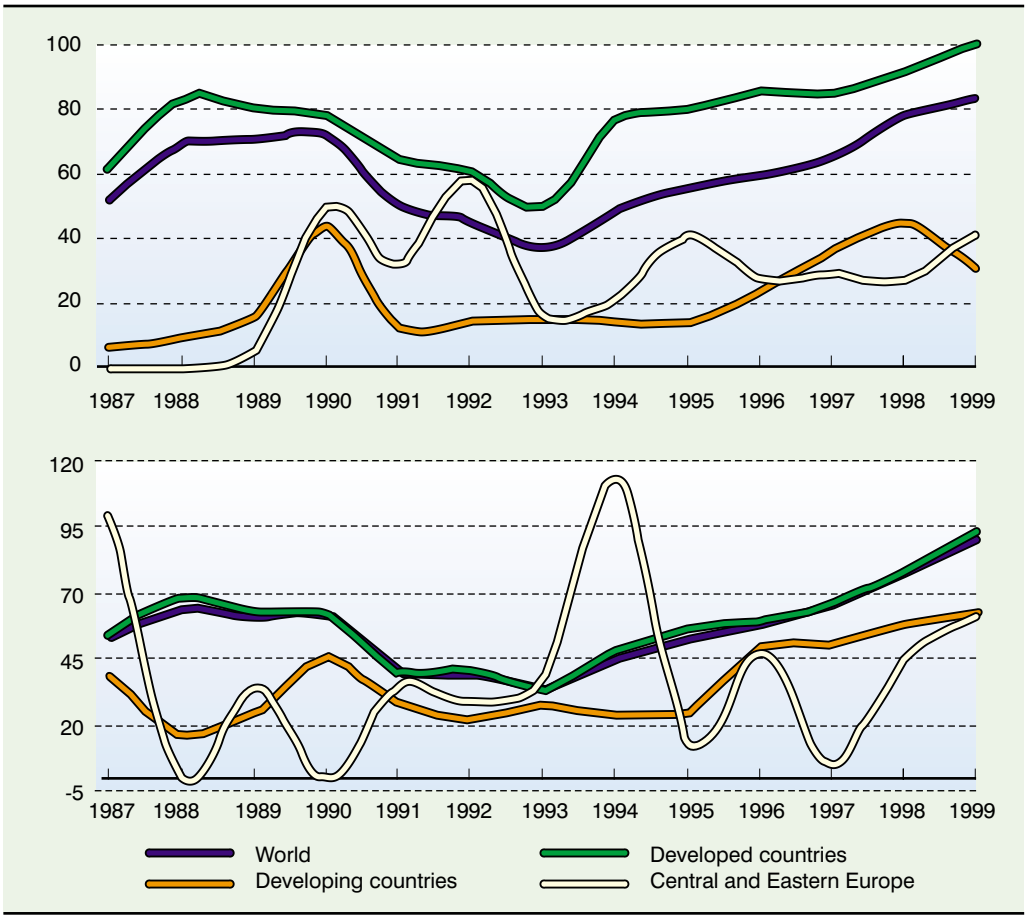
In contrast to 1998, FDI flows to developing countries increased as well — by 16 per cent, to a total of $208 billion in 1999. Africa (including South Africa) continued to attract small amounts of FDI flows, accounting only for 5 per cent of the developing country total (including South Africa). FDI increased however in 1999, with Angola, Egypt, Nigeria and South Africa being major recipients in that year. FDI inflows to Latin America and the Caribbean (where privatization is still a major magnet) increased by 23 per cent, to reach $90 billion. This increase meant that Latin America and the Caribbean had almost reached the amounts that developing Asia (including West Asia and Central Asia) had received that year, $106 billion, out of which $40 billion went to China alone; cross-border M&As influenced significantly the level of FDI flows in this region, in particular in the Republic of Korea.

Over the past two decades, firms from developing countries have also increasingly invested abroad — $66 billion in 1999, compared to $1.7 billion in 1980. As a result, their share in global FDI flows has risen from 3 per cent to 8 per cent during that period (figure I.9). Outflows of FDI from developing countries are dominated by firms from Asia, although firms from Latin America are increasingly venturing abroad as well.

FIGURE I.5

Value of cross-border M&As in relation to the value of FDI flows, world and by group of economies, 1987-1999

(Percentage)



Source: UNCTAD, FDI/TNC database and cross-border M&As database (based on data from Thomson Financial Securities Data Company).

[a] Cross-border M&A sales as a percentage of FDI inflows.
[b] Cross-border M&A purchases as a percentage of FDI outflows.

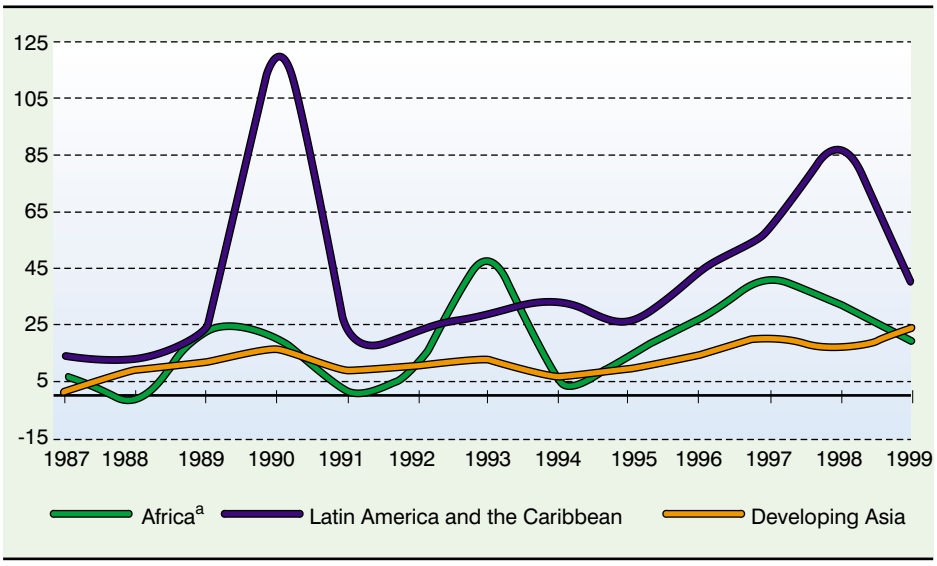
Flows to the economies in transition of Central and Eastern Europe[13] also reached a record level of $23 billion in 1999, with 70 per cent going to Central Europe. Furthermore, those flows concentrated on a limited number of countries in this sub-region (the Czech Republic, Hungary and Poland). Flows to the Russian Federation have not yet recovered fully to the previous levels.

By sector, services have for some years been the largest recipient of FDI (figure I.10), accounting for an estimated 53 per cent of global FDI outflows of 23 important outward investors in 1998. As services become more tradable, FDI is no longer the only means of reaching customers in different countries; hence one might expect a decline in FDI services. On the other hand, as services become more tradable — and here the internet plays an important role — firms can split the production process of services and, as in the case of manufacturing, locate parts of it abroad, increasing FDI in services (Sauvant, 1990). In addition, there are many services where proximity to the customer is still vital. Moreover, the ongoing deregulation and privatization of infrastructure continues to spur the growth of FDI in services. As a result, several infrastructure providers from developed and more advanced developing countries — many themselves newly privatized — have emerged as major TNCs in this industry, which is traditionally reserved for local firms.

An important feature of international production is the overwhelming importance of TNCs in trade and innovative activities. FDI and international trade are more and more determined simultaneously by TNCs as part of their decision of where they access resources and locate production, distribution or other activities (UNCTAD, 1996a). The location decisions of TNCs increasingly involve international trade as they rationalize and distribute facilities across national borders to maximize economies of scale, scope and location. TNCs are responsible for an estimated two-thirds of world trade (UNCTAD, 1996a). About half of TNC trade takes place between parent firms and their affiliates abroad, or among affiliates (UNCTAD, 1999a). TNCs also account for a large proportion of global R&D, perhaps as much as 75-80 per cent (UNCTAD, 1995a). Judging from German, Japanese and United States data — between two-thirds and nine-tenths of inter-country technology flows (approximated by royalties and fees) are also intra-firm, that is, within TNC systems (annex table A.I.1).

In addition, FDI is also the largest source of external finance for developing countries (box I.5). Moreover, in recent years, and especially during financial crises, developing countries have found FDI to be more stable than portfolio investment and bank lending. In fact, FDI inflows remained almost unchanged during the crisis in the five most seriously affected Asian countries, when other private inflows fell dramatically (figure I.11). The principal reason is that FDI is less directly influenced by factors that place countries under financial duress: the main requirement for receiving FDI is a match between the markets and productive factors that TNCs want and those that countries offer. Unlike other forms of private capital, access to which is influenced

FIGURE I.6
Value of cross-border M&As in relation to the value of FDI inflows in developing countries, by region, 1987-1999
(Percentage)



Source: UNCTAD, FDI/TNC database and cross-border M&A database (based on data from Thomson Financial Securities Data Company).

[a] Including South Africa.

by investment ratings and short-term financial considerations, FDI therefore responds more to underlying economic fundamentals.

This feature of FDI is important for countries at the bottom of the development ladder that do not have access to other investible resources. At the same time, there are common influences on FDI and other private capital flows, such as growth performance and prospects or macro-economic and political stability. In normal times, therefore, there is likely to be a high correlation between all forms of private financial flows: countries that receive more of one also tend to receive more of the other (table I.5). However, the correlation is not perfect. Some countries may get much more of one flow than of another, and FDI is more likely to go to low income countries than portfolio flows or commercial loans (Hausmann and Fernandez-Arias, 2000; Dunning and Dilyard, 1999).

In sum, a significant portion of cross-border transactions in the world economy is internalized within international production systems under the common governance of TNCs. The absolute and relative importance of international production raises a number of policy challenges.

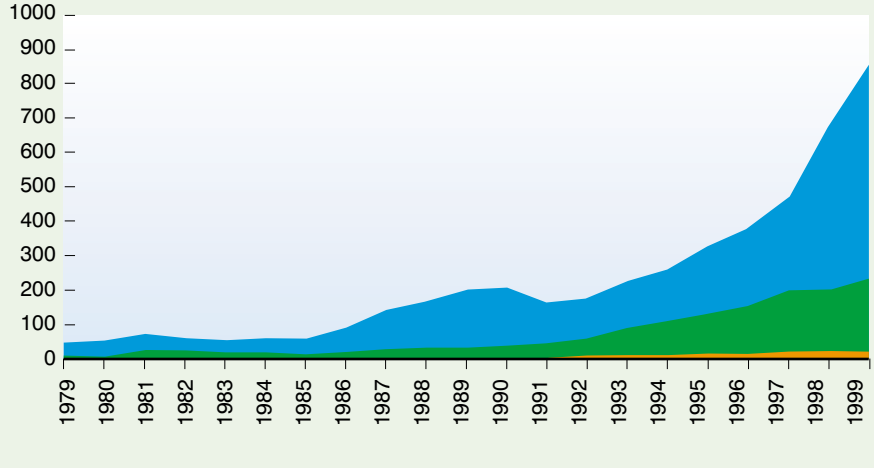
F. Challenges

International production is a growing and powerful force in today's global economy. Liberalization and new technologies increasingly allow TNCs to locate their production and other functions wherever it is most efficient and strategically appropriate for them. To benefit from the emerging system of international production, countries seek to attract FDI and pursue policies that allow them to benefit from it (UNCTAD, 1999a). This gives rise to three major challenges for policy.

The distribution challenge. The faster growth of international as compared to domestic production in the world means that economies too have become more transnational. The sum of world inward and outward FDI stocks, calculated as a percentage of world GDP, has risen from 10 per cent in 1980 to 31 per cent in 1999 (figure I.12). A more complex measure, the transnationalization index (imperfect as it may be) yields a similar picture:[14] for 23 developed and 30 developing host economies, the index rose by 0.8 percentage points for the former and 0.5 percentage points for the latter between 1996 and 1997 (figure I.13).

Despite those increases, however, the degree of transnationalization is not converging across individual countries or groups of countries. The FDI inward stock/GDP ratio is higher for developing than for developed countries (figure I.12), perhaps showing differences in the strength of local enterprises in the latter. The difference is growing over time. The ratio in 1999 was 1.7 times higher for developing than developed host countries, compared to 1.1 times twenty years ago (1980). Of course, there are significant variations among regions and countries. Similarly, the transnationalization index for host countries was 14.2 per cent in 1997 for developing countries, compared to 12.8 per cent for developed countries. Again, there were large

FIGURE I.7
World FDI inflows, 1979-1999
(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

FIGURE I.8
Components of FDI inflows, 1990-1998

Source: UNCTAD, based on IMF, June 2000 International Financial Statistics CD-ROM.

a Including two economies in Central and Eastern Europe: Estonia, for which data start in 1992, and Poland.

b Including: Australia, Finland, Germany, Iceland, Israel, the Netherlands, Portugal, Switzerland, the United Kingdom and the United States.

c Including: Antigua and Barbuda, Argentina, Barbados, Benin, Botswana, Brazil, Costa Rica, Dominica, Fiji, Grenada, Guatemala, Guinea, Honduras, Jamaica, Kazakhstan, Malta, Mexico, Morocco, Namibia, Panama, Paraguay, Saint Lucia, Saint Vincent and the Grenadines, Senegal, Swaziland, and Trinidad and Tobago. 1996 data are not available for the Netherlands Antilles and Trinidad and Tobago. Data from 1997 are not available for Antigua and Barbuda, Grenada, Saint Lucia and Saint Vincent and the Grenadines. 1998 data are not available for Benin and Senegal. Data for Kazakhstan are not available prior to 1995.

Note: Figures are based on 39 countries for which the data on each component of FDI inflows are available throughout the period.

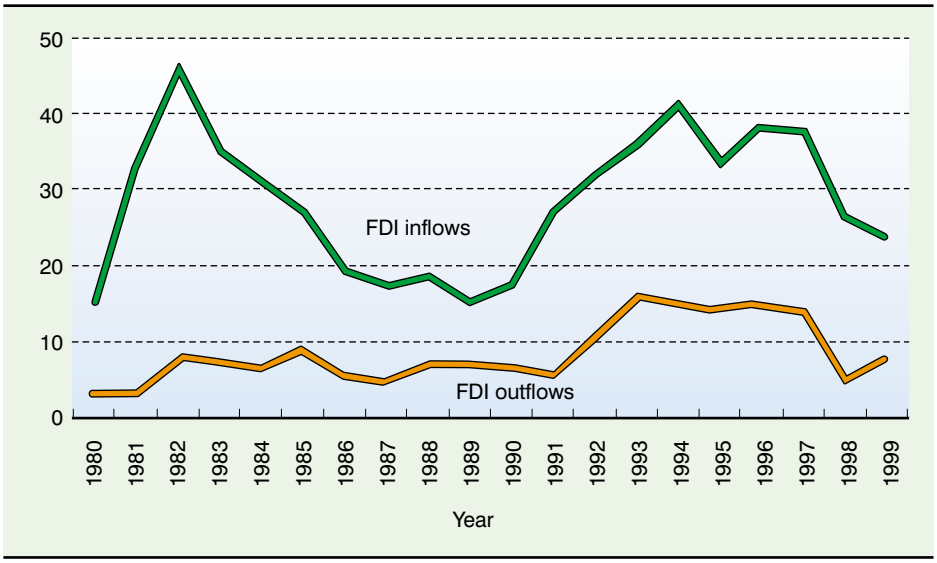
variations within each group, with the developed country group showing a smaller variance. The standard deviation for the 23 developed countries for which the transnationalization index was compiled in 1997 was 4 percentage points lower than that for 30 developing countries.

These data suggest that the spread of international production is very uneven. They also suggest that even small absolute amounts of FDI can be of great relative importance to some host countries. Take, for example, FDI inflows standardized by market size (GDP) (figure I.14). Africa (including South Africa) received only 1.2 per cent of global FDI flows, while developing Asia received 12 per cent. In relation to their GDP, however, these flows amounted to $16 per $1,000 GDP in Africa (including South Africa) and $26 in developing Asia. These figures do not, of course, take account of the quality of FDI flows. There can be a significant economic difference between "high quality" FDI (with strong forward and backward links to the domestic sector, with a strong export orientation or with high skills or technology spillovers) and "low quality" FDI (with few linkages with the domestic sector and so on).[15] If quality could be taken into account, there may be greater dispersion than the absolute figures suggest.

The policy challenge is therefore to help the countries that are relatively marginal to global investment flows to attract more and, where feasible, higher quality FDI. The countries themselves can do a great deal. They can improve the economic and political environment for private sector activity in general, which would also be conducive for foreign investors. They can improve their economic attractiveness to international investors, by providing better infrastructure, skills, institutional support and so on (UNCTAD, 1999a). They can promote inward FDI more effectively, and target high quality investors that match their national location advantages and can improve them. International organizations also have a role to play, as has co-operation among investment promotion agencies (box I.6).

The nationality challenge. The rapid growth, geographical spread and international integration of TNC activities makes it increasingly difficult to draw traditional distinctions between domestic and foreign firms or between production in different locations. Take, for instance, the ownership of companies. National boundaries are becoming blurred as firms start to list their shares in several stock exchanges and spread head office functions across countries. Until now this has been mostly in developed countries, where some TNCs like Shell and Unilever even have headquarters in different countries (the United Kingdom and the Netherlands). Others (like Astra-Zeneca) have the responsibility for R&D in one country and their corporate headquarters in another. Developing countries do not yet participate in this process to a similar extent, but as their stock markets grow and gain greater credibility, TNCs are likely to increase their presence there as well.[16] The spreading of head-office functions has already started, with some basic research facilities established in the

FIGURE I.9
Share of developing countries in world FDI flows, 1980-1999
(Percentage)



Source: UNCTAD, FDI/TNC database.

more advanced developing countries (for examples see UNCTAD, 1999a, pp. 213-214).

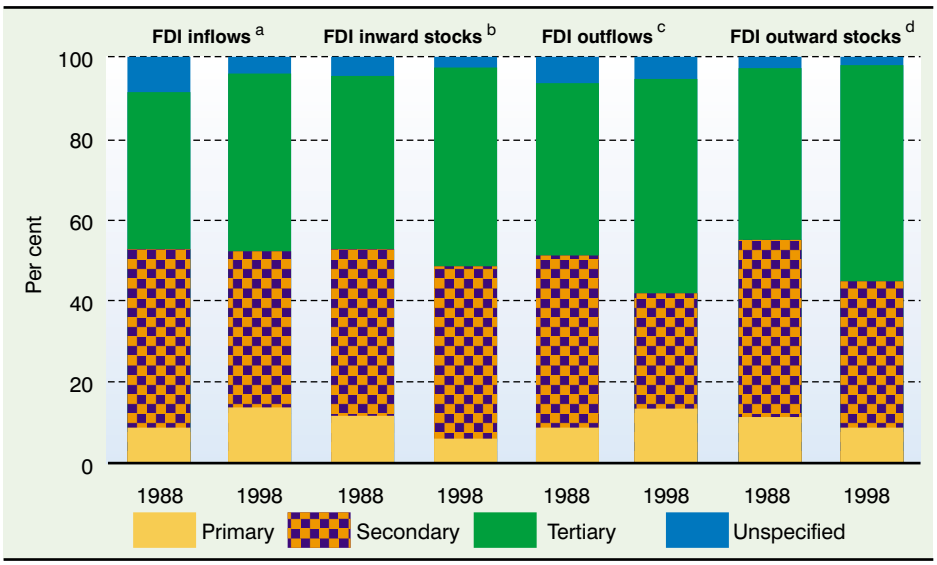
Over time, some companies may disperse ownership so widely that their "nationality" becomes very difficult to define. The spread of cross-border M&As, with extensive share swaps, and the rise of conglomerate cross-holding of shares make this even more complex. Thus, while firms become larger and more visible, where they are headquartered becomes less important — a very different scenario from the traditional transnational corporation with clear national origins, loyalties and culture. TNCs have not become stateless, but their spread and interests place them increasingly above individual national interests. This raises difficult challenges for national policies, which are not necessarily geared to transnational issues. The policy focus of national Governments will have to change, as it becomes more important to provide competitive conditions for businesses in general in the country rather than only for the country's firms in particular.

Similarly, the growth of integrated production systems means that it is difficult to define where a "product" actually comes from. Is a Ford made in the United Kingdom, when inputs come from all over Europe or further afield, design is done jointly in the United States and Europe, and stages of processing are spread over many locations, British, American or European? In some instances, as with television sets or videos, the whole product may have been manufactured by an independent local company, say, in the Republic of Korea, and sold under the brand of a Japanese TNC as part of an original equipment or contract manufacturing arrangement. Moreover, the sourcing of

FIGURE I.10

Flows and stocks of FDI, by sector, 1988 and 1998

(Percentage)



Source: UNCTAD, FDI/TNC database.

Notes: In order to represent as many countries as possible for each period, whenever data for the given years were not available, those for the latest year available close to 1988 and 1998, respectively, were chosen. Furthermore, in the absence of actual data, approval data were used in some countries.

a Data cover 40 countries in 1988 and 61 countries in 1998, accounting, respectively, for 73 and 91 per cent of world inward flows. Totals in 1988 do not include the countries in Central and Eastern Europe.

b Totals are based on data for 41 countries in 1988 and 60 countries in 1998. They account, respectively, for 71 and 81 per cent of world inward stocks.

c Flows in 1988 cover 15 countries with a 66 per cent share in world outward flows. In 1998, the total, composed of 23 countries, had an 89 per cent share in world outward flows.

d Data for 25 countries make up the total for outward stocks in 1988, and their share in world outward stocks is 77 per cent. The total in 1998 is based on data for 25 countries, which accounted for 80 per cent of world outward stocks.

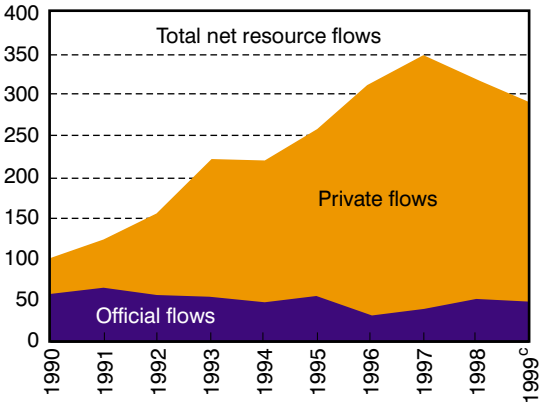
products and components may shift rapidly over time, as cost and demand conditions change. Again, traditional policies — e.g. rules of origin — based on a clear demarcation of national origin can become redundant, inefficient or distorting.

As a result of their international spread, TNCs are more insulated from national conditions and policies than national firms. They are more flexible in placing productive resources or functions in different countries, and are thus able to respond more quickly to

Box I.5. Financial flows to developing countries

The trend of rising private capital flows and declining official flows to developing countries was interrupted in 1998. In 1999, private external financing continued to decrease, following the disruption created by the outbreak of the Russian crisis in August 1998 (box figure I.5.1). Official flows to developing countries have grown since 1997 as a result of large-scale financial assistance packages organized for the various countries at the centre of the Asian, Russian and the later Brazilian crises. Grants (including technical cooperation grants) — part of official development assistance (mostly to the least developed countries) — nevertheless continued their now well established trend decline.

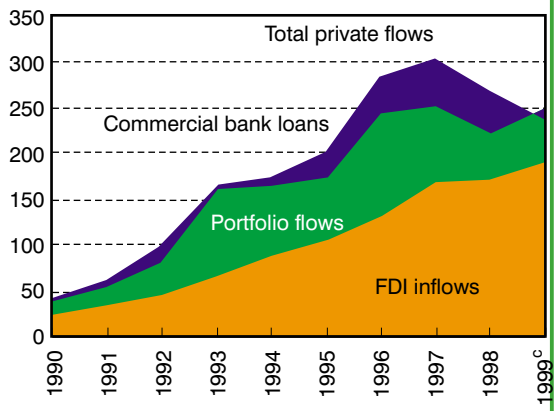
Box figure I.5.1. Total net resource flows[a] to all developing countries,[b] by type, 1990-1999



Source: UNCTAD, based on World Bank, 2000a.

While total private flows experienced a decline in both 1998 and 1999 (box figure I.5.2), there were marked differences in the pattern of net flows as regards the major categories of direct investment, portfolio investment and commercial bank financing. Inflows of FDI remained remarkably resilient, registering a marginal increase in 1998 and a rebound in 1999. Most of the decline in private external financing reflected a reduction in portfolio investment flows (including equity and bonds) in 1998 and commercial bank lending in 1999. The debt part of portfolio investment has continued to decline since 1997, while portfolio equity investment increased in 1999 after a decline during that period 1997-1998. The differentiated trends among these categories in the past few years reflects in particular the sensitivity of portfolio investment in debt securities and commercial bank lending with regard to default risk perceptions, which were dramatically revised in light of the Russian debt default of August 1998 and the Brazilian crisis in February 1999. Net financing by commercial banks remained especially unstable for some large, more advanced developing countries embroiled in financial crisis since 1998, which caused large negative balances on commercial bank loans in 1999.

Box figure I.5.2. Private net resource flows[a] to developing countries,[b] by type of flow, 1990-1999



Source: UNCTAD, based on World Bank, 2000a.

Source: UNCTAD.

a Defined as net liability transactions or original maturity of greater than one year.

b The World Bank's classification on developing countries is different from that of UNCTAD. Central and Eastern Europe is included in the former classification.

c Preliminary.

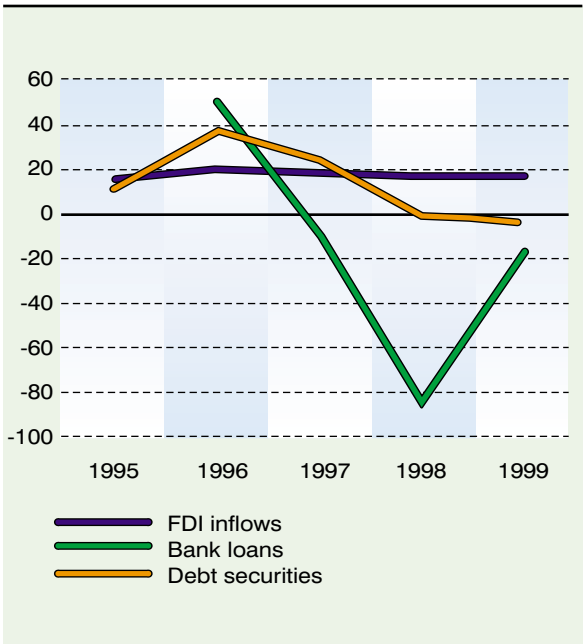
differences in economic conditions and policies. They can source inputs, information and personnel more readily across the world. They can thus bring international market forces to bear on national economies more quickly than other firms (and so exercise discipline on local markets and policy makers); at the same time, they are becoming less subject to national policies. Their large internalized markets mean that a large part of their international transactions can bypass national controls and scrutiny. For example, TNCs can use transfer pricing on intra-firm trade to minimize their tax exposure, so depriving host or home countries of tax revenue. The tax authorities of the United States, home to many of the largest TNCs, made income adjustments of $1.5 billion for 156 United States-controlled TNCs and $2 billion for 236 non-United States controlled TNCs in 1994 (UNCTAD, 1999b, p. 31). Perhaps this is not unrelated to the fact that 61 per cent of United States controlled TNCs and 67 per cent of non-United States controlled TNCs paid no income taxes in 1995 (United States, General Accounting Office, 1999, p. 5).

The development challenge. Governments of both home and host countries of TNCs have to develop responses to the challenges raised by the rapid growth of international production. Some are mentioned above, but there are several others, relating, for instance, to technology transfer,

FIGURE I.11

Private financial flows to the five Asian countries most seriously affected by the financial crisis,[a] 1995-1999

(Billions of dollars)



Source: UNCTAD, FDI/TNC database and BIS, various issues.

Note: Data for bank loans are available in the BIS statistics only from 1996 and up to September 1999. Debt securities include international money market instruments, bonds and notes.

[a] Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand.

Table I.5. Pattern of private financial flows in developing and transition economies[a], 1993-1998

(Percentage of total[b])

Rank	Economy	FDI inflows	Portfolio equity	Bonds	Bank and trade-related lending
1	China	25.7	10.8	4.4	1.3
2	Brazil	7.6	9.6	5.9	39.3
3	Mexico	6.5	10.9	10.8	13.0
4	Argentina	3.8	3.9	18.5	6.4
5	Malaysia	3.7	5.3	1.6	6.6
6	Poland	2.6	2.9	1.9	1.4
7	Chile	2.4	1.0	1.7	7.4
8	Indonesia	2.2	5.9	2.2	-3.7
9	Thailand	2.1	6.6	2.5	1.3
10	Russian Federation	1.8	3.0	15.2	6.8
11	Colombia	1.7	0.4	3.4	0.8
12	Hungary	1.6	1.9	2.1	2.1
13	Venezuela	1.6	1.1	1.8	1.5
14	Republic of Korea	1.6	14.1	12.1	-3.1
15	Peru	1.4	3.0	-0.2	1.2
16	Viet Nam	1.4	0.3	0.0	-0.3
17	India	1.4	6.1	5.6	-0.2
18	Czech Republic	1.1	0.4	1.2	1.8
19	Philippines	1.0	3.2	2.1	0.3
20	Nigeria	1.0	0.0	0.0	-0.5
21	Kazakhstan	0.7	0.0	0.3	1.3
22	Egypt	0.6	2.1	0.0	-0.7
23	Turkey	0.5	3.0	1.4	4.9
24	Romania	0.5	0.1	0.4	0.2
25	Panama	0.4	0.1	0.4	0.0
26	Pakistan	0.4	1.2	0.2	1.0
27	Ecuador	0.4	0.0	-0.0	-0.1
28	Trinidad and Tobago	0.4	0.0	0.0	-0.1
29	Morocco	0.4	0.6	0.1	0.6
30	Azerbaijan	0.4	0.0	0.0	0.1
	Total above	77.0	97.5	95.6	90.6
	Top 10	58.5	59.9	64.8	79.9
	Top 20	72.3	90.5	93.0	83.4

Source: UNCTAD, FDI/TNC database and World Bank, 2000a.

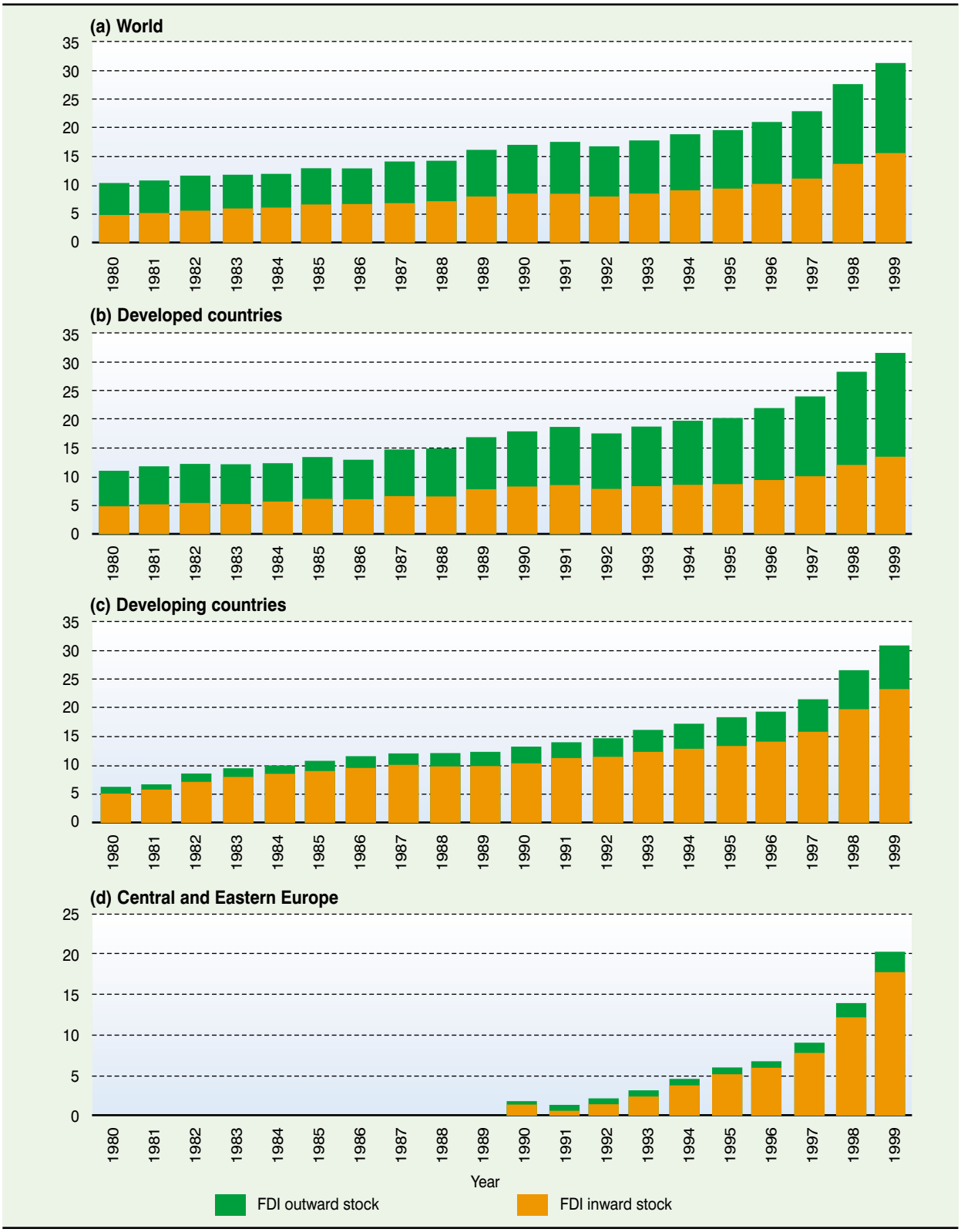
[a] 30 economies chosen and ranked on the basis of the magnitude of FDI inflows.

[b] Cumulative total of developing economies and countries in Central and Eastern Europe during 1993-1998. Excluding Bermuda, Cayman Islands, Hong Kong (China), Saudi Arabia, Singapore and Taiwan Province of China.

FIGURE I.12

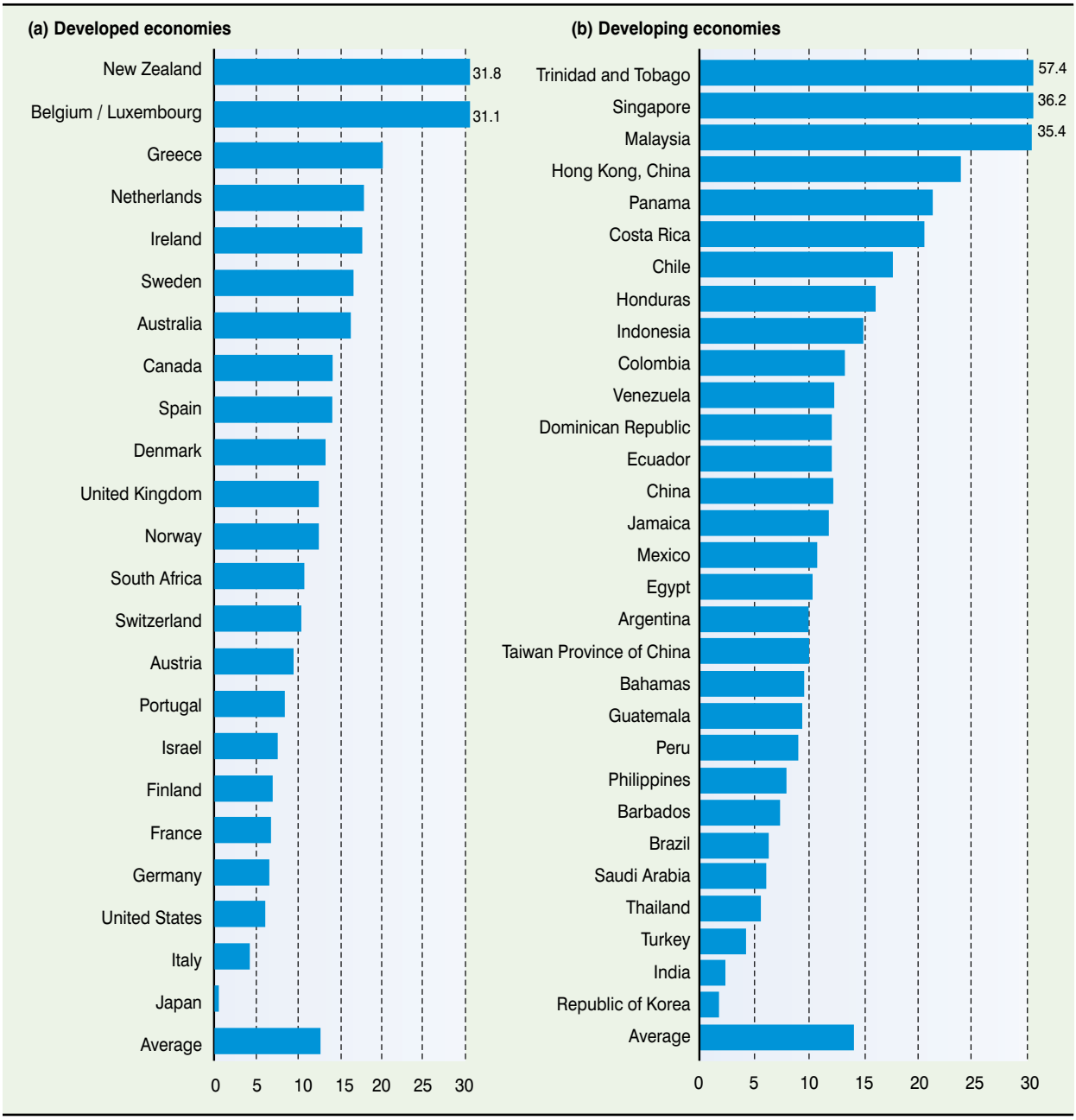
Inward plus outward FDI stock as a percentage of GDP, 1980-1999

(Percentage)



Source: UNCTAD, FDI/TNC database.

FIGURE I.13
Transnationality index[a] of host economies,[b] 1997
(Percentage)



Source: UNCTAD estimates.

[a] Average of the four shares : FDI inflows as a percentage of gross fixed capital formation for the past three years (1995-1997); FDI inward stocks as a percentage of GDP in 1997; value added of foreign affiliates as a percentage of GDP in 1997; and employment of foreign affiliates as a percentage of total employment in 1997.

[b] Only the economies for which data for all of these four shares are available were selected. Data on value added are available only for Finland (1996), France (1996), Italy, Japan, Norway, Portugal (1996), Sweden (1996), the United States, China, India (1995), Malaysia (1995), Mexico (1993), Singapore and Taiwan Province of China (1994). For other economies, data were estimated by applying the ratio of value added of United States affiliates to United States outward FDI stock to total inward FDI stock of the country. Data on employment are available only for Austria, Denmark (1996), Finland, France (1996), Germany, Ireland, Italy, Japan, Portugal (1996), Sweden (1998), the United States, Brazil (1995), China, Hong Kong (China), Indonesia (1996), Mexico (1993) and Taiwan Province of China (1995). For other economies, data were estimated by applying the ratio of employment of German and United States affiliates to German and United States outward FDI stock to total inward FDI stock of the economy.

employment, skills, local linkages and the like (UNCTAD, 1999a). A number of policies used traditionally to deal with TNCs are less used today, for instance offering protected markets or subsidies, engaging in extensive bargaining or discriminating against TNCs in favour of domestic enterprises. Not only do new international rules of trade and investment limit the freedom of national governments, many governments feel that their main function is to provide an efficient setting for market-based enterprises to operate.

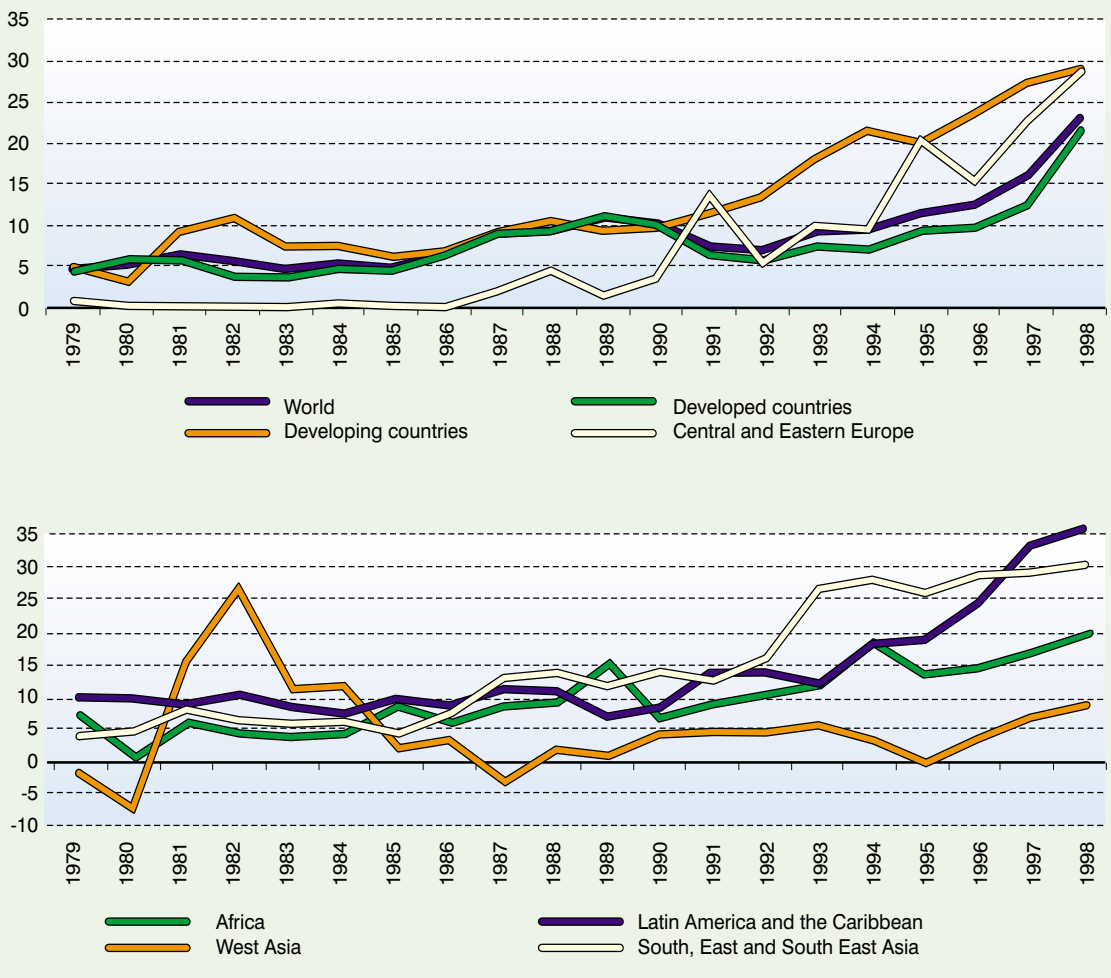
Markets and supporting institutions, however, do not work perfectly — far from it. Moreover, the interests of TNCs and host countries do not always coincide. Policy therefore matters. Governments have to make sure that they create conditions in which their economies gain the maximum benefits from FDI and suffer a minimum of losses. The issue of cross-border M&As is very relevant here (see chapter VI below). So is the issue of increasing the local roots and spillovers of TNCs, with corresponding benefits for the development of domestic enterprise. In general, the policy challenge with respect to FDI is twofold: to create the locational assets that would build genuine competitiveness and so attract more and better quality FDI; and to make sure that FDI benefits host country development as much as possible.

Because markets are not perfect, moreover, it is important for countries to preserve a "policy space" for themselves in the

FIGURE I.14

FDI inflows standardized by market size,[a] 1979-1998

(Dollars)



Source: UNCTAD, FDI/TNC database.

[a] FDI inflows per $1,000 GDP.

new international environment. They should, for instance, keep room for manoeuvre when negotiating international investment agreements in order to ensure that they are able to further national economic interests.[17] They should use the grace period provided in various WTO agreements to ensure that they are able to participate more effectively in international production, rather than withdraw from it. As was suggested in *WIR99*, however, simply participating in international production in a static way is not the way to develop: sustained growth requires that the base of domestic capabilities be dynamic. This calls for a number of policies which, while not directly related to FDI, are critical to benefiting from it.[18]

Finally, the spread of international production also raises complex and challenging broader policy management issues. There is no ideal or universal policy towards FDI, and each country has to mount its own to suit its needs and capabilities. This calls for considerable skill, information and flexibility on the part of national governments. Bargaining with TNCs remains vital in a number of areas, such as large resource extraction projects, infrastructure projects or large privatizations.

Box I.6. World Association of Investment Promotion Agencies

After its establishment in 1995, the World Association of Investment Promotion Agencies (WAIPA), headquartered in Geneva, Switzerland, has grown to a membership of 110 investment promotion agencies (IPAs) from 105 countries. Although IPAs compete worldwide for investment capital, they have many concerns in common, and there is considerable need for enhanced cooperation among them. Therefore, participating agencies in WAIPA have agreed to promote and develop understanding and cooperation amongst them; strengthen information gathering systems and information exchange; share country and regional experiences in attracting investment; assist each other to gain access to technical assistance and training through referrals to relevant agencies; facilitate access to funding and other assistance, through referrals to relevant bilateral and multilateral agencies, for the development and implementation of investment promotion programmes; and assist IPAs in advising their respective governments in the formulation of appropriate investment promotion policies and strategies. To this end, seminars, training courses and workshops, as well as conferences, are organized by WAIPA in cooperation with UNCTAD and other international organizations, and reports on specific investment promotion issues published.

The new work programme of WAIPA, defined at its Fifth Annual Conference in Bangkok, Thailand, in February 2000, reflects the challenges with which IPAs will be faced during the next decade, as well as issues related to investors' perception regarding the role of IPAs, regional strategies for investment promotion, and assistance that can be provided by international organizations.

While in most countries new policies and instruments for effective investment promotion have been put in place, not all countries have been equally able to benefit from these changes. For IPAs to meet the challenges of the future will require continuous evaluation and improvement in their operational structures as well as quick adaptation of investment related policies and strategies. In addition, regional cooperation in investment promotion will assume a more important role. Many IPAs already take advantage of the opportunities offered by increased regional economic integration and harmonization of policies, and several country groupings are promoted as single investment locations. Indeed, for many IPAs a regional strategy can assist to overcome such location disadvantages as small market size, accessibility problems or supply capacity limitations.

Financial support to the implementation of WAIPA activities is provided by the Governments of Ireland and the Netherlands. Furthermore, the following five international agencies established a Consultative Committee to support WAIPA activities and advise on its work programme: Foreign Investment Advisory Services (FIAS) of the World Bank, Multilateral Investment Guarantee Agency (MIGA), Organisation of Economic Co-operation and Development (OECD), United Nations Conference on Trade and Development (UNCTAD), and United Nations Industrial Development Organization (UNIDO).

Source: UNCTAD.

So does regulating TNCs in natural monopolies and providing a modern legal framework for property rights or dispute resolution. Effective competition policy is one of the most important tools in handling the spread of TNCs, particularly through cross-border M&As (see chapters IV-VI). Moreover, it is no longer sufficient to have a patchwork of good policies - they have to be integrated across traditional ministerial and departmental lines to achieve the coherence needed to raise competition and promote national development.

NOTES

1 The value added of all TNC systems in the world is estimated by extrapolating the data of foreign affiliates and parent firms of United States TNCs.

2 Calculated on the basis of 39 countries for which data for both manufacturing FDI and gross domestic capital formation are available.

3 Figures showing high shares (even exceeding 100 per cent in the case of Malawi) may result from the fact that the reported data on capital formation do not necessarily reflect accurately the actual value of capital formation and that FDI flows do not necessarily translate into capital formation.

4 Calculated on the basis of 113 countries for which data on private capital formation are available for 1998.

5 See UNCTAD, 1999a for a more thorough discussion.

6 The total number of DTTs, 1982 include the following types of DTTs: Income and Capital, 1754; Income, 4; Individuals/Legal Entities, 3; Air and Sea Transport, 97; Air Transport, 9; Air Services, 1; Transport, 2; Cooperation and Exchange of Information, 15; Inheritance and Gift, Specific, 56; Inheritance, 1; Technical/Administrative/Arbitration, 12; Tax Implementation Agreement, 1; Taxation of Frontier Workers Agreement, 1; and Protocols, 26.

7 The ten largest host countries, for example, accounted for 75 per cent of world FDI inflows in 1999, compared with 61 per cent in 1997 and 71 per cent in 1998.

8 Some of these are especially important in service industries, e.g. management contracts in the hotel industry.

9 The value of all cross-border M&As on an announcement basis was $1.1 trillion in 1999. It should be noted that the value and number of cross-border M&As differ, depending on whether they are given on an announcement or completion basis, or whether they cover all deals (i.e. including those of less than 10 per cent) or not. Data prior to 1987 are not systematically collected. For details see chapter IV.

10 For a more detailed discussion, see chapter IV.

11 It is a typical case that one dollar of cross-border M&As does not correspond to one dollar of FDI.

12 In current prices. In constant 1995 world import prices, this would have been higher.

13 Includes countries that are classified under developing Europe (i.e. countries of the former Yugoslavia), according to the United Nations classification.

14 Measured as the average of FDI inflows as a percentage of gross fixed capital formation over the past three years; FDI inward stock as a percentage of GDP over the latest available year; value added of foreign affiliates as a percentage of GDP over the latest available year; and employment by foreign affiliates as a percentage of total employment over the latest available year. The index is calculated for 53 countries for which data are available.

15 In practice it is very difficult to distinguish "high" from "low" quality FDI. Other conditions remaining equal, FDI projects with a high technology content or strong export-orientation are considered by most developing countries to be of higher "quality" than projects with low technology contents and no exports. Many countries would consider FDI with strong linkages to domestic enterprises that help upgrade or build up local capabilities as being of higher quality than that with weak linkages and little technological upgrading. However, priorities can vary by specific circumstances. Countries with high unemployment rates, for instance, may regard employment-creating FDI as high quality. Countries with large unexploited natural resources may regard extractive FDI as high quality. Those with weak skills and ample cheap labour may regard skill- and technology-intensive FDI as low quality, and so on. The generalization about quality being associated with linkages, skills, technology and export promotion does nevertheless apply to most developing countries with established industrial bases.

16 The reverse is certainly happening. A number of start-up companies from developing countries like India now have their initial public offerings in the United States.

17 For the discussion of the issue of flexibility in international investment agreements, see UNCTAD, 2000b.

18 See UNCTAD, 1999a, for a discussion of such policies.