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**2004 The Shift Towards
Services**



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PART TWO

THE SHIFT OF FDI TOWARDS SERVICES

INTRODUCTION

In a world with fewer investment and trade restrictions, shrinking economic distance and more mobile resources, only activities that are competitive survive and grow. Thus, competitive production has become essential for development. In order to achieve and sustain growth, structural change, desired patterns of income distribution, education, health, environmental protection and, ultimately, development, countries need firms that are efficient and productive enough to compete in open markets. Conversely, a competitive position can be maintained only if it can rely on development that benefits the majority of the population.

In ensuring a competitive production sector, services play a vital role, for three main reasons:

- Services are the largest productive sector in most economies, and their competitive (that is, efficient) production is critical to the welfare of a society as a whole. The growth and efficiency of services promote competitiveness in the broad sense of the term.
- Many services are crucial inputs into products that compete in domestic and international markets. Cheap, reliable and modern infrastructure, as well as financial, technical and other services are consequently the backbone of a competitive economy. With the rising importance of the information- and knowledge-based economy, the share of services in most activities is growing, which accentuates the need for the efficient provision of key services.
- Advances in information and communication technologies (ICTs) facilitate trade in services as they make it unnecessary for providers and users to be close to one another. New technology is making it easier to digitize information and send it across the world at negligible cost; and it allows services to be split into components, each of which can be located in countries that can provide them most efficiently and cost effectively. As a result, IT-enabled services

are now increasingly globalizing in the same way as manufactures have been for several decades.

From the perspective of the role of FDI and TNC activities in development, these factors imply new opportunities as well as risks.

On the positive side, TNCs in services can help improve the competitiveness of host economies. As in other sectors, they can provide capital, technology and managerial knowledge, enhance skills and restructure inefficient enterprises. They can also introduce new service products that previously were not supplied by domestic firms. There is potential for positive spillovers to the host economy, thereby stimulating improvements in competing service firms as well as for customers and suppliers. Where TNCs enter by acquiring State-owned utilities, they can improve the provision of basic services such as telecommunications, power and transportation, enhance the welfare of consumers and lower costs to industries using these services as inputs. Finally, service TNCs can open up new export opportunities by providing access to markets and skills not otherwise available.

In a knowledge-based economy, TNCs may have a larger impact in services than in manufacturing or resource-based industries. The role of services is closely linked to the knowledge content of the final product (goods or other services), and TNCs tend to have a competitive advantage in knowledge-intensive activities. Moreover, while in goods industries countries have a choice between imports and FDI as modes of international delivery, in many service industries, they may have to rely on FDI to get access to state-of-the-art knowledge and products.

FDI in services also entails potential costs, similar to those in manufacturing. For instance, FDI may crowd out local enterprises. In services that are natural monopolies, there is the risk of a possible abuse of monopoly power. In tourism, FDI inflows may have unwanted impacts on local communities and on the environment. FDI in certain kinds of simple exported services may relegate an economy to low-level tasks from which it may find it difficult

to upgrade. Reliance of foreign-service providers on expatriate personnel can hold back the development of local skills, while reliance on foreign subcontractors can undermine local service providers. Since many services are more deeply embedded in the social, cultural and political fabric of host societies than manufacturing, potential costs can also be more significant. Therefore, national policies need not only to facilitate the attraction of FDI in services, but also to minimize its possible negative consequences.

Notwithstanding the risks, countries are opening up to FDI in services. In response, FDI in this sector has expanded rapidly in recent years. In fact, a shift of FDI towards services has been under way for some time, but it has assumed new dimensions and patterns since the 1990s. However, its implications for development have not been fully explored.

The shift of FDI towards services and its changing mix manifest themselves in several ways:

- Services now account for the largest share of the inward FDI stock in many countries, and foreign-affiliate service providers play an important role in a growing number of services. Most service FDI has been domestic-market seeking, in such traditional services as finance, tourism and trading, or in industries that have only recently opened up to the private sector, such as electricity, water or telecommunications.
- The continuous process of liberalization and deregulation of key service industries has led to large inflows of FDI – with significant regional differences – into industries that were previously dominated by the State or by domestic private sector firms.
- A growing number of the world's largest TNCs are in service industries; even among the largest TNCs in manufacturing, services account for a rising proportion of value added.
- The ICT revolution has opened up export-oriented FDI in tradable services, even though the amounts involved are still relatively small and the destinations limited to a few countries. But as more service functions become directly tradable, international production systems involving services are being established.

Part Two of *WIR04* examines this shift. Chapter III takes stock of trends in FDI in services and examines the economic impacts. Chapter IV is devoted to one of the most interesting recent trends in the globalization of production with potential benefits for countries at all levels of development – the offshoring of corporate service functions. It assesses the current and future scope of the phenomenon, analyses the corporate strategies driving the process, considers the role of FDI in it and explores implications for host and home economies. Part Three then turns to the policy dimensions at the national and international levels.

CHAPTER III

THE GROWTH OF FDI IN SERVICES AND ITS IMPLICATIONS

Foreign direct investment is increasingly shifting towards services. Service industries that, until recently, were largely national, are becoming transnational. All countries are affected by the rise of services FDI and the broad-based growth of service TNCs. What does this mean for the development prospects of host countries? FDI in services, as in manufacturing, has the potential to enhance, directly and indirectly, the efficiency, productivity and supply capacity of host-country industries, thereby benefiting the economy as a whole. But it can also entail risks and costs against which the benefits need to be weighed carefully.

A. Changing patterns of FDI in services

How is the growth of services reshaping FDI patterns? First, the sectoral mix of FDI has shifted towards services, and the industry composition of services FDI is also changing, reflecting, in particular, a surge in flows into activities previously closed to FDI. Second, this has been accompanied by changes in the home and host country composition of FDI. Nevertheless, service industries and TNCs typically are less transnational than their manufacturing counterparts. This suggests that there is potential for services FDI to expand further – not counting non-equity forms of TNC participation (which are particularly important in this sector).

1. The growth of services FDI and its changing mix

The share of services (for definitions, see the annex to this chapter) in the national products of most countries has risen steadily during at least the past four decades, to reach 72% of GDP in developed, 52% in developing and 57% in the CEE countries in 2001 (UNCTAD 2003f). However, services accounted for a mere 20% of world exports in 2002 (IMF 2003).¹ Only one-

tenth of world services output enters international trade, compared to over half of the production of goods (World Bank 2003a). This largely reflects the non-tradable² nature of many services: most services are non-storable and hence need to be produced when and where they are consumed. Non-tradability is overcome in some cases by the temporary movement of individual consumers or providers. But in most services, the *only* way of serving foreign markets is by setting up local operations through FDI or by using non-equity arrangements (such as licensing). This may change as more services and service components become tradable via computer-communication links (the focus of chapter IV) but, so far, these services account for only a small part of the services sector.

Services FDI has grown more rapidly than FDI in other sectors.³ As a result, the composition of FDI has been shifting towards the services sector, initially in developed countries, followed by developing countries and economies in transition. This shift is in line with the growing importance of services in GDP on the one hand and the limited tradability of many services on the other. What is surprising is that these factors have only relatively recently been mirrored in FDI flows (box III.1) and that, even now, FDI and foreign affiliates' activities are less important in service industries of home and host economies than in goods industries – i.e. service industries are less transnationalized than goods industries. One major reason is that many service industries have until recently been relatively closed to foreign entry for various reasons (chapter V). Once the liberalization of FDI policies began around the mid-1980s and gathered momentum during the 1990s, services FDI surged.

The world's inward stock of services FDI quadrupled between 1990 and 2002, from an estimated \$950 billion to over \$4 trillion (based on 61 countries accounting for over four-fifths of the world's stock of FDI (annex table A.I.18), extrapolated to the world). Its share in the world's

total inward FDI stock rose to some 60% in 2002 (figure I.18), compared to less than half in 1990 and only one-quarter in the early 1970s (UNCTC 1989a, p. 8). On average, services accounted for about two-thirds of total FDI inflows (and 70% of outflows) over 2001-2002 (annex figure A.I.1) – an estimated \$500 billion (\$450 for outflows) per year (using the same methodology as for the estimation of stocks – annex table A.III.1, A.III.2).

Among individual economies, the share of services in total FDI varies considerably. For example, in the early 2000s, it ranged from 30% or less of the inward FDI stock in Bangladesh, Sweden and Venezuela to over 80% in Denmark, Luxembourg, Switzerland, Hong Kong (China) and Latvia; and from less than 40% of outward stock in Australia, Croatia and Sweden, to more than 70% in Austria, Colombia, Denmark and a number of other developed and CEE countries (annex tables A.I.22-A.I.23).

However, these figures present an imperfect picture of TNC activity in services. In some respects the role of services is inflated, because of FDI in holding companies (see below) and tax havens. In other respects it may be

understated, due to non-equity forms of investment. In addition, problems of inadequate data collection and reporting, and the lack of a uniform classification of service industries among countries, are particularly acute.

The growth of services FDI stock has gone hand-in-hand with changes in the industry mix of such FDI. Until 1990, services FDI was concentrated in trade and finance, accounting for 25% and 40%, respectively, of total inward FDI stock in services (table III.1). These activities are still important, with trade accounting for 18% and finance for 29% in 2002. They are critical for the international expansion of industrial firms and, more generally, for economic development.

Since the 1990s, however, other services have seen more dynamic FDI growth. Notable among them are electricity, telecommunications, water supply and business services – the last of these a diverse group, ranging from real estate to professional services to IT-enabled corporate services. For example, between 1990 and 2002, the dollar value of total inward FDI stock in electric power generation and distribution jumped by 14 times, to 3% of the world services inward

Box III.1. International delivery modes in goods and services

Given the non-tradability of many services across borders, one would expect services to be delivered to foreign markets mainly via FDI, and goods mainly via trade. Data for the United States (the world's largest exporter and importer of services and the largest home and host country for services FDI), permit such a comparison. It contradicts this expectation: international transactions in goods rely on FDI much more than on trade, and much more so than international transactions in services.

Since at least the mid-1980s, sales of majority-owned foreign affiliates of United States TNCs were far more important for the international delivery of goods than United States exports (by a factor of around 2.5). At the same time, the ratio of affiliates' sales to exports (whether by the movement of consumers or producers or via cross-border delivery) in services was close to one between the mid-1980s and the mid-1990s; while it started growing thereafter, it still lagged behind that for goods (1.7 vs. 2.5) at the end of the 1990s. The pattern for inward services transactions is similar:

imports and sales of foreign affiliates were largely similar in importance as modes of delivery in the 1980s and early 1990s, with the ratio increasing in favour of sales by affiliates only in the second half of the 1990s (Zimny and Mallampally 2002, p. 98).

More recently, in 2001, the ratio of foreign affiliates' sales to exports in services was still 1.8 for the United States, but exceeded 2 for Canada, Germany and Finland (annex table A.III.3); on the inward side, the ratio of foreign affiliates' sales was 2.5 for the United States (2001), and between 1 and 2 for most other countries for which data are available. According to United States data, the increase in the ratio of foreign affiliates' sales to imports and exports of services occurred not only for services in general but also for services that include many products that can be delivered via trade as well as FDI, including business, professional, telecommunications and financial services: the ratios increased from 1.6 in 1986 to 2.4 for outward transactions, and from 2 to 3.2 for inward transactions, following the pattern typical for tradable goods.

Source: UNCTAD.

FDI stock; that in telecommunications, storage and transport rose by nearly 16 times, to 11%; and that in business services by 9 times, to reach 26% of the stock⁴ (annex table A.I.18). Rapid expansion also occurred in health services and education; from a low level, their stocks rose by 12 times and by 4 times, respectively (annex table A.I.18). Rapid growth in demand for these services and privatization and liberalization in many countries facilitated this surge.

2. Changing distribution among home and host countries

The shift towards services FDI has gone hand-in-hand with a changing distribution among home and host countries. Outward FDI has become more evenly spread among developed countries (by far, still the main source of such investment), and some developing countries have

emerged as significant home countries, especially since 1990. On the inward side, developing countries as a group have seen their share increase noticeably.

a. Outward FDI

Some three decades ago, TNCs from developed countries held almost the entire *outward stock* of services FDI. The United States – already then one of the most service-oriented economies – alone accounted for two-thirds of the stock of the nine principal home countries. Since then, many other countries have emerged as outward investors, including some from the developing world (table III.2, annex table A.III.2). By the beginning of the 1990s, the United States' share had fallen to around one-quarter in terms of stock – a share it still held in 2002 (annex tables A.I.19 and A.I.21).

Table III.1. Distribution of FDI stock in services, by industry, 1990, 2002
(Per cent)

Sector/industry	1990			2002			
	Developed countries	Developing economies	World	Developed countries	Developing economies	Central and Eastern Europe	World
A. Inward FDI stock							
Total services	100	100	100	100	100	100	100
Electricity, gas and water	1	2	1	3	4	6	3
Construction	2	3	2	1	3	5	2
Trade	27	15	25	20	14	21	18
Hotels and restaurants	3	2	3	2	2	2	2
Transport, storage and communications	2	8	3	11	10	24	11
Finance	37	57	40	31	22	29	29
Business activities	15	5	13	23	40	10	26
Public administration and defence	-	-	-	-	-	-	-
Education	-	-	-	-	-	-	-
Health and social services	-	-	-	-	-	-	-
Community, social and personal service activities	2	-	2	2	1	1	2
Other services	10	8	9	2	4	2	2
Unspecified tertiary	2	1	2	6	2	-	5
B. Outward FDI stock							
Total services	100	100	100	100	100	100	100
Electricity, gas and water	1	-	1	2	-	2	2
Construction	2	2	2	1	2	2	1
Trade	17	16	17	10	12	17	10
Hotels and restaurants	1	-	1	2	2	-	2
Transport, storage and communications	5	4	5	11	7	19	11
Finance	48	62	48	35	22	39	34
Business activities	6	11	7	34	54	19	36
Public administration and defence	-	-	-	-	-	-	-
Education	-	-	-	-	-	-	-
Health and social services	-	-	-	-	-	-	-
Community, social and personal service activities	-	-	-	-	-	-	-
Other services	13	5	13	2	2	2	2
Unspecified tertiary	6	-	6	3	-	-	3

Source: UNCTAD, based on annex tables A.I.18 and A.I.19.

European Union TNCs traditionally have had a substantial FDI presence in banking, insurance, trading and air transport. The Single Market programme, announced in the second half of the 1980s and implemented in the early 1990s, provided impetus for the expansion of FDI in these and other services, notably in transport and telecommunications. The programme triggered an EU-wide restructuring of service industries, accelerating intra-EU services FDI (as well as inbound FDI, notably from the United States and Japan) (UNDESSED 1993). In the second half of the 1990s, EU service TNCs, having acquired experience in cross-border M&As within Europe, expanded into the United States in pursuit of the more ambitious goal of establishing a global presence. The resulting FDI boom in services (largely through M&As – section B.2 below) was instrumental in strengthening the EU's role as a leading home region: its share in the world's outward FDI stock rose from 39% in 1980 to 49% in 2003.

Japan's emergence as one of the largest home countries in the 1980s and the 1990s was driven by services FDI. Major TNCs involved were the *sogo shosha* (general trading companies), banks, securities companies and, to a lesser extent, insurance firms. FDI in real estate,⁵ transport and business services also expanded rapidly. Japan remains a major source of services FDI, although the stagnation of the Japanese economy during the 1990s slowed down its outward expansion.

Developing countries' outward FDI in services took off during the 1990s. Their share in the global outward FDI stock in services rose from 1% in 1990 to 10% in 2002 (table III.2).⁶ FDI in trading services expanded rapidly in this period, both in absolute value (annex table A.I.18) and as a percentage (12%) of the global FDI stock in these services (table III.2). This suggests that a good part of services FDI expansion by manufacturing firms was of a trade

Table III.2. Distribution of FDI stock in services, by group of economies, 1990, 2002
(Per cent)

Sector/industry	1990			2002			
	Developed countries	Developing economies	World	Developed countries	Developing economies	Central and Eastern Europe	World
Inward FDI stock							
Total services	83	17	100	72	25	3	100
Electricity, gas and water	70	30	100	63	32	6	100
Construction	77	23	100	47	45	8	100
Trade	90	10	100	78	19	4	100
Hotels and restaurants	87	13	100	70	26	3	100
Transport, storage and communications	58	43	100	71	22	7	100
Finance	76	24	100	77	20	3	100
Business activities	93	7	100	61	38	1	100
Public administration and defence	..	..	..	99	1	-	100
Education	100	..	100	92	4	4	100
Health and social services	100	..	100	67	32	1	100
Community, social and personal service activities	100	..	100	91	8	2	100
Other services	85	15	100	61	36	3	100
Outward FDI stock							
Total services	99	1	100	90	10	-	100
Electricity, gas and water	100	..	100	100	0	-	100
Construction	99	1	100	80	20	-	100
Trade	99	1	100	88	12	-	100
Hotels and restaurants	100	-	100	90	10	-	100
Transport, storage and communications	99	1	100	93	7	-	100
Finance	98	2	100	93	7	-	100
Business activities	98	2	100	84	16	-	100
Public administration and defence	-	-	-	100	..	..	100
Education	100	..	100	100	..	..	100
Health and social services	100	..	100	100	-	-	100
Community, social and personal service activities	100	..	100	99	1	-	100
Other services	100	1	100	90	10	-	100

Source: UNCTAD, based on annex tables A.I.18 and A.I.19.

supporting nature. But TNC activity in other services also contributed to this expansion: FDI increased particularly in business activities, hotels and restaurants, financial services, and transport, storage and communications, both in absolute values and in relative terms (annex table A.I.18 and table III. 2). For instance, the share of developing countries in the global FDI stock in each of these services was at best 2% in 1990. By 2002, it had risen to 7% for transport, storage and communication as well as for financial services; to 10% for hotels and restaurants, and even to 16% for business activities. In the last case, this was partly due to the inclusion of management holdings in business services by a number of countries.

Overall, the largest outward stocks in services were held (in 2001) by TNCs from the United States, followed by the United Kingdom, Germany, France and Hong Kong (China).

b. Inward FDI

On the inward side, the geographic distribution of services FDI has always been more balanced. The United States has long been the largest recipient but its share in the global inward FDI stock in services has never exceeded 30%. The expansion of inward services FDI has taken place mainly in Western Europe and the United States. Japan is an insignificant host for such FDI (as it is for FDI in general), although recently flows to that sector have increased (annex table A.I.20). During the second half of the 1980s, developing countries joined in and, since the early 1990s, the economies of CEE. In 2002, developed countries accounted for over two-thirds of the inward FDI stock in services (table III.2). This share was 25% for developing economies and 3% for CEE – comparable to their shares in world FDI stock.

Developing countries as a group have attracted sizeable FDI in some services, sometimes as much as developed countries. In construction, for example, developing countries' share doubled, from 23% in 1990 to 45% in 2002 (table III.2). Other examples are trade, hotels, restaurants and business activities. (In the last case, the inclusion of management holding companies is again a factor influencing the magnitude.) Conversely, the share of developing countries halved in transport, storage and communications, despite a noticeable rise in TNC

participation in their telecom industries. This is partly because of significant FDI in this industry among developed countries and CEE.

Overall, the largest inward FDI stocks in services were (in 2001) in the United States, followed by Hong Kong (China), the United Kingdom, China and France (annex table A.I.20).

3. Transnationalization is lower in the services sector and differs by industry and country

At the sectoral level, on the *outward* FDI side, data for a number of home countries show that shares of value added, employment and sales of foreign affiliates relative to total national value added, employment and sales are much higher in manufacturing than in services (table III.3). In other words, the services sector in home countries is less transnationalized than the manufacturing sector.

On the *inward* side, too, the degree of transnationalization of the services sector – that is, the importance of TNC activity relative to total host-country activity – is less than that in manufacturing. For example, in most countries, FDI inflows in 1992-2002 as a percentage of sectoral GDP were lower in services than in manufacturing, with some important exceptions (annex figure A.I.2). More significantly, foreign affiliates accounted for much lower shares of sales, value added and employment in the services sector, than in manufacturing in a number of host countries (figure III.1).

OECD data for 11 service categories covering between 5 and 18 member countries throw light on differences in the transnationalization of individual service industries in host developed countries. The pattern is quite consistent: transportation, telecommunications, real estate and hotels and restaurants (in that order) are, on average, the service industries in which inward FDI plays the smallest role in developed countries (OECD 2001, pp. 42-47). Business services, and especially computer and related services, are at the other end of the spectrum, while financial and trading services fall in between. In 10 out of 16 OECD member countries, for instance, the share of foreign affiliates in the total sales in computer services was 20% to 35%. In two of them, it was 10% to 15% and in four countries, below 10%.

Table III.3. Shares of value added, employment and sales of foreign affiliates of home-based TNCs in home-economy totals, by sector of parent firm, selected countries and years
(Per cent)

Economy	Value added			Employment			Sales		
	Manufacturing	Services	Year	Manufacturing	Services	Year	Manufacturing	Services	Year
Austria	..	..	..	28.7	11.8	2001	7.7	..	1998
Canada ^a	..	..	..	18.1	3.3	1999	..	..	..
Finland ^a	..	..	..	35.4	5.9	2002	42.5	..	1998
France ^a	..	..	..	..	..	..	16.1	7.8	1998
Germany	..	..	..	32.3	7.8	2001	..	..	..
Japan ^b	..	..	..	21.1	1.3	1999	9.6	7.8	1997
Portugal ^a	1.4	1.2	1999	0.6	2.6	2001	2.7	..	1999
Sweden ^a	..	..	..	69.4	13.7	2000	68.3	4.4	1997
United States ^c	21.2 ^a	2.6 ^a	2001	29.2	3.4	2001	..	..	..
Czech Republic	1.1	0.3	2000	0.4	0.2	2002	..	..	..
Macao, China	..	..	..	5.2	1.4	2001	..	..	..

Source: UNCTAD, based on FDI/TNC database (TNC data on value added and employment), the United Nations Statistical Office (total value added), ILO 2001a (total employment) and OECD 2001a (sales, all entries).

^a Data refer to majority-owned foreign affiliates only.

^b Data refer to foreign affiliates of non-financial TNCs only.

^c Data refer to foreign affiliates of non-bank TNCs only.

Judging from the shares of FDI flows as a percentage of GDP in selected industries in a number of developing and CEE countries, the pattern of transnationalization of individual service industries varies in these countries as well. They are frequently high in finance, electricity and, to a lesser extent, transport, storage and communications, whereas they tend to be low in construction and hotels and restaurants (annex figure A.III.1). This reflects, among other things, differences in the level of countries' openness to FDI, privatization programmes and the degree of reliance on non-equity forms of investment.

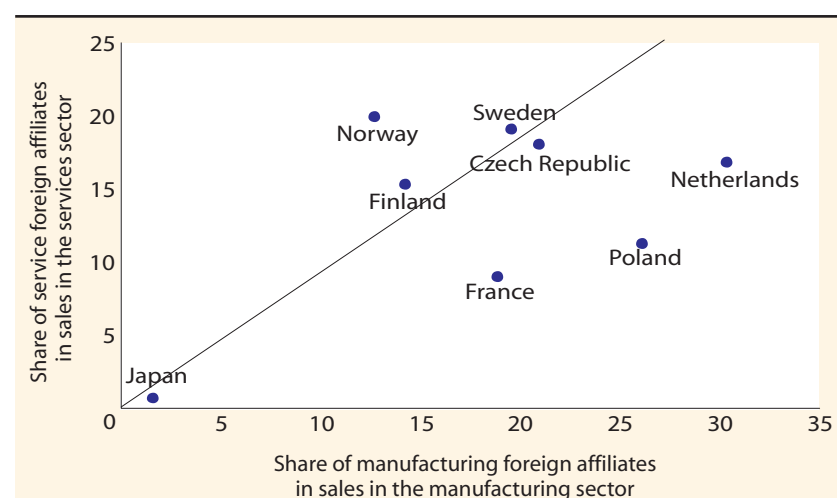
There are also considerable differences in the role of foreign affiliates in the same service industry among individual countries. In banking, for instance, in many countries in Africa, Latin America and CEE, transnational banks (TNBs) dominate, or play a much greater role than in developed countries (annex table A.III.4). In 29 economies, TNBs account for more than 70% of total banking assets

(table III.4) and in a few of these – Botswana, Guinea Bissau, Lesotho, Tonga – all banks are foreign-owned. In some smaller economies, the TNB penetration ratio can be very high, even without large investments by TNBs, because of the small size of the host country's banking system. In general, this ratio is higher in developing and transition economies than in

Figure III.1. Share of foreign affiliates in the total services and manufacturing sales, value added and employment of selected host economies, various years

(Per cent)

a. Sales



Source: UNCTAD, based on FDI/TNC database (www.unctad.org/fdistatistics) and OECD 2001a.

Note: 1997 for Japan, the Netherlands, Norway, Sweden; 1998 for the Czech Republic, Finland, France, Poland.

developed countries, with the exception of New Zealand (99%) and the United Kingdom (46%). In many other developed countries, the foreign bank penetration ratio is 11% or less (annex table A.III.4).

Similar disparities exist in the case of telecommunications, electricity and water, in which, after the wave of privatizations during the past decade or so, foreign companies are playing an important, if not dominant, role in a number of countries in Latin America and CEE. Hotels in a number of small countries, such as in some Caribbean countries, are mostly owned or operated by international hotel chains, while many other countries have failed to attract these chains. There is also a growing presence of international retail chains in large developing countries such as Brazil and Mexico. In business services, large international business consultancy, advertising or legal firms are present in many developing countries, but they tend to cater mainly to foreign investors, and the bulk of domestic enterprises are served by local service providers.

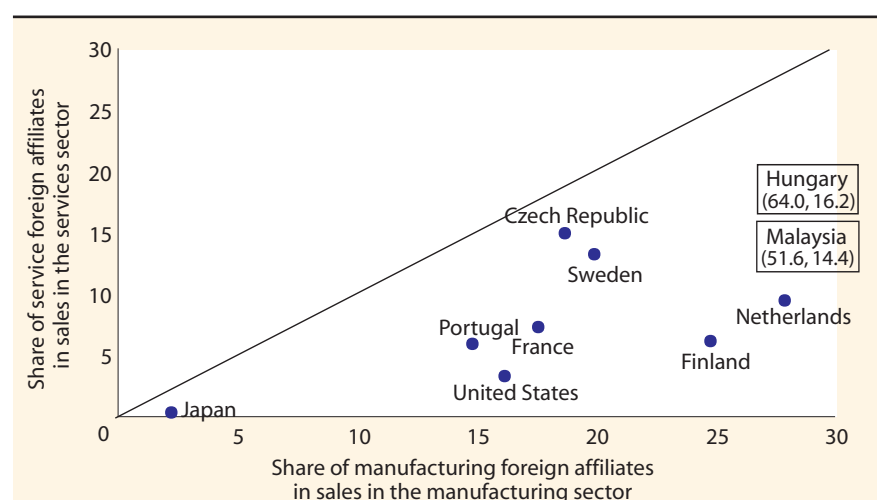
All told, however, the dominance of the global FDI stock in services does not translate into a corresponding importance of foreign service affiliates in host countries. One reason is that, while the services FDI stock is large, so is the services sector in most economies. Many services, such as education, media, health, government services and transportation, are predominantly domestic

in nature, and therefore mainly provided by domestic companies or public undertakings. However, partial privatization in some of these, such as education and health services, has attracted FDI. In others, such as telecommunications, electricity, gas, water and

Figure III.1. Share of foreign affiliates in the total services and manufacturing sales, value added and employment of selected host economies, various years (concluded)

(Per cent)

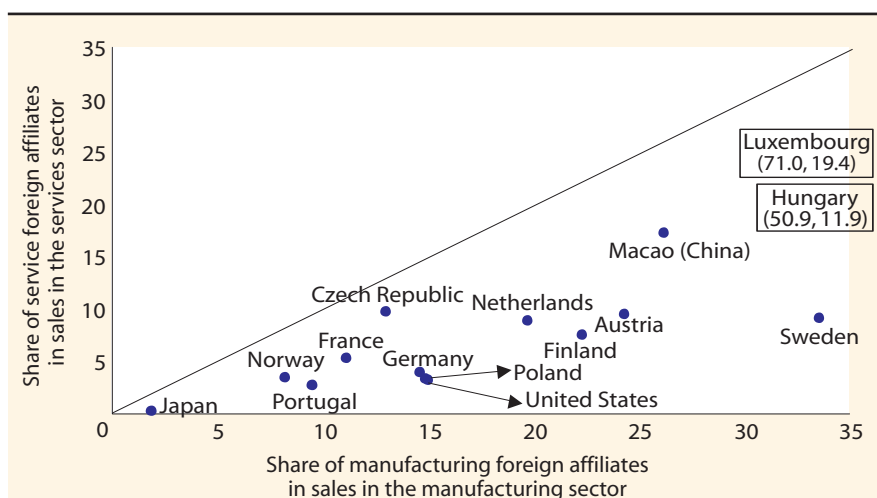
b. Value added



Source: UNCTAD, based on FDI/TNC database (www.unctad.org/fdistatistics) and OECD 2001a.

Note: 1995 for Malaysia; 1997 for the Netherlands and Sweden; 1998 for the Czech Republic and France; 1999 for Finland, Japan and Portugal; 2000 for Hungary and the United States.

c. Employment



Source: UNCTAD, based on FDI/TNC database (www.unctad.org/fdistatistics) and OECD 2001a.

Note: 1997 for the Netherlands and Norway; 1998 for the Czech Republic and France; 1999 for Japan; 2000 for Hungary, Luxembourg, Poland and the United States; 2001 for Austria, Finland, Germany, Macao (China), Portugal and Sweden.

business services, FDI growth has been impressive, but is relatively recent. Another reason is that a good deal of services FDI – notably that in holdings and financial affiliates (section B.1) – involves activities with little value added, employment, sales or investment expenditure on fixed capital.

Thus, the picture has changed over time, as FDI in services has grown rapidly due to changes in economic and policy-related factors that influence TNC activity in services. The relative importance of FDI in services is not (yet) as high as in manufacturing, although the gap is narrowing. Moreover, there is a significant TNC presence in some individual services, but it involves non-equity arrangements of various kinds, and not (much) FDI. Consequently, such activity is not captured in data on either FDI or the economic activities of foreign affiliates. To that extent, the transnationalization of the services sector is higher than what is reflected in the data on FDI in services.

4. Non-equity forms of investment are common in services

A striking difference between TNC activities in services and goods is that non-equity forms of TNC participation are important in a number of service industries. Such forms include franchising, management contracts, concessions, partnerships, turnkey, build-operate-and-transfer (BOT) and build-transfer-and-operate (BTO)

projects. They are important, and sometimes dominant, in hotels, fast-food outlets, restaurants, car rentals, retailing, construction and various professional services. For example, a survey of 34 large international hotel chains in the 1990s showed that fully- or partially-owned foreign affiliates in 1990s accounted for only 36% of their overseas properties. The rest took the form of such non-equity arrangements as management contracts (37%) and franchising agreements (28%) (Contractor and Kundu 2000, p. 300). In fact, non-equity participation by TNCs appears to be gathering further momentum (box III.2).

Partnerships rather than equity links are used in business consultancy (which grew out of accounting services), engineering and legal services. Franchising is common in retail trade and car rentals. Concessions, giving rise to management contracts, are commonly used by some countries in infrastructure services such as electricity, transportation and water. Except for capital inflows, these forms of participation can have all the impacts characteristic of FDI.

The greater popularity of non-equity forms of TNC participation in service industries than in goods is due to a number of reasons. The competitive advantages of service firms consist of knowledge-based, intangible assets (soft technologies), rather than tangible ones (hard technologies) that are more important in manufacturing firms. Intangible assets, such as organizational and managerial expertise, can be separated from tangible and capital-intensive ones

Table III.4. Host economies with a penetration ratio^a of foreign bank affiliates exceeding 70%, 2001
(Per cent)

Developed countries		Developing economies							
		CEE	Africa		Asia and the Pacific		Latin America and the Caribbean		
New Zealand	99.1	Estonia	98.9	Botswana	100.0	Tonga	100.0	Belize	94.6
		Czech Republic	90.0	Guinea-Bissau	100.0	Fiji	98.9	Aruba	92.3
		Croatia	89.3	Lesotho	100.0	Vanuatu	94.1	Grenada	88.7
		Hungary	88.8	Gambia	95.8	Singapore ^b	76.0	Mexico	82.7
		Slovakia	85.5	Benin	91.0	Bahrain	72.0		
		Lithuania	78.2	Guinea	90.0	Hong Kong, China ^b	72.0		
		Bulgaria	74.6	Côte d'Ivoire	84.2	Cambodia ^c	71.0		
		Bosnia and Herzegovina	73.0	Senegal	78.7				
				Niger	73.4				

Source: UNCTAD, based on annex table A.III.4.

^a Ratio of assets of majority-owned foreign bank affiliates (including branches and representative offices) to total bank assets.

^b Data from Committee on the Global Financial System (CGFS) 2004, p. 9.

^c Data from the World Bank 1998 survey, www.worldbank.org/research/projects/bank_regulation.htm. Data relate to the late 1990s.

(such as real estate in the case of hotels or water distribution networks). More importantly, because the critical knowledge transferred by TNCs and the capabilities of local firms in a number of services are frequently codifiable (e.g. as in a management contract), they can be equally well protected and enhanced in non-equity-based arrangements as in equity-based operations. For example, in the hotel industry, contracts can be designed to ensure that incentives are compatible for all sides to an agreement, to protect the interests of both the investor owning the physical and capital-intensive parts of the business (the hotel) and of those holding the knowledge, managerial expertise and reputation. Such non-equity participation arrangements offer hoteliers a way to expand rapidly their networks and maintain brand dominance without having to commit capital; at the same time they protect the asset owners by defining the conditions under which managers can exit from their contract.

In other service industries, host countries' policies are decisive in determining the mode of entry and the forms of cross-border inter-firm cooperation. A case in point is air transportation, where, in spite of deregulation and liberalization, many FDI restrictions remain. As a result, the principal mode of TNC activity in the industry takes the form of cross-border alliances (sometimes accompanied by minority equity holdings) rather than FDI (box III.3).⁷ In the case of accounting, host-country regulations as well as industry-specific practices have led to a reliance on networks and partnership involving local firms (box III.4). Partnerships are also a common feature of TNC activity in legal services (box III.5). Thus, industry characteristics as well as host-government policies influence the mode of TNC participation.

In the context of one particular policy measure, privatization, FDI has been the typical means of acquiring State-owned assets, especially of public utilities. But in some regions, notably West Asia and North Africa, about 60% of electricity investment has taken the form of concessions, including with foreign firms taking over the management of State-owned enterprises for a specified period.⁸ Concessions are also common in water services.

Given the limited availability of systematic information on non-equity participation by TNCs in services, the full extent of such forms and the scope of TNC involvement

are difficult to ascertain. However, if receipts of royalty fees – paid by host-country firms for the use of the assets and expertise obtained under contractual agreements of various types – are used as a proxy for non-equity based activity, they are growing fast. For example, royalty fees in the services sector received by German TNCs from abroad rose from \$11 million in 1989 to \$323 million in 2002. Japanese TNCs' royalty fees in services increased over 10-fold (to some \$150 million) during the same period, and those of United States TNCs rose at a similar rate (table III.5).

B. Players and driving forces

FDI in services mirrors, to some extent, the global expansion of service TNCs, in the same way as FDI in goods production mirrors the global expansion of TNC goods producers. But a substantial proportion of services FDI also includes services production in host countries by TNCs in manufacturing, for local sale or export (in the same way as some goods FDI is undertaken by service TNCs).

However, the role of service TNCs is expanding: large TNCs have emerged in a number of service industries and from a number of home countries. Their expansion into host countries has often occurred through M&As. Firm-specific advantages and location advantages of countries drive this expansion. It is taking place in the context of growing markets for services, the rapid spread of information and communication technologies and increased competition. Market-seeking motivations and strategies dominate TNC activities in services, but integrated international production networks are also emerging as efficiency-seeking TNCs take advantage of the growing tradability of many service products.

1. Goods TNCs invest in services

A large – but declining – proportion of outward FDI in services is controlled by goods rather than service TNCs: at least 41% in the case of the United States in 1999 (a decline from 50% or more in the late 1980s (UNCTC 1989a)) and 10% in Germany in 2000 (table III.6). Comparable data are not available for other

Box III.2. Transnational hotels: non-equity participation on the rise?

Hotels with foreign names remain one of the most visible symbols of FDI in global tourism, especially in developing countries. But appearances can be misleading: there is increasingly less reason to assume that, just because a well-known chain runs a hotel, it also owns it. As in many other service industries, franchising, leasing and management contracts are becoming more popular forms of TNC participation while equity purchase and ownership are declining. The Intercontinental Hotels Group (IHG) (annex table A.III.5), for example (which claims to be the world's most global hotel company and the largest, with 3,500 hotels and 535,000 rooms), has slated for sale almost \$1 billion worth of its total \$6 billion portfolio since April 2003.^a The move is part of a wider strategy to reduce its capital investment and increase the spread of its operations by management contracts and franchising.

rely heavily on non-equity modes. Plans include management contracts for another 6,145 rooms, plus ownership of another 5,646 rooms, taking the total proportion of rooms owned down to 80% (and those managed, up to 20%) by 2007.

At the same time, hoteliers make every effort to ensure that quality and reputation are not compromised. One reason deterring the choice of non-equity participation seems to be the extent to which a hotelier's service is customized, as opposed to standardized. For example, even hoteliers with a general preference not to own the "hardware" will make an exception when the building in question is famous or a landmark. Similarly, hoteliers tend to retain ownership of their luxury or highest quality ranges. Reflecting such factors are the high ownership ratios of Asian TNCs hotel chains such as Orient-Express Hotels and Shangri-La. They are firms that target small numbers of high-end properties and clients.

Box table III.2.1. Selected leading hotel chains: modes of operation, 2003

Hotel group	Home economy	International rooms as per cent of total rooms	Mode of participation (Per cent of total rooms)		
			Full or partial equity	Management contract	Franchised, leased or other
Starwood Hotels & Resorts	United States	34	24 ^a	41	35
Accor	France	74	21	17	62
Orient-Express Hotels Ltd. ^b	Bermuda ^c	100	92	..	..
Hilton Group plc	United Kingdom	80	17 ^d	32 ^d	50 ^d
Shangri-La Hotels and Resorts	Hong Kong, China	97	90	10	-

Sources: UNCTAD based on annual company reports.

^a Includes leased rooms.

^b Figures based on reported revenues and earnings, not hotel rooms.

^c Management decisions are made in the United Kingdom.

^d Based on numbers of hotels, not rooms.

Even TNCs that historically eschewed non-equity participation seem to be moving towards it. Shangri-La Hotels and Resorts, for example, which was the second largest global hotel TNC in terms of foreign assets, currently owns 90% of its 20,000-plus hotel rooms, one of the highest proportions of equity ownership among the top hotel TNCs (box table III.2.1). However, its annual reports indicate that the company's planned expansion into China and other parts of Asia will

In terms of country and regional patterns, different TNCs follow different strategies.^b For example, IHG follows a predominantly franchising model in the United States, an ownership model in Europe, and a management model in Asia and the Pacific. Accor, by comparison, relies more on ownership modes of operation in the United States, and on franchising in Europe (including France). In Latin America, its most common mode of entry is via management contract.

Source: UNCTAD, based on Contractor and Kundu 2000, World Travel and Tourism Council 2003; company annual reports.

^a IHG divested itself in April 2003 from the United Kingdom brewing, pub and hotel group Six Continents (www.ihgplc.com/ accessed July 2004).

^b Factors such as perceived risk do not appear to prompt non-equity modes, but there is evidence of a positive association with the level of GDP per capita (Contractor and Kundu 2000).

countries, but the proportion of foreign affiliates in services held by non-service parent firms was at least 20% in Japan in 2001, and, in the late 1980s, the stock of services FDI held by non-service parent firms was 20% in the United Kingdom (*WIR 1993*, p.78). This reflects the globalization of corporate service functions by TNCs in the manufacturing and the primary sectors rather than the global expansion of service TNCs. This is typical for trading and financial services (other than banking and insurance), where the role of TNCs from non-service industries is the greatest.

Goods TNCs often invest in trading, marketing or financial affiliates in support of their exports from their home bases or their local sales of goods produced in host countries (for example, affiliates of automobile manufacturers provide credit to buyers of cars; oil companies operate their own tankers and gas stations; and sales agencies of electrical goods companies market their parent firms' products).⁹ In some manufacturing industries, such as pharmaceuticals and electronics, TNCs locate R&D affiliates wherever a cost-competitive, well trained workforce and agglomeration economies are available. Moreover, some large manufacturing TNCs have gradually shifted much of their activity to services. Prominent examples include IBM and GE which, judging from their range of activities, could now be classified as both manufacturing and service firms.¹⁰ Some manufacturing TNCs have taken over service companies unrelated to their major activity in search of new areas of future growth. With the offshoring of corporate service functions by TNCs in all sectors (chapter IV), FDI in services by TNCs in the manufacturing (and primary) sectors is likely to continue to grow. That may not, however, have a significant impact on the flows and stocks of FDI, as most corporate services are human-capital intensive rather than physical-capital intensive, and therefore do not require significant investment expenditure at the outset.

A specific subset of services FDI results from the establishment of affiliates abroad that perform finance- and management-related services for goods-producing firms. As these affiliates often manage the financial assets of TNCs, they generate large FDI stocks but disproportionately small economic activity in host countries. A case in point is holding companies.

Countries often classify them under management services, financial intermediation or business services. Investment in holding companies and some kinds of financial activities may distort the picture of FDI flows and stocks in these services and in the countries involved. Luxembourg, for example, attracts many holding companies that receive funds from parent firms to invest in affiliates in other countries; because of such transshipped FDI, Luxembourg was the world's largest home and host country in 2002 (*WIR03*, p. 69). Another example is Hong Kong (China), one of the world's largest host economies for services FDI (including in business services), owing to the large concentration of holding companies (reported under business services). The location of holding companies is often determined by tax considerations, although the situation may be changing (box III.6). Financial affiliates (including in the form of holdings) are often established in tax havens, again inflating inward and outward FDI figures, but with little employment or value added. For example, the small island of Bermuda had an inward FDI stock of \$81 billion in 2003, almost equal to that of Denmark or Japan, and much larger than that of Malaysia (annex table B.3).

2. Service TNCs are expanding rapidly

a. The players

A United Nations study (UNCTC 1989a, p. 41) described TNCs in service industries as they were some 20 years ago, as follows:

... although TNCs are found in all major service industries, the propensity to engage in foreign production is fairly uneven. Typically, only a handful of mostly large firms have world-wide networks of affiliates and account for most of an industry's transnational activities. Normally, many small- and medium-sized domestic firms coexist with transnational firms. In many service industries the process of transnationalization is determined mainly by a limited number of large TNCs.

The study also found that almost all of the largest service TNCs were headquartered in developed countries (UNCTC 1989a, p. 45). The

Box III.3. Airlines: little FDI, many alliances

FDI is of little importance in airlines, compared to other services and to non-equity arrangements such as alliances: fewer than 25% of the world's 1,010 airlines are owned by foreign investors (including banks and other airlines) (box table III.3.1), compared with 17% three years ago. Many countries have statutory limits on foreign ownership levels in national carriers; and most international air services are governed by bilateral air service agreements between countries (often containing restrictions regarding national ownership and control). The proportion of airlines owned by foreign investors is similar in both developed and developing countries. At the regional level, Latin America and Western Europe had the highest proportion, while CEE and West Asia had the lowest. North America also had a low proportion, but this is changing: the number of airlines owned by foreigners has risen sharply in recent years, from 8 airlines with foreign ownership in 2001 to 29 by 2004.

The proportion of airlines owning shares in other foreign airlines is even smaller. Only 65 airlines out of a total of 1,010 have invested in foreign airlines. Again, there are no significant differences between developed and developing countries, although there are very few carriers in North American and in other developed countries in Asia and the Pacific that have holdings in foreign airlines.

Alliances have become an increasingly important vehicle through which airlines seek to benefit from closer ties with other airlines. Their number has risen markedly, from around 20 worldwide in the early 1990s to a total of 1,222 by 2001 (box table III.3.2). Alliances can be of any size in terms of participants, temporary or permanent, with different strategic objectives and involving different degrees of cooperation. In 2001, the most common arrangement involved code-sharing, frequent flyer programmes and cargo arrangements (box table III.3.2), and the least common, joint terminals and training.

Box table III.3.2. Alliances among airlines, 2001^a
(Number, per cent)

Agreements containing provisions on	Number	Per cent of total agreements
Code-sharing	911	75
Frequent flyer programmes	114	9
Cargo	106	9
Marketing	78	6
Joint venture on destination	55	4
Pooling agreement	33	3
Joint-ground handling	32	3
Regional connection/franchise	31	3
Others	165	14
Total number of agreements	1 222	...

Source: WTO 2001, pp. 7-8.

^a As agreements between two airlines may cover several areas of cooperation, and categories may overlap, the sum of percentage shares in the far right column exceeds 100.

Box table III.3.1. FDI by, and in, airlines, by region, 2004
(Number, per cent)

Item	Developing countries					Developed countries					World
	Africa	Asia ^a	West Asia	Latin America	Sub-total	Western Europe	North America	Other developed countries	Sub-total	CEE	
Number of operating airlines	91	143	53	135	422	223	149	60	432	156	1 010
Number of airlines owned by foreign investors/airlines	24	37	8	39	108	60	29	10	99	23	230
Percentage of airlines owned by foreign investors/airlines	26	26	15	29	26	27	19	17	23	15	23
Number of airlines owning stakes in foreign airlines	7	7	5	9	28	26	6	2	34	3	65
Percentage of airlines owning stakes in foreign airlines	8	5	9	7	7	12	4	3	8	2	6

Source: UNCTAD, based on information provided by the International Civil Aviation Organization.

^a Excluding West Asia.

Source: UNCTAD, based on information provided by the International Civil Aviation Organization.

single most important home country was the United States. Not surprisingly, therefore, United States service TNCs were strongly represented in most service industries. They were also considerably more transnationalized (as measured by the number of their foreign affiliates) than West European firms and, especially, Japanese firms; the latter, however, had gained considerable ground, especially in banking and wholesale trading (UNCTC 1989a, p. 60).

Many of these general observations are still valid, especially those concerning the dominant role of the largest TNCs in individual industries. But many things have also changed, mirroring the expansion of service TNCs and changes in the pattern of services FDI.

Most importantly, a large group of new TNCs has emerged in service industries that are new for FDI – notably telecommunications (box III.7), electricity (box III.8), water (box III.9) and postal services (box III.10) – somewhat sidelining long-standing TNCs in traditional FDI industries such as banking or trading. Take telecommunications. Once consisting of uni-player domestic industries, it is now a multi-player global industry. Top players are present almost everywhere, dominating the provision of telecom services in many developing countries and economies in transition. Many of them are former State-owned monopolies from Europe: France Telecom, Deutsche Telekom, Telecom Italia and Spain's Telefonica are among the ten largest firms in the industry (box III.7). The largest, Vodafone (which ranked second on the list of the world's largest TNCs in 2002, annex table A.I.3) – originates from the United Kingdom. All these firms have expanded abroad through cross-border M&As, many involving privatizations. Vodafone apart, there are some 40 telecom TNCs with foreign sales of \$100 million or more.

Electricity, too, is an industry with a substantial number of important international players. Some 30 TNCs have foreign sales of \$100 million or more. France's Electricité de France and two German companies (RWE, E.ON) lead the list (box III.8 and annex table A.III.8). The same cannot be said about the water industry where only a handful of companies dominate the market (box III.9).

The largest service TNCs are now more evenly distributed among home countries, especially when considering the size of their

foreign assets, employment or sales (annex table A. III.5). United States TNCs still have a strong presence in many services, but they are less dominant than 15 years ago, and in some industries they no longer occupy leading positions. Even in advertising and media, believed to be strongholds of United States TNCs, European firms now lead. In insurance, too, European TNCs have taken over the lead from United States and Japanese firms (box III.11). In retail trade as well, the home-country composition of the largest TNCs has changed dramatically over the past 20 years of rapid transnationalization (box III.12). Whereas, in 1986, nine of the top ten retail TNCs were from the United States (UNCTC 1989a, pp. 191-192), in 2002 only one was from that country. In international trade, *sogo shosha* continue to play an important role for Japan, but it has declined dramatically (box III.13).

Changes in banking have involved Japanese firms in particular. In 1986, Japanese banks dominated the list of the world's largest banks (ranked by assets): five of them led the list, and as many as 12 featured among the top 20 (UNCTC 1989a, pp. 176-181). Today the picture is different. Although the second largest bank is still Japanese (Sumitomo Mitsui), only four banks from Japan figure among the top 20 (box III.14). This is in large part due to the restructuring and consolidation of the Japanese banking industry in response to widespread banking distress during the economic recession of the 1990s. It also reflects government efforts to reform and deregulate the Japanese banking system and to deal with the critical problem of non-performing loans.¹¹ The list of the world's top TNBs is now dominated by European banks: more than half are from four EU countries (box III.14).

The rise to prominence of European TNCs in many services has occurred in parallel with their increasing participation in cross-border M&As (discussed below). Growing competitive pressures on the one hand and improved competitive strengths on the other – partly due to operating in a unified European market – propelled the rapid international expansion of European firms during the 1990s.

Another big change is the rise of service TNCs from developing economies. Most of them originate from Hong Kong (China), many hail from Singapore and a few are from Mexico and

Box III.4. Accountants network, led by the Big Four

Mirroring the transnationalization of various industries that draw upon its services, the accountancy industry has become global as well. Today, it is a large and highly regulated industry dominated by four firms known as the “Big Four” (box table III.4.1). The Big Four have grown and expanded through the formation of networks and partnerships with local accounting firms under a brand name and through mergers. Concentration was driven by mergers among the “Big Eight” accounting firms during the 1980s and 1990s, and the dissolution of one of the top firms (Arthur Andersen) in 2002, following a major corporate governance scandal.

The Big Four are substantially larger than the other accounting firms, each with thousands of partners, tens of thousands of employees, offices around the world and annual revenues running into billions of dollars (box table III.4.1). They perform both accounting and management consulting services, although the trend is increasingly towards

the separation of these activities. The combined revenues of the four amounted to some 33% of the global market for accounting services – estimated to be \$142 billion in 2002 – and 84% of the total revenues of the 10 largest accounting firms in 2003.^a There is a considerable revenue gap between the fourth and fifth largest firms (box table III.4.1).

Historically, accounting firms went abroad to service clients from their home countries. Today, the Big Four audit the bulk of publicly listed companies in developed countries: 78% in the United States, 80% in Japan, 80% in Italy, 90% in the Netherlands and an estimated 95%-98% in the United Kingdom (United States, General Accounting Office 2003). They have global operations, and are among the most transnationalized business service enterprises, with a presence (between them) in all but 43 countries. The latter are mainly low-income (including 25 LDCs) and small Pacific and Caribbean island countries.^b

Table III.4.1. The top ten accounting firms, ranked by total revenue, 2003

(Billions of dollars and number)

Name	Headquarters	Total revenue	Employees	Number of host countries
PricewaterhouseCoopers	New York	16.0	122 820	139
Deloitte Touche Tohmatsu	New York	15.1	119 770	144
Ernst & Young	New York	13.1	103 000	140
KPMG	Amsterdam	12.2	98 900	148
BDO	Brussels	2.6	23 230	99
Grant Thornton	Chicago	1.8	21 500	110
RSM	London	1.8	20 000	80
Moore Rowland ^a	High Point, NC	1.8	20 850	92
Horwath	New York	1.5	18 680	86
Baker Tilly	London	1.5	17 000	67

Source: UNCTAD, based on company annual reports and websites.

^a Figures for total revenues and employees are for 2002.

The mode of expansion of accounting firms abroad relies largely on non-equity forms of investment. It has been determined to a great extent by the specific nature of the industry, including, in particular, its legal features, and by national regulatory constraints. In many parts of the world, regulatory authorities grant the right to practice government accountancy services only to national firms in which locally recognized professionals have 51% to 100% ownership and management control. More generally, international accounting firms wishing to expand network membership face various barriers, including as regards the regulation of trade and commercial presence, accounting standards and the recruitment of highly specialized professionals.

Hence, these firms usually expand operations by adding members to a network of firms that are usually legally separate, locally owned and locally managed. They are typically operated as partnerships.^c

The global expansion of the Big Four firms can present problems for local small and medium-sized accounting firms, which face considerable barriers (such as lack of capacity and capital limitations) when competing for the audits of large national and public companies. Some of them have responded by focusing on SMEs or by reorienting their services away from audit and attestation, and towards accounting and other business services.

Source: UNCTAD.

^a Datamonitor (2004). Data include all revenues generated by accountants, auditors, tax advisers, bookkeepers and related services.

^b Data from Big Four companies' web sites.

^c Partnerships in this context include general partnerships, limited partnerships and limited liability partnerships. In some jurisdictions, the most common form chosen is the limited liability company.

South Africa (box table I.3.1). They are present in particular in the hotel industry (annex table A.III.5), logistics (annex table A.III.5) and telecommunications (annex table A.III.7). But with a few exceptions, their degree of transnationalization is much lower than that of TNCs from the Triad. Moreover, they typically operate within their home regions, and, on average, in a smaller number of countries than their counterparts from developed countries.

b. M&As take the lead in entry patterns

TNCs in all industries use cross-border M&As as a speedy and practical mode of entry into host countries, or as a tool for global or regional restructuring. However, in some services, the propensity of TNCs to enter new markets through M&As, rather than greenfield FDI, is particularly high. In banking, for example, it is less common for banks to build their affiliate networks in a host country from scratch. Rather, they take over existing networks wherever these are available, if permitted to do so. In infrastructure services such as basic telecommunications, electricity and water, M&As are frequent. Privatization programmes open to FDI, which peaked in many countries during the 1990s, added to the number of cross-border M&As.

During the 1990s, M&As became a widely used mode of TNC entry and expansion in virtually all industries. Indeed, they drove the FDI boom during the second half of the 1990s.¹² But it was in services that most M&As took place, helping to shift the FDI pattern towards services. From 36% of total global cross-border M&A sales during 1987-1990, their share worldwide rose consistently during the 1990s, to peak at 63% during 1996-2000; they remained at a similarly high level during the subsequent economic downturn (annex table A.III.13). The share of services in cross-border M&A sales was slightly higher in developing (64%) than in developed countries (57%) during the period 1987-2003 taken as a whole. A similarly high proportion was evident in CEE, which saw the fastest growth of services cross-border M&As in both value and proportionate share of total cross-border M&A sales. The picture is similar on the purchasing side, with the exception of CEE. The composition of the world's 100 largest

cross-border M&As sales also shifted towards services (annex table III.14).

As regards individual services, the share of telecommunications, electricity, water and business services in cross-border M&A sales rose, while that of traditional industries – finance, trade, hotels, restaurants – fell between 1988-1990 and 2001-2003 (table III.7). But, notwithstanding these structural changes, the M&A boom of the second half of the 1990s affected almost all service industries (annex table A.III.15).

On average, more than three-quarters of global M&A transactions in the services sector took place among developed countries during 1987-2003 (annex table A.III.13). Intra-Western Europe transactions (the bulk of which comprise intra-EU transactions) and transatlantic transactions dominated the picture (table III.8). The latter were characterized by an increasing imbalance in favour of EU purchases in the United States. This reflects a change in the relative roles of EU and United States TNCs in cross-border M&As generally: traditionally, United States TNCs had been the champions of foreign takeovers; but since the second half of the 1990s and especially the M&A boom of the second half of the 1990s, European TNCs have become the dominant players. Services accounted for 36 and 64 deals among the top 100 cross-border M&As in 1987-1995 and 1996-2003, respectively. Western Europe's share in these deals rose from half to two-thirds between these two periods (as compared with 14% for United States firms in both periods) (annex table A.III.14). In terms of value, the share of Western Europe in the top deals increased from 52% to 82% over the same period.

The increasing use of M&As as a mode of entry by European TNCs goes back to the announcement and inception of the EU's Single Market programme. It triggered a wave of intra-EU cross-border M&As, particularly in services, which regained momentum during the global M&A boom of the late 1990s. At the same time, EU service TNCs began to expand into non-EU markets, notably the United States, but also other regions. The increasing role of European TNCs in cross-border M&As in services and in services FDI worldwide and their rise to prominence among the largest service TNCs suggest that their competitive strength has increased. This is at least partly due to growth as a result of domestic and

intra-EU cross-border mergers following deregulation in national markets and liberalization within the EU. It also suggests that increasing competition at home and within Europe drives EU service firms to seek markets abroad on a much larger and wider scale than ever before.

Developing countries' participation in cross-border M&As in services is also on the rise, still more as sellers than as buyers. During 1987-1994, developing countries' cross-border sales of service companies amounted to an average of \$5 billion per year, rising to \$53 billion per year during 1998-2000, and \$34 billion in 2001-2003 (annex table A.III.16). Purchases rose by eight

times their value, to an average of \$26 billion per year during 2001-2003. This latter amount was almost half the total annual average of cross-border purchases by United States TNCs.

In conclusion, cross-border M&As have been instrumental in boosting services FDI in all groups of countries, and thus shifting the pattern of FDI towards services. Although global M&A sales in services fell by more than half during the downturn of 2001-2003 compared with the boom of 1998-2000, they were still at a much higher level than in any period before the boom for almost all groups of countries (annex table A.III.16). Finally, the growing participation of non-United States TNCs in M&As in general and

Box III.5. Legal partners

In less than a decade and a half, the United States outward FDI stock in legal services – the country whose firms dominate international legal services – had grown over 30 times, from a modest \$27 million in 1988 to \$918 million in 2002 (box table III.5.1). But these figures are a highly imperfect measure of the transnational activities of United States law firms: legal service TNCs typically organize their activities in the form of partnerships with host-country firms.

Of the 20 largest legal TNCs ranked by the number of lawyers employed in 2002, 12 were based in the United States, 7 in the United Kingdom and 1 in Australia (annex table A.III.6). Their total income ranged from close to half a billion to more than one billion dollars a year. They operate in a variety of legal areas, serving mostly large TNCs. The top ten operate in an average of 20 countries. For example, the largest of these, Baker & McKenzie, now has offices in 68 locations in 38 countries; it operates in anti-trust and trade, banking and finance, intellectual property, real estate, environment and tourism.

The legal business is skills-oriented and strongly host-country specific. Each country has its own legal code under which firms operate. Superimposed on these written legal codes are a country's values, culture and beliefs. Given the complexities of these features, law firms seldom set up greenfield affiliates, preferring to form partnerships or engage in cross-border M&As. Indeed, M&A activity in this profession has steadily risen in recent years, with most M&As

carried out between European and North American firms. A few have also taken place in such countries as Poland, Thailand and the Republic of Korea. In 12 of the 71 M&As reported in 1988-2003, legal TNCs acquired non-legal firms (e.g. employment agencies, pre-packaged software, security brokers, dealers, floatation companies, business consulting services, advertising agencies, commercial arts and graphic designers, automotive services, investment advisers). And with the rebound of global M&A activity, those by legal TNCs may pick up again.

Box table III.5.1. United States outward FDI in legal services, 1988-2002
(Millions of dollars)

Year	Stock	Outflows
1988	27	6
1989	94	44
1990	138	44
1991	181	43
1992	242	60
1993	88	44
1994	75	65
1995	145	70
1996	214	69
1997	413	71
1998	504	85
1999	370	297
2000	559	241
2001	738	232
2002	918	232

Source: UNCTAD, based on data from United States, Department of Commerce.

Source: UNCTAD.

Table III.5. Royalty receipts of TNCs in Austria, Germany, Japan and the United States, 1989-2002
(Millions of dollars)

Sector/industry	1989				1994				1999				2002			
	Austria ^a	Germany	Japan	United States	Austria	Germany	Japan ^b	United States	Austria	Germany	Japan ^c	United States	Austria ^d	Germany	Japan	United States
All industries	27	916	1 309	12 800	57	1 077	3 919	33 957	78	1 471	5 499	35 638	83	1 754	6 884	..
Primary	-	-	-	8	-	-	-	27	1	-	-	2	-	-	1	..
Manufacturing	17	10	1 296	11 385	24	1 052	3 520	23 642	47	1 255	5 396	23 319	55	1 423	6 733	..
Services	10	11	14	993	33	12	399	10 240	30	203	102	10 379	28	323	150	..
Electricity, gas and water	-	-	..	7	0	-	..	7	-	-	..	3	-	-	..	..
Trade	7	5	4	216	7	9	369	1 127	17	1	75	3 451	15	305	54	..
Hotels and restaurants	-	-	..	6	1	-	..	41	1	-	..	-	-	-	..	..
Transport, storage and communications	-	-	..	7	-	-	..	687	1	-	..	758	3	-	77	..
Finance	2	-	..	268	4	-	..	25	5	-	..	109	3	-	..	..
Business activities	1	5	4	488	2	3	18	6 451	3	202	18	6 058	4	18	4	..
Other services	-	-	5	1	19	-	11	1 902	2	-	9	-	3	-	15	..

Source:UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

^a 1991.

^b 1995.

^c 1998.

^d 2001.

in services in particular has made the pattern of services FDI (and, consequently, overall FDI) more balanced among both home and host countries. Cross-border M&As, once almost the exclusive domain of United States TNCs, are now being undertaken by TNCs from other countries, including developing ones, and can be expected to remain an important mode of FDI entry in services.

c. Catching up with manufacturing TNCs?

Whether measured in terms of the share of foreign affiliates in total TNC assets, employment or sales, service TNCs are less transnationalized than TNCs in other sectors, judging from United States data (table III.9): whereas the foreign content of manufacturing TNCs overall was almost 40%, that of service TNCs was just above 20% in 2000. And although the foreign content has increased for both manufacturing and services, the gap between them has remained more or less the same.

An examination of the top TNCs confirms the difference in the degree of transnationalization of TNCs in the two sectors.

In 2002, the average Transnationality Index¹³ of the service TNCs on UNCTAD's list of the world's 100 largest TNCs was lower than that of the manufacturing and primary-sector firms on the same list. But, for these big firms, the gap has narrowed since 1995 (table III.10). This suggests that the larger service firms are transnationalizing faster than the smaller ones. In fact, in the case of developing countries, the largest services TNCs are now more transnationalized than their manufacturing counterparts, judging from the Transnationality Index of the top 50 TNCs from developing countries.

There do not seem to be large differences among service industries as regards the degree of transnationalization of the top TNCs. In every industry, there are companies with very large and very low Transnationality Index values. But values are generally lower for United States TNCs, which have a large domestic market at their disposal, than for European ones. Using the number of host countries as an indicator, Japanese transnational banks were much less transnational than their European counterparts in 2002: the most transnational, Tokyo-Mitsubishi, had 104 subsidiaries in 20 countries; by comparison, Deutsche Bank, the third largest bank in the

Table III.6. Foreign affiliates, by sector of foreign affiliates and parent firms, Germany, Japan and the United States, selected data, various years

Home country	Number of foreign affiliates		Assets of foreign affiliates		FDI outward stock	
	By sector of:		By sector of:		By sector of:	
	Foreign affiliates	Parent firms	Foreign affiliates	Parent firms	Foreign affiliates	Parent firms
Germany, 2000						
All sectors	..	..	..	..	532	532
Primary	..	..	..	..	3	..
Manufacturing	..	..	..	..	168	208
Services	..	..	..	..	361	324 ^a
Japan, 2001						
All sectors	12 476	12 476	..	..	..	..
Primary	220	45	..	..	..	..
Manufacturing	6 522	7 866	..	..	..	..
Services	5 734	4 565	..	..	..	..
United States, 1999						
All sectors	23 121	23 121	4 632	4 632	1 133	1 133
Primary	907	477	218 ^b	68	71	31
Manufacturing	8 335	14 387	1 126	2 143	328	690
Services	13 879	8 257	3 287 ^c	2 421	734	412

Source: UNCTAD, based on Japan, Ministry of Economy, Trade and Industry (METI) 2004; Germany, Deutsche Bundesbank 2002; United States, Department of Commerce 2004a.

^a Includes primary.

^b Only mining.

^c Includes agriculture, forestry, fisheries and hunting.

world, had 981 subsidiaries in 45 countries (annex table A.III.12).

3. Drivers and determinants

What drives the expansion of TNC activity in services?

The rise in the share of services in economic activity, the externalization of services to independent providers,¹⁴ the growing service intensity of the production of goods, the deregulation of service markets and the liberalization of FDI policies have created opportunities for increased services FDI. At the same time, greater competitive pressures in

service markets (especially in home developed countries) have pushed firms to seek markets abroad and strengthen their competitiveness. Within that context, the ownership-specific advantages of firms, location-specific advantages of countries and internalization advantages to firms from investing directly abroad combine to determine the extent and pattern of expansion, particularly by firms from service industries (UNCTC 1989a).

Ownership-specific advantages. FDI in services has traditionally been undertaken by service firms moving abroad to support trade or overseas manufacturing by their domestic manufacturing clients (or by the manufacturing

Box III.6. Tax havens – no longer tax heavens?

Tax havens are countries with typically zero income tax or low rates of tax, no foreign currency controls, strong bank and commercial secrecy laws and administrative practices, modern information and communications facilities to support financial services, a stable currency, and active self-promotion as offshore financial centres. Some tax havens offer zero or low taxes only to non-residents through forms such as international business corporations; others levy no income taxes at all but rely instead on licence fees.

While tax havens have existed for many years (Naylor 1987; Palan 1998, 2002), the rapid growth of the Internet in the 1990s facilitated their spread. According to one estimate, there are 59 such havens (Eden and Kudrle forthcoming). In 2001, the United States Senate Subcommittee on Governmental Affairs estimated that the size of offshore havens had grown from 30 jurisdictions with \$200 billion in assets in 1983 to 60 jurisdictions with \$5 trillion in mid-2001, \$3 trillion of which were in bank accounts (Levin 2001). Oxfam (2000) estimated assets of \$6 to \$7 trillion in offshore centres, of which half were savings of wealthy individuals.

Why do countries become tax havens? Some small, poor economies lacking natural resources or other obvious attractions for FDI use tax-haven status to attract foreign banking and commercial activities. Historical ties with rich countries, that include preferential status for investments in the poorer partners, also encourage low tax rates since the host tax rate becomes the

effective rate. Tight secrecy laws and an unwillingness to exchange information further support haven activities.

Firms set up “letterbox” companies in tax havens to collect patent royalties, licensing fees and interest on loans. As long as tax havens do not share information on banking activities with other countries, clients can keep their financial activities hidden from scrutiny. In fact, tax havens may not provide much of a tax advantage to TNCs in high tax locations. The advantage only occurs if the home country does not tax income earned in havens on an accrual (earned) basis, but either exempts such income from home-country tax or permits deferral of the tax until the income is repatriated. In spite of the reduced tax advantages, secrecy laws, high rates of return on capital due to minimal regulation and low lending rates continue to be powerful magnets.

The OECD is working with affected jurisdictions to improve transparency and information exchange (OECD 1998, 2000a, 2004b).

At the beginning of the twenty-first century, “tax heavens” relying on certain characteristics may be coming to an end. Consequently, a critical challenge for the tax havens, particularly the smaller island economies, is the development of other sources of long-term competitive advantage. For many of the smaller islands, tourism, and some agricultural exports are the only other competitive sectors in addition to the offshore sector. These countries face difficult choices in the years to come.

Source: Eden and Kudrle forthcoming.

firms themselves to support their own activities). Thus, banks, insurance companies and transporters set up offices in countries as a complement and support to primary and manufacturing FDI. This is still true today, especially for TNCs from developing countries.

However, service firms are increasingly investing overseas on their own account, as they seek to serve new clients and exploit (and sometimes augment) their own unique competitive advantages. Such advantages take several forms:

- In producer services such as banking, finance, business and professional services, firms are building global advantages based on their possession of, or privileged access to, proprietary information, tacit knowledge, skills, brand names and learning (including those derived from their foreign affiliates).
- In consumer services such as hotels, fast food, car rentals or retailing, firms are exploiting their home-based and/or local capabilities to organize activities, acquire knowledge about their customers, network with other agents and create strong brand names.
- In services such as stock broking, foreign exchange or securities dealing, business consultancy, commodity-broking, data processing, data provision, data transmission and information-gathering and processing, ownership advantages are often based on the possession of software and hardware skills and technologies.
- Some service firms' outward expansion is based on their need for economies of scale and scope, as well as access to global markets and supply capabilities. Examples include firms in insurance, trade, banking, professional business services and retailing.

Location-specific advantages. The location advantages that countries can offer services TNCs have also grown and diversified. In non-tradable services,¹⁵ liberalization and market growth remain key to attracting FDI. In directly tradable services (chapter IV), the main location advantages are access to a good information and communication infrastructure, well-developed institutions and trained human resources available for employment at

competitive cost. All these have been improving in a number of locations worldwide.

The recent liberalization of services FDI regimes has also done much to attract TNCs. One particularly important form of liberalization has been the privatization of State-owned utilities to foreign investors, notably in Latin America and the Caribbean and in CEE for attracting FDI in the telecoms, electricity and water industries. In some services (such as telecoms and computer services), adequate protection of intellectual property rights can influence the choice of a FDI location.

Internalization advantages. FDI means that firms with ownership advantages prefer internal expansion abroad rather than licensing or entering into other arrangements with local firms. They choose internalization for a number of reasons, especially when it is important to safeguard proprietary knowledge (e.g. banking and financial services, most information-intensive and professional services), ensure product quality (e.g. advertising, market research, some consumer services), minimize transaction costs associated with opportunism, protect property rights, avoid search and negotiation costs, tap synergies from geographical diversification (financial services), obtain inputs or develop new markets (trading companies) (Dunning 1993, pp. 52-54). In other services, non-equity links or minority joint ventures are preferred. In these cases, quality control, performance commitments and the minimization of transaction costs can be embodied in management contracts or franchising agreements (e.g. hotels, restaurants, car rentals). On the other hand, it is also important in some services to have specialized local knowledge or to customize products (engineering, architectural, technical services). Furthermore, cooperative ventures are a way of sharing financial risk in such industries as investment banking or insurance.

The balance between the forces making for internalization and externalization varies among industries and firms. And it is difficult to establish firmly that internalization advantages of TNCs in the relevant service industries have risen over time. However, many of the improvements in firms' ownership-specific advantages are based on proprietary knowledge on which profits might be maximized through internalization.

Box III.7. Telecoms: the emergence of a global industry

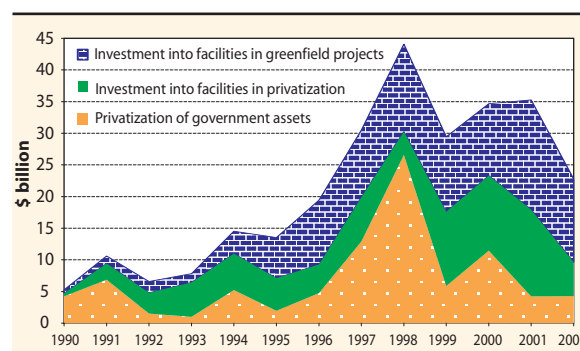
Over the past two decades, rapid growth and major restructuring have changed the global landscape of telecom services. Many countries liberalized their telecom industry and opened it to foreign investors. A dramatic increase in inward FDI stock worldwide took place: between 1990 and 2002, FDI in communications, transport and storage^a rose 16 times, from an estimated \$29 billion to an estimated \$476 billion, the largest increase of all service industries (annex table A.I.18). In developing and transition economies as a whole, the rate of growth of inward FDI stock in this industry was less pronounced than for the world average, but still quite high: between 1990 and 2003, this stock rose 11 times, to \$138 billion.

On the basis of World Bank estimates, FDI represents about 40% of the costs of private investment projects in telecoms in developing and transition economies (Sader 2000, p. 152). Overall, privatization was the dominant form of investment, accounting for around two-thirds of the \$274 billion invested in telecoms between 1987 and 2002.^b It was primarily driven by large sell-offs of State-owned fixed-wire networks, especially in Latin America; about half of these investments were used for the initial purchase of assets while the remainder represents additional investment into facilities. Investments in greenfield projects (box figure III.7.1) accounted for one-third of total investment in the industry, focusing on the expansion of cellular telephony. This was of particular importance in Asia and the Pacific where almost 60% of private investment over the period was spent on greenfield projects. Technological changes have shifted the modes of investor-entry in telecoms from privatization towards greenfield projects, as mobile telecommunications have increasingly become dominant (Dutta et al. 2004, p. 55).

A large part of the activity took place in Latin America and the Caribbean and, to a lesser extent, in the CEE countries that joined the European Union in 2004. In the developing world, Latin America and the Caribbean attracted almost 63% of private investment in telecoms, Asia and the Pacific 28% and Africa only 9%. Private investment in telecoms in developing countries and transition economies declined after

1998. Besides heightened concerns about currency risk (following the Asian financial crisis) and the completion of major privatisation programmes in Latin America and Central Europe, major turbulence in the telecom industry worldwide were the main culprits.

Box figure III.7.1. Private investment in the telecom industry in the developing countries and CEE, 1990-2002
(Billions of dollars)



Source: UNCTAD, based on World Bank (2004b)..

Large telecom companies – mainly from developed countries – that shared in the substantial investment that took place in the industry over the past decade experienced very rapid expansion: in 2002, there were eight telecom firms listed among the world's 100 largest TNCs (annex table A.I.3), compared to only two ten years ago. Such expansion resulted, in some cases, in instability stemming from overspending on new technologies and new licences. Some of these companies had to slow down their expansion abroad, or even withdraw from some markets, leaving the activities to new competitors from developing countries. This is reflected in the composition of the list of the 30 largest telecom TNCs: though still dominated by companies from Europe and the United States, it also includes four companies from developing countries – Singapore Telecommunications, América Móvil (Mexico), MTN Group (South Africa) and Telekom Malaysia (annex table A.III.7). Today, the top players are present everywhere, dominating the provision of services in many developing countries and economies in transition. On average, they are present in 15 host economies.

Source: UNCTAD.

^a Statistics refer to the “communications, transport and storage category”.

^b Based on data from World Bank (2004b).

4. Most services FDI is still market-seeking – but this is changing

Traditional host-country market-oriented services (such as finance and retail trading) or new dynamic ones with a similar orientation (telecommunications, electricity, water) dominate services FDI in most countries. The share of local sales and exports of United States foreign affiliates in host countries bears this out. In 2001, for example, 84% of worldwide sales of services in host countries by foreign affiliates of United States TNCs were local sales, while the corresponding share for goods was 61% (Borga and Mann 2003, p. 71). Even more striking, local sales accounted for 93% of sales of services by United States affiliates of foreign companies and for an estimated 91% of sales of goods.

Because many services are not tradable and require face-to-face contact between providers and customers, TNCs in services have to rely largely on stand-alone affiliates that often are miniature versions of their parent companies. These affiliates need to operate as self-contained units that serve local markets, replicating the production organization of their parent firms (WIR93, p. 118). There are, of course, exceptions: FDI in tourism such as hotels has direct parallels with resource- or asset-seeking FDI with an export orientation rather than a local-market orientation.

But as the cross-border tradability of information-intensive services increases, the offshoring of services by both manufacturing and service TNCs can be expected to rise as well (chapter IV). The fact that TNCs in various

industries locate one or more functional activities along the value chain of services in affiliates abroad, and integrate them with activities elsewhere within their production systems, indicates that services production is evolving in the direction of integrated international production networks.

This development is well known in manufacturing, where firms over the past few decades have increasingly pursued integrated production strategies across countries. This has involved locating the production of components, parts or final products in different affiliates to exploit the comparative advantages of different countries (such as the availability of natural resources, lower costs, better skills, access to large regional markets) (WIR93). In fact, TNCs have long practised “simple integration” strategies in the primary sector: FDI was undertaken to extract or cultivate natural resources and/or process primary commodities for sale through parent companies in the home countries of the TNCs involved and in other countries. Later on, such integrated strategies spread to such manufacturing industries as clothing, toys, semiconductors and other electronic products. In these strategies, foreign affiliates essentially “work” for parent companies, triggering intra-firm trade between parent firms and their affiliates.

“Complex integration” strategies rely additionally on foreign affiliates producing components – not necessarily for their parent firms, but for other affiliates that specialize in other components – thus giving rise to inter-affiliate trade.

Table III.7. Shares of selected industries in cross-border M&A sales in services, 1988-2003
(Per cent)

Industry of sale	1988-1990	1991-1994	1995-1997	1998-2000	2001-2003
Telecommunications	8.8	10.2	7.1	34.2	20.8
Electricity	0.2	3.3	14.2	6.0	9.4
Business services	9.6	8.8	9.3	12.3	11.3
Water	0.4	0.1	0.4	0.9	1.6
Sub-total	19.0	22.4	31.0	53.7	43.1
Finance	32.4	30.6	29.8	25.1	29.2
Trade	15.4	17.3	13.5	6.6	7.1
Hotels / restaurants	15.8	4.9	4.1	2.1	2.5
Sub-total	63.6	52.8	47.4	33.8	38.7
Other	17.4	24.8	21.6	12.5	18.2
Total	100.0	100.0	100.0	100.0	100.0

Source: UNCTAD, based on annex table A.III.13.

Box III.8. An electrifying rise

The privatization of public utilities in developed economies beginning in the 1980s was followed by their consolidation through M&As. This process has created a handful of large private (or joint public-private) utility firms with considerable strength.

When developing countries and economies in transition undertook privatization programmes in the electricity industry, utility firms based in developed economies took the opportunity to expand and invest in the newly privatized firms. In 2002, nine of the world's 100 largest non-financial TNCs (annex table A.I.3), ranked by foreign assets, were in the electricity industry – a remarkable ascendancy, considering that only 15 years ago there were hardly any TNCs in the industry. Many of the largest electricity TNCs, especially European ones, also have operations in other utilities, most notably in the gas industry.

Firms from developed economies dominated the list of the 25 largest TNCs in this field in 2002 (annex table A.III.8). Three European TNCs – E.ON (Germany), RWE (Germany), Electricité de France (France) – were by far the largest. Thirteen of the largest TNCs were from Europe and nine from the United States. Only three were from developing economies: Korea Electric Power (Republic of Korea), CLP Holdings (Hong Kong (China)) and Hong Kong Electric Holding Limited (Hong Kong (China)). European TNCs had a greater international presence than their counterparts from the United States: the average number of host economies for them is 15.6, compared to 4.8 for the United States TNCs (annex table A.III.8).

About 28% of private investment in electricity took the form of FDI in developing countries and CEE during 1990-2002 (based on Sader 2000, p. 9). However, a large part of the projects in electricity also involved non-equity flows in the forms of commercial lending on a project finance basis for concessions and BOT-type investments.

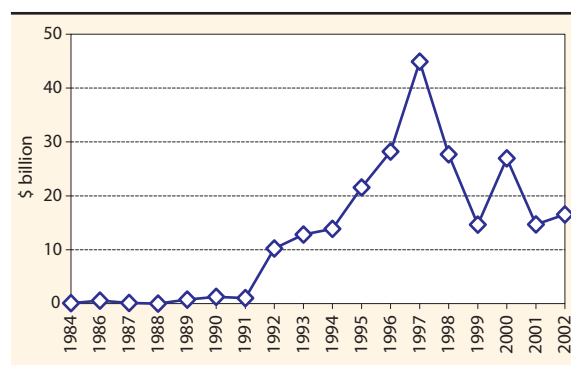
Private investment in electricity in developing countries and CEE rose at an average annual rate of 24% over this period, nearly double the rate for all infrastructure projects, with a peak in 1997 (box figure III.8.1). It totalled almost \$200 billion over this period, with Latin America and the Caribbean accounting for the largest share, followed by East Asia and the Pacific. These two regions together accounted for nearly three-quarters of all private investment in the electricity industry in developing countries.^a Within them, investment has been concentrated in a relatively small number of countries: 25 projects in 15 countries accounted

for three-quarters of the total, with Brazil taking up the largest share (21%), followed by China (10%) and Argentina (7%). The fall of investment in recent years reflects the effects of the completion of major privatisation programmes, especially in a number of Latin American countries, as well as the 1997 Asian financial crisis which had a significant impact on the industry. Conditions in international capital markets for raising capital turned less favourable, companies became more aware of currency risks, confidence began to erode and companies in the industry experienced financial difficulties as stock prices fell.

Of the three segments that make up the electricity industry (generation, transmission, distribution), the power generation segment has been privatized the most (73%). The other two segments remain largely under State control, as they are mostly regarded as natural monopolies because of the characteristics of the infrastructure required to provide the service. From a survey of 52 developing countries, the World Bank estimates that privatization is either in progress or completed in 31% of them and planned in a further 18%. The rest is expected to remain State-owned (World Bank 2004a, p. 153).

Foreign investors continue to be guardedly interested in the electricity industry of developing countries. A survey of energy TNCs that invested in these countries found that, although they were not satisfied with their experiences in all cases, about half of the 48 respondents still had as much or even more interest in the electricity industry in developing countries than they had in 2000 (Lamech and Saeed 2003). The trend towards increased TNC participation in the electricity industry in developing countries may therefore continue.

Box figure III.8.1. Private investment in the electricity industry of developing economies and CEE, 1984-2002
(Billions of dollars)



Source: UNCTAD, based on World Bank (2004b).

Source: UNCTAD.

^a Based on data from World Bank (2004b).

In practice, of course, the two types of integration can be (and have been) pursued simultaneously within a TNC, giving rise to international production networks and flows of goods, technology and capital among various units of a corporate system.¹⁶ The shift towards such integrated strategies by manufacturing TNCs signified a shift towards an international intra-firm division of labour.

As in manufacturing, such an international intra-firm division of labour in services can take various forms:

- Breaking up service activities into components that are produced wherever it is most efficient to do so, in a manner similar to that followed by manufacturing TNCs for producing, say, labour-intensive components. For example, certain foreign affiliates perform back-office functions of various kinds for the parent firm (chapter IV). When foreign affiliates provide a service (component) to the parent company only, this represents simple integration; when the division of labour involves various foreign affiliates and possibly also the parent firm, it involves complex integration.
- Assigning one or more foreign affiliates a global (or regional) mandate each to provide a particular service product or function to all members (or all members within a

region) of a TNC system. For example, an affiliate is designated to do all the accounting work for a TNC's regional headquarters or perform co-ordination functions for a TNC's activities in a particular region.

- Entrusting an activity to a few affiliates that work on it simultaneously. For example foreign affiliates are set up to undertake R&D on a centralized database throughout the world, with activities being undertaken simultaneously and/or shifted to the next affiliate at the end of the day. (This form is specific to services.)

However, even in the case of service functions that lend themselves to standardization and fragmentation, quality is more important than cost. In addition, there could be tacit elements in provider-customer relations that could make integrating even simpler tasks more complicated than in manufacturing. On the other hand, the logistical challenges facing integration are more formidable in manufacturing: establishing production facilities, accessing supplies and transporting output are more complex for many goods than for tradable services. In the latter, production in a foreign location can be quickly started and services easily transported, provided the necessary human resources and ICT infrastructure exist. Each firm, be it in services

Table III.8. The geographic composition of global cross-border M&A deals in services, 1987-2003
(Per cent of the global value)

Home and/or host region	1987-1990	1991-1994	1995-1997	1998-2000	2001-2003
A. Deals among developed countries	83	75	69	82	74
of which:					
Intra-Western Europe	22	29	26	43	32
Transatlantic	24	25	24	27	27
United States-United States ^a	16	6	6	3	3
Other ^b	22	15	12	8	12
B. Deals with participation of developing countries	13	21	23	13	18
Developing countries' sales to developed countries	8	9	12	8	8
Developing countries' purchases in developed countries	4	5	5	3	4
Deals among developing countries	1	7	7	2	6

Source: UNCTAD, based on annex table A.III.16.

Note: Transaction shares by subregion do not add up to 100, because deals involving two or more buying firms from different countries are included in totals but not assigned to home and host countries.

^a Purchases of United States firms by foreign affiliates located in the United States.

^b Transactions involving developed countries other than those in the EU and the United States.

Box III.9. Water services: falling in developing countries and rising in developed ones?

FDI in water services is low compared to that in other privatized or liberalized utilities, and it has different characteristics. Total private investment commitments in water and sewerage in developing countries was \$35 billion in the period 1987-2002 (box figure III.9.1); on the basis of World Bank estimates, it is likely that less than 10% of this was FDI.^a However, a great number of the new water and sewerage projects in developing countries are under the governance of TNCs through equity as well as non-equity forms (concessions, management and lease contracts or BOT-type investments, for example).

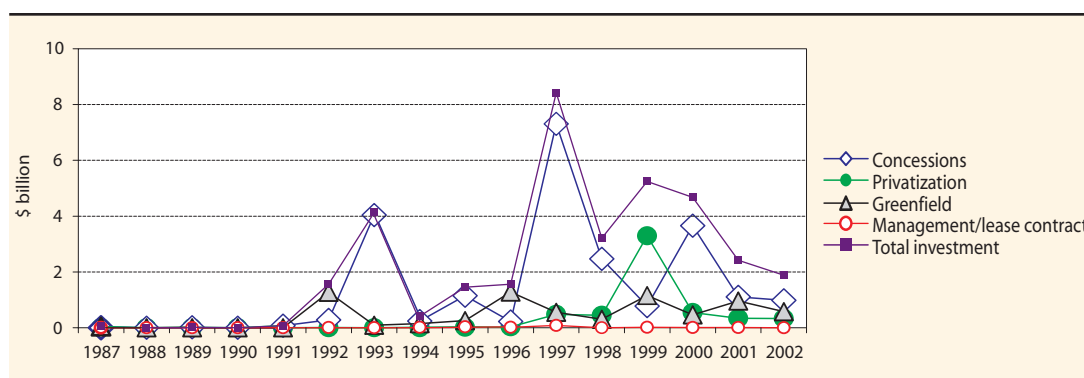
A small number of large TNCs dominate FDI in water services. Historically, the largest and most important ones were France's Suez Environnement and Veolia Environnement SA (formerly Vivendi). A new and significant major player has emerged since 2000 – Germany's RWE. Typically, TNCs active in water services are also involved in other businesses such as energy services and, historically, in the media.^b In terms of water services alone, Thames/RWE has become the leading investor in recent years, accounting (by value) for more than half of total water service M&As (i.e. excluding other affiliated activities) over the past decade (box table III.9.1). About half of this stemmed from the initial merger of RWE AG and Thames Water Plc; the remainder involved subsequent investment in Chile, Poland, Spain and, in particular, the United States. Following Germany are France (15% of total water M&As), the

United States (12%) and the United Kingdom (8%).^c

Latin America and the Caribbean led private investment in water services in developing countries and transition economies between 1987 and 2002 (with 52% of the total amounts invested over that period), followed by South, East and South-East Asia (36%) and CEE (6%). Central Asia and sub-Saharan Africa had negligible amounts.

The most common mode of entry in water services has been through management contracts and concessions. As management contracts are the most restrictive form in terms of operator responsibility over physical assets, they typically result in barely any financial flows in terms of new or rehabilitation investments, representing only about 0.5% of the total value of private investment in the industry during 1987-2002 in the developing world (World Bank 2004b). Concessions, on the other hand, accounted for 64%, as investors buy the right to rehabilitate (or to build) and operate water services for a fixed period (usually 20-30 years), after which ownership reverts to local control. Greenfield projects accounted for another 20%; these involve mainly the construction of bulk water and wastewater treatment facilities. Privatizations accounted for the remaining 16%. Most of the concession and greenfield projects in the past decade have been awarded in Latin America and the Caribbean and South, East and South-East

Box figure III.9.1. Concessions dominate annual private investment in water and sewerage in developing countries and CEE, 1987-2002
(Billions of dollars)



Source: UNCTAD, based on World Bank (2004b).

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Box III.9. Water services: falling in developing countries and rising in developed ones? (concluded)

Box table III.9.1. The three largest TNCs in the water service industry, 1988-2003
(Millions of dollars)

Corporation	Home country	Value of water service M&As ^a	Percentage of total water service M&As
Thames /RWE AG	Germany	14 153	51
Suez Lyonnaise des Eaux SA	France	3 474	13
Veolia Environnement SA.	France	460	2

Source: UNCTAD cross-border M&A database.

^a Cumulative total of cross-border M&As in water services (a sub-set of total M&As undertaken by the TNCs shown), during 1988-2003.

Asia. Of the management and lease projects, most have been in CEE (two-thirds of the total) and sub-Saharan Africa.

Private investment – and with it FDI – in developing countries in water services peaked in 1997 and then declined (box figure III.9.1); as with other infrastructure projects, exchange-rate risks and volatility played an important role. In developed countries, however, FDI in such services appears to be continuing. The annual value of cross-border M&As (the only available indicator of FDI in this case), which involved for the most part developed countries, peaked in 2000, and rose again in 2003. Further increases are expected: the fact that many EU countries still need to comply fully with current environmental European standards indeed offers new opportunities for FDI in those countries (e.g. Suez Group annual report 2003). To date, the United Kingdom has been the single largest recipient of FDI in water through M&As (48% of the total between 1988 and 2003), followed by the United States (43%).

Although the total value of private sector investment in the water industry to date has not been large compared to other formerly State-owned infrastructure industries, the broader

questions it has raised have been profound, especially in developing countries. It is widely accepted that the investment needs of the industry go beyond the scope of government or other public organisations. But private investors may find it not profitable to serve remote or low-income areas or may set cost-recovery prices that are considered unacceptably high.

On the other hand, the commercial requirements of private investors need to be balanced against wider social needs. Access to water has been identified as a basic human right, enshrined in the United Nations Covenant on Economic, Social and Cultural Rights.^d Foreign involvement has not always produced the improved scale and quality or lower costs that host countries expected, nor the profits that investors anticipated, and creating a regulatory framework that addresses the needs of all parties is not easy, as evidenced in early terminations of contracts or their re-negotiation. Hence, the challenge for governments and industry regulators is to find a framework that takes the needs of both sides into account. Successful strategies in some public-private partnerships have included tariff regulation and the use of subsidies to low-income areas (e.g. Chile) (UNDP 2003, pp. 111-121).

Source: UNCTAD, based on World Bank (2004b); annual company reports, Grusky (2003); UNCTAD database.

^a Sader (2000) attributes the low proportion of foreign, rather than domestic, investment in part to the relatively high debt-to-equity ratios in water projects, combined with the preponderance of concessions. Note that the investment commitments are for the duration of a given agreement.

^b For example, the Suez group has interests in electricity and gas, and, until recently, in television.

^c UNCTAD cross-border M&As database.

^d “Water is a limited natural resources and a public good fundamental for life and health. The human right to water is indispensable for leading a life in human dignity”, Committee on ESCR, General Comment No. 15, E/C.12/2002/11 (26 November 2002).

or manufacturing, therefore needs to determine how best to configure its corporate network to become as competitive as possible. And best practices in this respect are likely to be imitated by other firms.

Data on intra-firm trade for the United States – the largest home and host country for services FDI (annex tables A.I.20, A.I.21) and the leader in the offshoring of services – suggest that integrated international production networks in services are indeed emerging. The share of intra-firm imports in total United States imports of “other private services”¹⁷ rose from 30% in 1986 (Zimny and Mallampally 2002, p. 100) to 42% in 1997, then to 47% in 2002 (table III.11). It was particularly high in business, professional and technical services and in financial services; together these accounted for more than two-thirds of United States imports of “other private services” in 2001-2002. On the export side, the share of intra-firm trade remained relatively stable, at about one-third. It was high for business professional and technical services, but not for financial services.

Looking into the composition of intra-firm trade by destination within TNC systems can give a rough idea about the extent to which integration strategies have moved from simple to complex. In goods, there has been a long-term shift towards complex strategies: between the late 1970s and early 1990s, the share of affiliate-to-affiliate exports in *total intra-firm trade* of United States TNCs (comprising parent firms’ exports to foreign affiliates, affiliates’ exports to parent firms and affiliate-to-affiliate exports) rose from 30% to 44%, and in *total intra-firm exports of affiliates* (comprising the last two categories) from 37% to 60% (table III.12).¹⁸ Trade with other affiliates was particularly intensive for United States affiliates in manufacturing located in developed countries, and especially those in the EU (e.g. Ford’s network in Europe, one of the first to be set up). In services, the value of affiliate-to-affiliate exports in total intra-firm exports in services of United States TNCs was 34% in 1996 and increased marginally to 35% in 2001 (table III.12), still below the corresponding share for goods even compared to the early 1980s. The dominant – albeit declining – share of parent-to-affiliate trade in total intra-firm trade of services suggests that integrated international production in services remains largely simple integration.

These data need to be interpreted bearing in the mind the context and the proportions. Given that only a small proportion of services production is traded internationally, both intra-firm trade in services and the associated TNC strategies affect only a small part of the services economy. However, the picture is likely to change in the direction of more intra-firm trade as firms identify an increasing number of services that can be offshored by means of ICTs to take advantage of the availability of the necessary human resources, infrastructure, cost differences and other advantages of an international division of labour within the framework of corporate strategies – a matter examined in chapter IV.

C. Impact on host countries

Services account for the largest share of economic activity in most countries. Furthermore, the services content of manufacturing has been rising steadily. The efficiency and productivity of service industries are therefore important for the overall competitiveness of economies, i.e. their ability to raise living standards on a sustained basis. In particular, the availability, cost and quality of modern intermediate services – infrastructural, financial, professional, business – affect the competitiveness of products in all sectors, in both domestic and foreign markets. Furthermore, improved conditions for the provision of key consumer services, especially basic services such as health, education, water and sanitation, directly contribute to improving living standards as well as to building human resources. Increasing awareness of the role of services in building systemic competitiveness in their economies has prompted policy-makers in developing countries to pay greater attention to this sector, including by opening it up to FDI.

Services FDI spans such a wide range of activities that it is difficult to make a generalized assessment of its impact on host countries. The fact that developing countries are liberalizing their policies and regulations on FDI in services (chapter V) suggests that, on balance, they consider it potentially beneficial for achieving their development objectives; equally, the restrictions they maintain indicate that many service industries remain sensitive. Clearly, the economic impact of FDI in activities as diverse

as tourism, banking, media, telecommunication, transportation or retailing must differ. These differences call for varying policy responses. This section highlights some of the main impacts, while chapter V deals with the policy dimension.

Until recently, developing countries' more restrictive FDI policies towards services indicated that they considered FDI in their services sectors to be less desirable than in manufacturing, for a number of reasons. The main economic reason was that services FDI was not seen to provide advanced technologies, access to export markets or linkages to local enterprises – the most important benefits expected of manufacturing FDI. This perception has changed. TNCs in services are now seen to transfer new technology, if “technology” is defined broadly to include organizational, managerial, information processing and other skills and knowledge. They can provide vital inputs into the production of export-oriented primary and manufacturing industries (and, increasingly, export-oriented service industries), and can furnish valuable information on, and contacts with, international markets. With the growing tradability of services, TNCs can now also add directly to host-country exports by investing in services or service functions in which a host country has a comparative advantage (taken up in the next chapter). They can also provide backward linkages to local producers. More generally, FDI can add to the availability of competitive services, and thereby help domestic firms become internationally competitive in an increasingly globalized and knowledge-based world economy. Thus, the overall impact of services FDI on the industries concerned and the economy as a whole can be significant.

Services FDI has also been regarded by host countries as entailing more risks and social costs than manufacturing FDI. In some cases,

such risks or costs arise from the nature of the service. For instance, some services are inherently monopolistic, and therefore susceptible to exploitation of market power by TNCs (as well as domestic firms), unless the government can set up and manage a complex regulatory system. Others, like the media, are of considerable social or cultural significance, and may arouse resentment if controlled by foreigners. Again others, such as retailing, may involve particular traditions, and their disruption by new practices introduced by TNCs may be regarded as socially undesirable, especially if this displaces small service providers. Yet others, such as air transport or finance, are often considered strategically important to a country, and the loss of national ownership would be regarded as harmful to long-term national interests.

Many of the perceived costs and benefits of services FDI are similar to those of FDI in manufacturing. Governments may worry, for instance, that foreign takeovers of local banks will “crowd out” local banks, or that foreign ownership of infrastructure services that are inherently monopolistic may lead to high prices. As with some manufacturing activities, service TNCs may cause environmental damage (say, in tourism), or they may employ locals in low-level, poorly-paid jobs and not upgrade them over time (say, in call centres). If services TNCs prefer to use expatriate managers or professionals, they may be regarded as holding back local skills development. And if they prefer to use foreign suppliers, they may be viewed as not contributing to local enterprise development.

With the rather scanty information available, it is difficult to assess how well-founded these expectations and fears are. The discussion that follows reviews the impact of services FDI on host countries in general terms, focusing on some key differences between

Table III.9. The degree of transnationalization of United States non-bank TNCs, by sector, 1986, 1992, 2000

(Share of foreign affiliates in total TNC activities)

Sector of parent firms	Assets			Sales			Employment		
	1986	1992	2000	1986	1992	2000	1986	1992	2000
Total	19.7	24.0	29.7	26.7	32.1	30.7	26.0	27.5	29.5
Primary	15.6	22.5	36.8	22.6	27.3	22.4	42.2	32.8	31.4
Manufacturing	27.7	33.1	38.6	33.1	39.8	37.9	29.9	33.1	36.6
Services	11.4	13.3	23.5	15.6	15.0	21.5	18.8	18.9	23.3

Source: UNCTAD, based on data from United States Department of Commerce.

Box III.10. Postal services go transnational

Technical innovations and liberalization in the 1990s have led to the reorganization of many large postal operators into more diversified and transnationalized entities. These efforts were spurred by increasing competition, largely from operators such as UPS, Deutsche Post World Net (DPWN, which owns DHL), FedEx and TPG (which owns TNT) (box table III.10.1). The stagnation in domestic demand in the mail and parcel delivery segments in some countries such as the United States and the Netherlands also played a role. Some of the leading operators have become quite transnationalized, with European

operators at the forefront, particularly through M&As since the mid-1990s (box table III.10.2).

TPG and DPWN illustrate the transnational expansion of this industry. In the second half of the 1990s, TPG acquired several large foreign express and logistics companies such as TNT and GD Express Worldwide. TPG also diversified into niche markets such as direct mailing, international mail or international remailing. In 2000, it formed joint ventures with Consignia (the former British Post Office) and Singapore Post. As a result of its international acquisitions and joint-ventures, the share of foreign sales in

Box table III.10.1. The big four of the postal-courier industry, selected indicators, 1990, 2003

Indicator	DPWN (Germany)	TPG (Netherlands)	UPS (United States)	FEDEX (United States)
Employees 1990	313 177	63 000 ^a	252 000	58 000
Employees 2003	341 572	163 028	357 000	190 918
Growth rate per annum, 1990-2003 (%)	0.7 ^b	9.0	2.7	9.6
Share of foreign employment 1990 (%)	-	<1	..	..
Share of foreign employment 2003 (%)	39	58	11	..
Turnover in 1990 (\$ million)	7 734	2 351	13 600	5 183
Turnover in 2003 (\$ million)	45 267	13 423	33 485	22 487
Growth rate per annum, 1990-2003 (%)	14.6	14.3	7.2	11.9
Share of foreign turnover 1990 (%)	<1	11 ^c	..	..
Share of foreign turnover 2003 (%)	43	68	..	..
Share of mail service in turnover 1990 (%)	67	>90	..	..
Share of mail service in turnover 2003 (%)	28	33	..	..

Source: UNCTAD, based on Dörrenbächer 2003, p. 44, and information provided by firms and annual company reports.

^a 1992.

^b Growth rate is not directly comparable with that of other firms, due to the integration of the postal services of the new Länder, into those of DPWN, at the beginning of the 1990s.

^c 1995.

Box table III.10.2. Selected large cross-border M&As by European postal operators, 1995-2003

Buyer	Country	Year	Acquisition share (%)	Acquired company	Country	No. employees of acquired company
DPWN	Germany	2001	51 ^a	DHL	United States	55 000
TPG	Netherlands	1995	100	TNT Express Division	Australia	24 000
DPWN	Germany	2003	100	Airborne	United States	22 000
DPWN	Germany	1999	100	Danzas	Switzerland	16 000
TPG	Netherlands	1996	100	GD Express Worldwide	Netherlands/Sweden	14 000
DPWN	Germany	1998	50	Securicor Omega Express	United Kingdom	12 500
DPWN	Germany	1999	100	Nedlloyd European Transport & Distribution	Netherlands	11 500
La Poste	France	2001	85	German Partners of DPD	Germany	10 000
TPG	Netherlands	1996	100	TNT Logistic Division	Australia	9 000
DPWN	Germany	1999	100	Air Express International (AEI)	United States	7 500
DPWN	Germany	2001	51	ASG	Sweden	5 700
Consignia	United Kingdom	1999	100	German Parcel	Germany	4 500

Source: UNCTAD, based on Dörrenbächer 2003, and information provided by firms.

^a The remaining 49% were acquired in 2002.

/...

services and manufacturing FDI and on effects specific to services.¹⁹ The analysis focuses on the following areas of impact with special reference to developing countries: financial resources and balance of payments; services provision, competition and crowding out; technology; exports; and employment.

1. Financial resources and balance of payments

Initially, FDI in services injects financial resources into a host economy. The amounts involved can be quite substantial.²⁰ In developing countries, for instance, the stock of services FDI rose from an estimated \$160 billion in 1990 to an estimated \$1.1 trillion in 2002 (annex table A.I.18). Not much is known about the composition of this stock in terms of the shares of equity, intra-company debt and reinvested earnings, but there is no reason to expect that it differs greatly from that in manufacturing.

The same can be said about the financing of capital expenditures by foreign affiliates in services and in manufacturing from extra-corporate sources. FDI inflows generally comprise only part of the financing of foreign-affiliate operations in host countries. TNCs also raise funds from capital markets in host countries

and from international capital markets; such funds are not included in data on FDI inflows. Does the source of these funds matter? When funds are raised in international capital markets, they are a net addition to FDI flows.²¹ Where they are raised locally, however, and if they are substantial, domestic interest rates may rise, making capital more expensive for domestic enterprises. The significance of this risk is difficult to establish, especially in globalizing capital markets. In any case, the pattern of financing is likely to reflect the nature of the host economy (e.g. its risk, the nature of its banking system, the relationship with international financial markets), rather than whether the investment is in services or in manufacturing.

In some service industries, the financial aspects of the FDI package are especially important for developing countries. In particular, the capital requirements of infrastructure services are enormous, and they are growing apace. In electricity, for example, projections for 2001-2030 suggest that investment needs will be around \$5 trillion in developing countries and \$1 trillion in the transition economies (International Energy Agency 2003). In telecoms, they are estimated at \$187 billion per year for the period 2005-2010 (Fay and Yepes 2003), while annual projections for water and sanitation in developing countries alone amount to \$49

Box III.10. Postal services go transnational (concluded)

total sales rose from 11% to 68% between 1995 and 2003, and the share of foreign employment rose from almost nil in 1990 to 58% of total staff in 2003. Its international expansion strategy has focused on Europe, which in 2003 accounted for 77% of its foreign sales, while the United States, Australia and Asia accounted for the remaining share.

DPWN has pursued a three-pronged strategy. First it focused on rationalization, reducing its work force from 313,000 in 1990 to 263,000 in 1998. In the second phase, it diversified and globalized its business through a wave of M&As that brought its workforce back to the pre-rationalization level. Its foreign employment rose from nil in 1990 to almost 40% of its workforce in 2003. In the third phase, DPWN focused on integrating many of its new businesses into its

global operations, to realize synergies. Its total turnover between 1990 and 2003 rose more than five times, to \$45 billion. Like TPG, it expanded abroad through a wave of M&As starting in the late 1990s, a major acquisition being DHL. Its foreign turnover had reached 43% in 2003, as against less than 1% in 1990.

While these firms are consolidating, they face increasing competition from other large European operators such as Consignia of the United Kingdom and La Poste of France and from Asian companies, such as the postal operator of the Republic of Korea. The Ministry of Information and Communication of the Republic of Korea has explicitly declared its intention to expand abroad (Republic of Korea, Korea Post 2001). This will intensify global competition and bring about further structural changes in the industry.

Source: UNCTAD, based on Dörrenbächer 2003 and information provided by the firms and company websites.

billion in 2001-2015 (Camdessus 2003). Given the budget constraints facing most governments in these countries, FDI can contribute significantly to the financing of capacity expansion in such services.

China, for example, has progressively opened up to FDI in electricity generation, mainly because it lacked both the financial resources and manufacturing capacity to meet the demand for power generating equipment (Gabriele 2004, p. 13). Up to the mid-1990s, foreign financing provided about 10% of investment funds for the industry, of which over 80% came from foreign governments and multilateral lending institutions. By mid-1998, 24 plants funded by FDI were in operation and 12 others were under construction, most of them operated by United States companies (Gabriele 2004, p.13).

Similarly, in several Latin American countries, large-scale financing needs were one of the main reasons for privatization and FDI involvement in the electricity, telecoms and water industries. They were also the major factor behind the sale to foreign banks of domestic banks in some CEE countries where the private sector lacked the necessary funds for large-scale bank

recapitalization after the transition to free markets (Kraft 2004). In a number of cases, fiscal pressures also lay behind bank privatizations and the partial or complete sale of domestic banks to foreign investors. These are also the reasons, in addition to the threat of bank failure, for privatizations and sales to foreign investors of distressed banks in some East Asian and Latin American countries following financial crises.

A number of developing host countries fear that FDI in services will negatively affect their balance-of-payments situation. A large proportion of services FDI is market-seeking, and hence does not contribute directly to foreign-exchange earnings; but it does lead to external payments (repatriated profits, interest and sometimes equipment imports). For example, profit remittances can be quite high (annex tables A.III.17 and A.III.18), amounting to 35% of the total income of services foreign affiliates of United States TNCs in 2002 and 53% of the total income of services foreign affiliates of Japanese TNCs in 2001; comparable figures for manufacturing foreign affiliates were 50% and 62%, respectively (annex table A.III.18). Such payments can quickly outweigh the initial capital inflows, and thus entail net foreign-exchange

Table III.10. The top TNCs, by sector: indicators of transnationality, 1995, 2002^a

A) The world's top 100 non-financial TNCs

Sector	Number of companies		Foreign assets/ total assets		Foreign sales/ total sales		Foreign employment/total employment		TNI ^b	
			(Per cent)							
	1995	2002	1995	2002	1995	2002	1995	2002	1995	2002
Services	12	31	42.4	57.6	45.7	52.7	39.9	52.6	43.1	54.3
Manufacturing	68	56	47.8	54.5	59.7	62.9	53.9	56.5	54.3	57.9
Primary	15	10	49.6	64.6	55.7	60.4	44.9	60.0	49.5	61.7
Diversified	5	3	34.7	49.0	38.4	50.3	47.3	55.9	40.2	51.7

B) The top 50 non-financial TNCs from developing countries

Sector	Number of companies		Foreign assets/ total assets		Foreign sales/ total sales		Foreign employment/total employment		TNI ^b	
			(Per cent)							
	1995	2002	1995	2002	1995	2002	1995	2002	1995	2002
	Services	8	16	31.7	49.3	25.0	53.0	35.2	46.6	29.8	49.6
Manufacturing	24	23	34.2	47.5	37.5	51.8	41.2	45.5	32.9	48.2
Primary	5	5	13.7	34.8	33.6	37.9	11.9	28.6	18.3	33.7
Diversified	13	6	22.8	65.6	40.0	63.4	48.5	63.9	39.4	64.3

Source: Based on annex table A.I.3, box table I.3.1 and W/R97, tables 1.7 and 1.8, pp. 29-33.

^a The percentages shown are simple averages of the percentages for all of the TNCs in each sector.

^b TNI, the abbreviation for "Transnationality Index", is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

losses. In times of crisis, moreover, TNCs can accelerate transfers abroad and so exacerbate crises.

While services FDI (like market-oriented manufacturing FDI) may involve a net outflow of foreign exchange, this is not necessarily a correct measure of its overall balance-of-payments impact. A full assessment needs a counterfactual: what would have happened to the balance of payments had that investment not taken place? For example, if a local firm had made the investment (assuming it had the financial and technological resources), it also would not have earned foreign exchange and may also have imported new equipment. While it would not have repatriated profits, it would not have provided the initial inflow of foreign capital either. And it may not be as efficient (at least initially) as the foreign investor. After all, TNCs exist because they have ownership advantages over domestic firms in technology, organizational and managerial skills and entrepreneurship. Where these advantages lead to more efficient and better quality services, FDI promotes the competitiveness of tradable activities that use these services. At the same time, however, foreign affiliates (in services as well as goods) may repatriate earnings or loans to shore up parent firms' balance sheets (observed in Asia and Latin America in 2002 – *WIR03*). Further, since

revenues of services foreign affiliates are in local currency, they are more sensitive to exchange-rate fluctuations, and parent firms may more easily withdraw funds if they expect a devaluation. Hence, evaluating the balance-of-payments impact of services FDI cannot be done simply by looking at direct foreign-exchange inflows and outflows.

Moreover, the full economic value of an investment goes well beyond its balance-of-payments effects. The welfare effects of better service provision on consumers have also to be considered, as well as its spillovers to other economic activities.

2. Services provision, competition and crowding out

How does FDI affect the provision of services in terms of supply, cost, quality and variety in host economies and what impact does this have on domestic firms? It is again difficult to generalize. In some industries – especially those involving expensive and risky projects – FDI can add significantly to the volume of services available in a host country. TNCs' financial strength and ability to implement and manage complex systems can enable them to increase supply capacities quickly in complex,

Table III.11. Trade in selected services and the share of intra-firm trade, United States, 1997-2002
(Billions of dollars and per cent)

Trade in selected services	1997	1998	1999	2000	2001	2002
Imports						
Other private services ^a	42	46	53	58	63	69
Intra-firm (%)	42	43	49	50	47	47
Financial services	6	8	9	12	11	9
Intra-firm (%)	46	54	63	61	63	60
Business, professional and technical services ^b	21	23	28	31	33	38
Intra-firm (%)	70	67	70	71	70	71
Exports						
Other private services ^a	83	91	104	107	116	123
Intra-firm (%)	33	29	32	33	34	35
Financial services	13	14	18	19	19	20
Intra-firm (%)	18	19	23	20	22	20
Business, professional and technical services ^b	44	46	54	55	62	65
Intra-firm (%)	51	50	49	54	54	56

Source: Based on Borga and Mann 2003, table E, p. 65.

^a Includes, in addition to the two categories shown below in the table, education, insurance services, telecommunications and other services (film and television tape rentals and "other").

^b Includes computer and information services, management and consulting services, operational leasing and other business, professional and technical services.

capital-intensive services such as telecommunications, power, water or transport – perhaps more quickly than any feasible alternative. For example, in Latin America, FDI in telecommunications in Argentina, Brazil, Chile and Mexico contributed to a doubling or more of main telephone lines in 1990-1999 (ECLAC 2000, p. 197) and to a number of other improvements in the conditions of service supply (box III.15).

However, experiences in infrastructure-related FDI have not all been positive. In Latin America, for instance, results have been uneven in electricity. In Brazil, privatization with both foreign and domestic participation did not reverse the declining investment trend in the electric power industry (ECLAC 2004). Before that, Chile suffered an energy crisis in 1998, in spite of an early start in electricity privatization with FDI participation. This was provoked by a drought, but revealed weaknesses in the regulatory and institutional frameworks and public bodies that

dealt with enterprises in the industry (Gabriele 2004).

Indeed, much depends on government policy and, specifically, on the regulatory framework for private monopolies. In Argentina, the electricity industry was privatized during the 1990s, mostly involving foreign investors who negotiated tariffs fixed in dollars, and indexed according to United States inflation rates. The initial impact was beneficial. Supply capacity rose, the wholesale price of electricity fell and Argentina turned from being an energy importer in the 1980s to an energy exporter in the 1990s. By the end of the 1990s, however, prices began to rise as a result of the indexation mechanism and local price deflation. By 2004, the country was again facing energy shortages due to higher energy demand of the growing Argentinean economy and the problems that arose following the electricity price freeze (in nominal pesos) in 2002.

Box III.11. Insuring and reinsuring the world

The life insurance business dominates the insurance industry accounting for almost 60% of all insurance premiums in 2003 (\$2.9 trillion) (Sigma 2004). However, the trend among the largest insurance TNCs is to diversify from life insurance into other financial services and from non-life insurance to life insurance.

Twenty years ago or so, the insurance groups heading the list of the largest insurance TNCs were life insurers (UNCTC 1989a, pp. 184-186). Today, their business has diversified and, as a result, insurance groups now compete more directly with banks and financial service firms. Deregulation, particularly in Europe, was a major factor behind this trend: it opened the door for banks to combine with insurance firms. Today, for example, Allianz has stakes in Deutsche Bank, Dresdner Bank, HVB Group and AGF; ING in the Netherlands is a typical example of a financial services group selling insurance and banking products under the same name. So far, bancassurance (broadly defined as the sale of insurance products by banks) has been most successful in France, Italy and Spain where more than half of all life insurance products are

distributed through banks. In the United States, nearly five years after the Gramm-Leach-Bliley Act (which liberalized financial services), banks account for only 5% of life insurance sales (Deloitte Touche Tohmatsu 2004).

A parallel trend towards consolidation of activities has also taken place among non-life insurers. In the top ten, property/casualty companies such as Aviva, American International Group (AIG) and Prudential have expanded their activities into the life insurance business (annex table A.III.9).

Partly as a result of the greater varieties of services – including non-insurance services – that they provide and the resulting growth, European firms now dominate the list of the world's largest insurance TNCs. Some 20 years ago, nine out of the top ten companies, ranked by total income, originated from the United States and Japan (UNCTC 1989a, pp. 184-185). Today, nine companies from European countries dominate the list of the ten largest companies.^a The two largest reinsurance groups, Munich Re and Swiss Re, also make it into the top ten (annex table A.III.9).

Source: UNCTAD.

^a Ranking is by foreign insurance income. If only total income is considered, Nippon Life (Japan) would feature among the top ten.

In banking, foreign banks are often more efficient than domestic ones in the developing and transition economies. But it is not always clear how this translates itself into benefits and costs for a host economy. The range of potential impacts is wide (box III.16).²² It differs across countries as regards, for instance, the impact on interest rate margins between deposit and lending rates, the cost of capital, fees for services and the variety of new products introduced.²³

The impact of TNBs also varies when it comes to the provision of services to various market segments, SMEs in particular. For big banks geared mainly towards corporate lending, it can be relatively costly to undertake an evaluation of SME loans and to manage them, because of the small loan size typically involved. In fact, credit scoring techniques often used by TNBs for corporate lending may not be suited for use with SMEs in developing countries, partly because information on such borrowers is generally more difficult to obtain. Moreover, foreign banks are often more conservative and risk-averse than domestic banks, and lending to SMEs arguably involves higher risk than lending to large companies. Domestic banks – and especially smaller ones – may therefore be better suited to SME lending than foreign ones. With

the high degree of market segmentation that often prevails in banking, TNBs can therefore choose not to extend credit to SMEs and concentrate, instead, on other market segments.²⁴

Access to services for all sections of a market is a particularly important consideration with regard to utilities and other basic services. In the absence of appropriate government policies, privatizing State-owned enterprises with TNC involvement may lead to an inequitable distribution of services. Take the case of telecommunications: where policies have not specified the provision of services to poorer customers (e.g. through performance conditions or universal service funds²⁵), foreign entry can lead to uneven access. In Peru, for example, improvements in telecom services were unevenly distributed: availability increased mainly in Lima, but less elsewhere. At the same time, the price of local telephone calls went up, as well as that of fixed charges, while long-distance charges decreased slowly (Torero and Pasco-Font, 2000).

Countries may fear that the entry of service TNCs crowds out domestic firms. Is this likely? And is it more likely in services than in manufacturing? Unfortunately “the jury is still out” on the extent of crowding out, owing to the lack of systematic evidence. In major areas of

Table III.12. The relative importance of intra-firm trade in services of United States non-bank TNCs, selected years
(Billions of dollars and per cent)

Category	1996		1999		2001	
	Value	Share	Value	Share	Value	Share
A. Intra-firm exports of services						
Parents to affiliates	5.6	27.6	22.2	45.0	24.7	36.1
Affiliates to parents	7.9	38.9	14.5	29.4	19.8	28.9
Affiliates to affiliates	6.8	33.5	12.6	25.6	24.0	35.0
Total intra-firm (1+2+3)	20.3	100.0	49.3	100.0	68.5	100.0
B. Affiliates' exports of services from host countries						
Total exports	21.9	100.0	50.0	100.0	74.5	100.0
Exports to other affiliates	6.8	31.1	12.6	25.2	24.0	32.2
Memorandum	1977		1983		1993	
Intra-firm exports of goods						
Share of affiliate-to-affiliate exports in total intra-firm exports of United States TNCs (%)	30		40		44	
Share of affiliate-to-affiliate exports in total host country exports of United States MOFAs ^a (%)	37		53		60	

Source: UNCTAD, based on Zimny and Mallampally 2002, Borga and Mann 2003, and United States, Department of Commerce, 2004c.

Note: The term “affiliate” refers to foreign affiliates only.

^a Non-bank majority-owned foreign affiliates.

services FDI such as electricity, water or telecommunications, TNCs often enter via privatization. This is usually in response to a deliberate government policy to sell utilities to foreign investors and therefore cannot be considered as crowding out local providers. (There may, however, be the indirect effect of crowding out local suppliers of the previous State-owned company, if foreign affiliates switch to their own global suppliers.) Crowding out takes place in services in which both domestic and foreign companies exist and can enter freely. For instance, it can occur in the hotel industry, where the entry of large foreign chains can squeeze out small domestic hotels from segments

like mass tourism; on the other hand, in most countries both foreign and domestic hotels coexist, catering to different sets of tourists. In retailing, TNCs with competitive advantages in terms of ways of doing business, pricing structures, information management, marketing and merchandising methods and, in some cases, firm-level economies of scale, greater financial resources and negotiating power with suppliers, may squeeze out local competition. But this may also have beneficial effects: the remaining local retailers could be forced to upgrade (Goldman 2000; Lo et al. 2001) and consolidate (Toktali and Boyaci 1998), leading to improved services.²⁶

Box III.12. Consumer goods anyone? The rise and spread of retail TNCs

Trade is a service industry in which FDI is relatively high. Since the 1970s, the world's largest retail TNCs have grown significantly. In 1976, the total sales of the largest retail TNC (Sears Roebuck) were below \$15 billion (UNCTC 1989a, p. 191); in 2002, they (for Wal-Mart Stores) amounted to \$245 billion. Over the past three decades, the home-country composition of the largest transnational retailers has shifted dramatically, away from the United States and towards European countries. In 1986, 14 of the 20 largest retailers were based in the United States (UNCTC 1989a, p. 191); by 2002, that number had shrunk to 2 (annex table A.III.10). At the same time, the number of European retail TNCs on the list rose from 3 to 17. Food retailers or general merchandisers, rather than specialty providers, dominate the expansion of the retail industry (annex table A.III.10).

The degree of transnationality of the largest retail TNCs has risen dramatically. By 2002, leading players had extended their operations to 20-30 countries. In the near future, large retail TNCs may become as transnationalized as manufacturing TNCs. Nevertheless, despite their fast foreign expansion, most of the retail TNCs cannot yet be called fully global firms (Currah and Wrigley 2004), as they continue to derive an important part of their revenues from their home markets. Of the retailers listed, the share of foreign sales in total sales exceeded 50% in seven (IKEA,^a Delhaize, Christian Dior, Ahold, Kingfisher, Pinault-Printemps-Redoute, Otto Versand). For Tesco, foreign markets represented 22% of sales, and for Wal-Mart 19%.

Source: UNCTAD.

^a According to Coe 2003, p. 7, IKEA's foreign sales accounted for 85% in 2001.

The expansion of retail TNCs follows a complex organizational geography. Different firms and activities are organized and coordinated on different spatial scales. With the notable exception of Africa, where smaller South Africa-based TNCs such as Shoprite and Pick'n Pay dominate (Weatherspoon and Reardon 2003), the largest retail TNCs of the world are extending their presence into Latin America, East Asia and CEE, i.e. countries outside the Triad. Within those regions, retail TNCs target the more attractive markets that have larger consumer bases. In Latin America, much of the inward FDI has been directed to Argentina, Brazil and Chile; in East and South East Asia to Malaysia, the Republic of Korea, Taiwan Province of China, Thailand and, increasingly, China; and in CEE to the Czech Republic, Hungary, Poland and, to a lesser extent, Slovakia.

On the demand side, the global spread of urbanization is resulting in new shopping habits in many developing and CEE countries. It is the most important determinant of the fast growth of the retail industry, and its TNCs in particular. On the supply side, it is the combined effect of saturated home markets and good financial positions that prompt large retailers from the developed countries to try to sustain their profitability through international expansion (Coe 2003). This leads to strong inter-firm competition in all markets. In addition, technological progress in many areas related to retailing facilitates international expansion and competition. Trade liberalization and the opening of markets to FDI are the most important policy developments that have accelerated the process.

In banking, FDI has sometimes taken place through the privatization of troubled State-owned banks (e.g. in CEE) or following financial crises (e.g. in Mexico in 1995 and in East Asia after the financial crisis that began in 1997), with TNBs taking over distressed privately-owned banks. Both types of foreign entry have often occurred with government encouragement. There are not many clear-cut cases of domestic banks being driven out of business as a result of the entry of TNBs. One reason may be that TNBs often cater to a different segment of the market than domestic banks (Pomerleano and Vojta 2001; Clarke et al. 2000), although this is less likely to be the case where foreign bank penetration is high and where such banks have acquired large domestic banks active in retail markets.

The competitive impact of FDI entry on service supply conditions, as well as the likelihood of its crowding out domestic firms, depend considerably on initial country conditions, especially the level of economic and service-industry development, the market structure of the service industries and the regulatory framework in the host country. FDI can improve supply capacity and conditions. Where markets are oligopolistic or segmented, however, the entry or presence of TNCs may not necessarily result in benefits to customers unless the necessary policies and regulatory mechanisms are in place.

3. Technology, knowledge and skills

As in manufacturing, the most important potential contribution of services FDI to development is the transfer of technology. Service TNCs may bring both *hard* technology (e.g. equipment, industrial processes) and *soft* technology (e.g. knowledge, information,

expertise, organizational skills, management, marketing, technical know-how).

Service industries differ greatly in their hard and soft technology mix. Industries such as air and rail transport, communications, broadcasting, electricity, gas and water are highly capital-intensive. United States data (for the mid-1980s) suggest that only a few services are in the lowest capital-intensity group (Quinn 1987, p. 124). Since the equipment used by service firms is generally not proprietary, it is also available to local service providers. In this sense, FDI is not essential for countries to access hard technologies.

Soft technologies are the main form of knowledge and skills transfer in services FDI. Taking average salaries as an indicator of skill levels, United States data suggest that the average skill levels of employees in parent firms in services are lower than those in manufacturing. The difference between the average skill levels of parent firm employees in the two sectors has increased over time (table III.13). However, foreign affiliates of service TNCs in developing countries were more skills-intensive than those of manufacturing TNCs, and that difference, too, rose somewhat during the period 1989-2000. In addition, compensation in service affiliates in developing countries was much closer to that of affiliates in developed countries (63%), while the comparable figure in manufacturing was lower (31% in 2000).

This points to a major difference between FDI in services and manufacturing, with implications for their respective potential for technology transfer: FDI in manufacturing is better able to take advantage of low labour costs in developing countries by splitting up the value chain and moving less skilled processes (remunerated at a lower level) to those countries

Table III.13. Average compensation of employees in United States parent firms and their affiliates, selected years

(Compensation per employee, thousands of dollars)

Item	1982		1989		2000	
	Services	Manufacturing	Services	Manufacturing	Services	Manufacturing
Parent firms ^a	24.2	29.8	30.5	39.3	42.2	58.4
Foreign affiliates ^b	18.8	16.9	27.8	25.8	34.6	29.1
In developed countries	19.1	20.6	28.8	34.0	39.7	43.5
In developing countries	15.0	8.7	15.8	9.6	25.0	13.4

Source: UNCTAD, based on data from United States Department of Commerce.

^a United States non-bank parent firms with non-bank affiliates.

^b Majority-owned non-bank foreign affiliates of United States non-bank parent firms.

Box III.13. FDI by *sogo shosha*: shifting from manufacturing to services

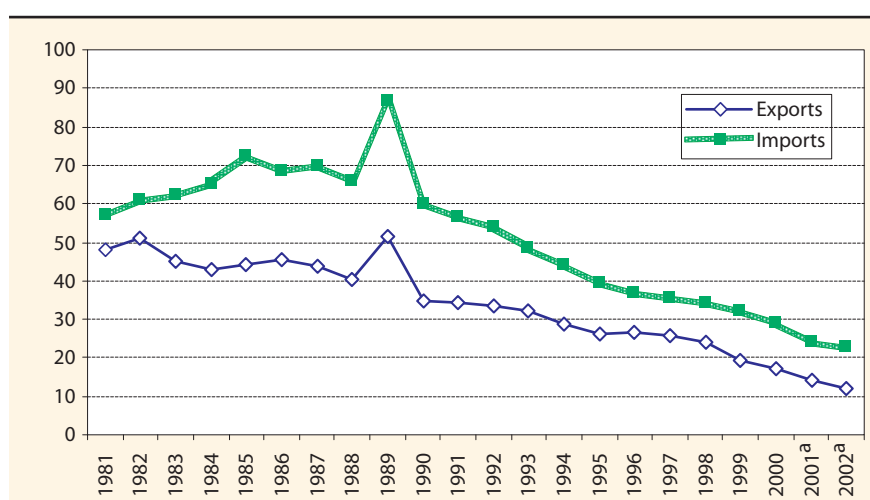
Sogo shosha – or “general trading companies” – have traditionally played a major role in Japan’s domestic and international trade.^a There are more than 11,000 trading companies in Japan, but only seven^b (annex table A.III.11) are classified as *sogo shosha*. They have contributed significantly to the development of Japan’s trade, particularly that of corporate groups (*keiretsu*), but also that of other Japanese firms, especially SMEs, which they have helped penetrate international markets and integrate into global production chains. Today, they have started playing a key role in business promotion, research and information, market development, group management, risk management, logistics, finance and large-scale project organization^c (Japan Foreign Trade Council 2004).

At the same time, the share of Japan’s imports and exports accounted for by the *sogo shosha* has declined gradually but significantly (box figure III.13.1). But their share in imports has consistently remained above their share in exports. This reflects the important role of these firms as suppliers of strategically important items, especially oil, gas, minerals and other primary products. On the export side, the decline is largely due to Japan’s manufacturing TNCs establishing their own marketing and sales networks overseas. In addition, while the *keiretsu* continue to maintain a close relationship with the *sogo shosha*, the latter’s business transactions outside these corporate groups are increasing.

Indeed, *sogo shosha* invest in many industries, but the industries in which they make new investments are changing. Prior to 1980, 46% of the nine *sogo shosha*’s foreign affiliates (1,338 firms) were in manufacturing (in particular textiles and chemicals), ahead of commerce (31%) (Yasumuro 1998). By host economy, they were concentrated in Asia (46%) and the developed countries (37%).

According to a survey conducted in November 2002, the five largest *sogo shosha* own more than 1,500 foreign affiliates, operating, as in the past, in almost all industries and business activities (Toyo Keizai 2003). The geographical concentration has not changed much (41% in Asia and 41% in developed countries). But manufacturing no longer constitutes the major part of their FDI portfolio: foreign affiliates in services account for 69% (of which half is in commerce).^d In commerce, other than their traditional overseas offices that are located virtually all over the world,^e an interesting trend is an increase in trade of foreign brands of automobiles in developed countries (where *sogo shosha* operate as dealers in brand-name products) and in wholesale and manufacturing in China,^f as well as their rising participation in ICT activities. Among the *sogo shosha*’s other service affiliates, the majority of them are either holding companies or they manage project investments. In addition to finance, insurance and transportation, they cover a wide range of

Box figure III.13.1. The share of the eight *sogo shosha* in Japan’s external trade, 1981-2002 (Per cent)



Source: JETRO.

^a Calculated based on the financial results of seven *sogo shosha*.

/...

than is (still) the case with FDI in services. Most services do not lend themselves, so far, to a similar separation of low- and high-skilled processes, and hence there tends to be greater employment of local staff in high-skilled (better remunerated) jobs. But this is changing for some information-intensive services in which functions can be separated to an increasing extent and located in foreign affiliates (chapter IV).

The skills involved in services affiliates generally have three main components: technical knowledge and know-how, marketing and organizational and managerial expertise. Some skills are linked to the use of sophisticated equipment, but most involve specialized education, professional training or experience. TNCs that have skill advantages can, under appropriate conditions, contribute to host-country capabilities.²⁷ Take some examples:

- Insurance requires specialized skills in risk management (i.e. the measurement, identification and minimization of risk). Foreign affiliates can transmit these skills to local employees, who can then disseminate them when they move.
- In banking, where risk-management techniques and technology have been changing due to competition and the use of ICTs, TNBs may transfer organizational, managerial and marketing expertise to affiliates. They may also transfer know-how regarding new or standardized products, created and tested in parent companies and

other units within their global corporate systems, to their foreign affiliates, and perhaps also to banks in which they hold a minority interest. This is often an important aspect of their competitive advantage over competitors in foreign markets. It also enables local employees in their affiliates to acquire new skills and knowledge, and to pass them on should they move to a local competitor.²⁸ For example, foreign banks have transferred the latest banking skills and techniques to banks in Hong Kong (China) (Carse 2001). Imitation can also be important. For instance, following the entry of TNBs, Turkish banks began to adopt modern planning, budgeting and management information systems and electronic banking techniques (Denizer 2000).

- In the hotel industry, specialized skills concern the pre-operational phase (engineering, architecture, mechanical, interior design, choice of location and market segments) as well as the operational phase (preparation of rooms and food, laundry, other personal services). They also involve direct interaction between personnel and customers and the processing of information (e.g. computerized reservation systems, credit facilities, centralized billing, check-in and check-out, other front- and back-office operations). Foreign affiliates as well as franchisees are likely to have greater access to this soft technology.

Box III. 13. FDI by *sogo shosha*: shifting from manufacturing to services (concluded)

activities – from industrial park development to aircraft leasing and to database development.

In examining the 139 foreign affiliates established by the top five *sogo shosha* in 2000-2002, the shift from manufacturing to services

becomes clear: 82% were in services (40% in commerce and 42% in other services). Most of the new FDI was directed to developed countries (51%); in developing countries, the focus remains on Asia (30%).

Source: UNCTAD, based on various publications and communications by Shigeki Tejima.

^a Originally, the *shosha* were known as “trading companies” or “trading houses”. As their activities expanded, some of them became “general trading companies”. Most *sogo shosha* began from a base in a specific industry (e.g. metals or textiles) and gradually moved to a variety of activities (Roehl 1998, p. 202).

^b There used to be nine, but one of them, Kanematsu, became “*senmon shosha*” (specialized trading company) in 1999. With the merger between Nissho Iwai and Nichmen in April 2003, they are now seven.

^c They also coordinate Japanese ODA projects (www.euroact.co.jp/oda-japan/AboutODA/Key_Players/Sogo_Shosha).

^d According to the 2003 annual reports of the five largest *sogo shosha*, out of 660 foreign affiliates listed as their *principal* subsidiaries and associated companies, 49% are in commerce and 28% in other services.

^e The majority were established in the 1960s as wholly-owned affiliates. Among the 248 foreign affiliates established prior to 1980, 57% are in commerce and 14% in other services.

^f Almost all affiliates in China were established in the 1990s.

The potential for technology and skills transfer does not mean that it occurs equally in all host countries. What determines the outcome?

Intensity of competition. This determines the incentive for foreign affiliates to use the best technologies available within their TNC systems.

Quality of education and training in host countries. This determines the ability of host countries to attract knowledge- and skill-intensive services. It also determines the capacity of employees to absorb the expertise and skills provided by formal training, contacts with experts, international communications, or the transfer of equipment and operating procedures.

Training and personnel policies of TNCs. These determine whether the skills needed by foreign affiliates are acquired by training host-country employees, competing for skilled labour in host-country markets or hiring expatriates (an expensive option and one that may be limited by host-country policy). The first involves the transfer of technology, while the second, depending upon the labour market, may represent an internal brain drain that could crowd out local firms.

Adapting to the local environment. This concerns the ability and willingness of foreign affiliates to create and utilize knowledge effectively in a host economy and transmit entrepreneurship and trust-based institutional mechanisms to their employees and to other firms with which they have dealings.

Labour market structure and mobility. Competition in host-country labour markets and efficient labour market institutions help foreign affiliates hire the best qualified employees. They also facilitate labour mobility, important for diffusing new skills.

Linkages between foreign affiliates and domestic service suppliers and buyers in host countries. These allow domestic firms to acquire soft technologies from foreign affiliates by contact with experts, information flows and observation.

Systematic evidence on the extent of transfer and dissemination of knowledge, expertise and skills by service TNCs is limited. But TNCs in services such as banking, insurance, professional services (management, engineering, accounting), and hotels and restaurants generally provide training to their employees at various levels (UNCTC 1989b, p. 22; WIR95, p. 185;

WIR94, p. 229; Denizer 2000). In addition, transnational consultancy firms help upgrade indigenous management expertise in domestic firms (in the goods as well as services sectors) (WIR95, p. 185).

4. Export competitiveness

Direct cross-border exports by service TNCs, or goods TNCs investing in services, relatively limited until recently, have started growing as a result of IT-enabled trade in services (chapter IV). However, the indirect impact of services FDI on export competitiveness – i.e. on systemic competitiveness – can be significant. FDI in intermediate services can directly and indirectly help goods producers become more efficient. Such services range from trade-support, banking, insurance and business services to transport, electricity and telecommunications. For example, transnational trading corporations can help boost host-country exports through their foreign affiliates; these can be important intermediaries between host-country producers and markets abroad. Some – such as the Japanese *sogo shosha* – have played an important role by investing in export-oriented primary, manufacturing and service activities in host countries (box III. 13). FDI and international alliances in air transport can improve air-cargo services. And, as discussed above, TNCs have played an important role in expanding telecom services and enhancing the competitiveness of these services in a number of developing countries, thus facilitating trade.

TNC (equity and non-equity) involvement in tourism services catering to foreign travellers has improved the export competitiveness in the tourism industry of host countries. International tourism is an important foreign-exchange earner for four-fifths of developing countries, and the principal one for one-third of them (World Tourism Organization 2002). After petroleum, tourism is the primary source of foreign-exchange earnings in all 50 LDCs. It is particularly important for small island countries, notably in the Caribbean. Many, but not all, segments of tourism in developing countries need FDI to compete internationally. A large number of countries focus, in varying degrees, on attracting international hotel chains. In Botswana and the Caribbean, for example, nearly two-thirds of the hotels are foreign-owned, but in most, there is a mix of international and local hotels.

Box.III.14. The world's bankers

The financial services industry has traditionally accounted for the largest share of services FDI in all regions. In developing countries and CEE, its share in services FDI stock is still high, at 22% in 2002. In developing countries, the stock of FDI in financial services grew 1.5 times between 1990 and 2002, to \$250 billion (annex table A.I.18). In CEE, it rose from virtually nothing to \$37 billion over the same period. In banking alone, cross-border M&As, the principal mode of foreign entry into developing countries and CEE during the 1990s (CGFS 2004), amounted to nearly \$80 billion for the period 1995-2003 (compared to \$2 billion for 1987-1994).

Among the major players, there is a split between financial conglomerates offering a wide range of financial services and specialized financial service providers. Some banks have integrated various financial services under one umbrella, while others remain specialized and concentrate on specific business lines. For example, ING ranks high on the list of both the largest banks and the largest insurance providers.

Among foreign investors in banking, TNBs lead, although non-bank investors (such as investment funds) also sometimes take direct investment positions. Today, the 20 largest TNBs (annex table A.III.12) are dominated by banks from a small group of developed countries: more than half are from the EU (France, Germany, the Netherlands, the United Kingdom) and the remainder are from Japan, Switzerland and the United States. As noted in the text, the most dramatic change in the list of the largest TNBs in the past 20 years or so is the marked reduction in the number of Japanese banks.

About 60% of a large sample of TNBs are from developed countries, about a third from developing countries and 5% from CEE.^a Of the TNBs' 10,102 foreign subsidiaries, 65% were located in developed countries, 30% in developing countries and 6% in CEE at end-2002. TNBs from developing countries and CEE are generally relatively small by international standards and less internationally active (with a physical presence in relatively few foreign banking markets). None

of them are global players, and only a few (with the major exception of some South African TNBs in Africa) are strong regional players, while a mere handful are from LDCs (Bangladesh, Senegal, Togo).

The largest TNBs ranked by asset size are not necessarily the most transnationalized in terms of the geographic spread of their foreign subsidiaries. An indication of this is the differences in the ranking of the 20 largest TNBs (annex table A.III.12) by the number of host countries in which they maintain at least one subsidiary compared to their ranking by their total assets. *Crédit Agricole*, while highly global in operations, is much smaller than *Sumitomo Mitsui Banking Corporation*. The latter, though very large, is much less global. In fact, the largest Japanese TNBs have become less transnationalized, due to a significant scaling down of their foreign operations as a part of the restructuring of parent banks. Indeed, *Fortis Bank*, *Banca Intesa* and *Standard Chartered Bank*, for example, are not even among the 20 largest ranked by assets, but all have a higher global presence than do the much larger "big four" Japanese TNBs. These differences become more marked the larger the number of TNBs included in the ranking. TNBs from developing countries begin to enter the ranks of the most global TNBs before they enter the rankings in terms of size, as they are in general relatively small. But, as expected, the largest players are among those TNBs with a global reach. For example, *HSBC* and *Citigroup*, two commercial banking giants with clearly stated global ambitions, are at the same time among the very largest and most transnational players.

A significant proportion of TNBs' foreign subsidiaries are located within the region of the home country. For TNBs from Africa, as well as those from Latin America and the Caribbean and South, East and South-East Asia, 48% of their foreign subsidiaries are located in the region of their home country, compared to 37% for TNBs from the EU and 30% for those from CEE. These figures indicate the fairly strong intra-regional nature of TNBs in terms of physical presence, particularly in developing countries.

Source: UNCTAD.

^a Based on almost 400 TNBs with majority-owned foreign affiliates (subsidiaries) involved in financial services (data from the *Bankers Almanac* database, October 2003). Central banks are excluded.

International chains are often prominent in the highest quality end of the market, and the presence of at least some can be critical to putting a country on the global tourist map. These chains can attract a critical mass of international tourists, while other tourists relying on less expensive, locally-owned hotels, might follow. The large chains also have access to international tour operators, another vital feature of the tourism network. Analysts of the life cycles of tourist destinations have noted that, while drifters or backpackers might “discover” destinations (such as Goa, Bali or Morocco in the 1970s), the real economic pay-off comes from attracting international hotel chains and being part of mainstream tour-operator programmes. The potential offered by tour operators based in tourism-generating countries is especially important for many developing countries that lack the resources needed for international marketing campaigns. Large tour operators influence many aspects of tourism demand in host countries, including image creation, access to consumers, volume and type of tourism.

5. Employment

FDI in services, as in manufacturing, creates employment in host countries. In the short term, employment effects vary according to whether a particular project is greenfield, a merger or an acquisition. In the special case of M&As, there may be a decline in employment as companies are restructured and rationalized. Indeed, most studies find that employment in privatized firms usually falls.²⁹ In Argentina, for example, increased profitability, efficiency and operational productivity in telecommunications came at the cost of a large cut in employment (Galiani et al. 2003). This was also true of Brazil (Anuatti-Netto et al. 2003) and Chile (Fischer et al. 2003). However, negative short-term employment effects are often reversed in the medium to long term as sales rise (Sheshinski and López-Calva 2003).

How large is employment generation from services FDI compared to that from manufacturing FDI? Perhaps contrary to expectations, given the larger human element traditionally associated with services, services FDI generally does not create as much employment per dollar invested as manufacturing FDI. According to data for Germany, Japan, Switzerland and the United States for the period

1999-2001, services accounted for a much larger proportion of FDI stock (50% to 60%) than the share in total employment of their respective TNCs’ foreign service affiliates (about 40%, except for Japan where it was only 15%).

This suggests that, while employees in foreign service affiliates are, on average, better trained and better paid than those in manufacturing, the direct job-creating potential of these affiliates is lower than in manufacturing. It also reflects the stand-alone nature of most foreign affiliates in services and the (still) limited ability of TNCs to break up service products into components and to find the best location for their production. However, FDI in holding companies and in some kinds of financial affiliates (included in services FDI) generates little economic activity and, hence, little employment in host countries (section B.2). For example, in the case of United States outward FDI, on average \$136,000 of FDI stock (excluding stock in banking) generated one job in 2001; the corresponding figure for stock in financial affiliates was \$656,000 and for stock in holdings, \$21 million. Of course, non-equity forms of TNC participation (which do not contribute to FDI flows or stock) contribute to employment generation, but foreign-affiliate employment data do not capture this.

The potential for job creation by services FDI is growing with the rise of export-oriented services. FDI in these services can be expected to generate more employment per dollar than FDI in location-bound services (chapter IV). Also, aside from the direct impact of services FDI on employment, indirect effects are important. In particular, the greater availability and better quality of producer or intermediate services as a result of FDI can stimulate production in downstream industries and add to employment in those industries. In host countries where supplier industries of international standards exist or can be developed, production and employment in upstream industries can also increase. These effects can be particularly significant in some services such as telecom services.³⁰

6. An assessment

The net effects of services FDI on host countries are difficult to assess — but it is important to start with a clear view of the potential benefits. Technology in the provision of many services is changing rapidly, and services are playing an increasing role in boosting

competitiveness. They are becoming indispensable for most production activities, and they are constantly changing and improving. Manufacturing activities themselves have a steadily growing component of services (in R&D, design, logistics, marketing, servicing), many of which are subcontracted to sophisticated, specialized suppliers. Service providers in areas such as banking, media and transport can serve as valuable links to the outside world, providing information, contacts and skills. And, increasingly, many services can be exported directly, thanks to ICTs.

The entry of service firms from more advanced countries can thus improve the conditions of service provision to consumers and producers in host developing economies, including for producers of goods and services that are newcomers to international competition. Service TNCs can bring with them state-of-the-art techniques (soft technology) which, where properly transferred and deployed, can transform the provision of services in the relevant activities and raise skill levels in host economies. TNCs can also provide new services that local firms have not developed, or cannot develop without

Box III.15. FDI in telecommunications: effects on supply and costs in host economies

Evidence on the availability and performance of telecom services after large-scale foreign entry, covering 85 developing countries for the period 1985-1999, points, on balance, to an improved and more competitive provision of services owing to better firm performance (Fink et al. 2002). FDI has increased supply capacity in telecommunications in developing and transition economies and improved reliability, especially by providing mobile telephony. In countries with strong regulatory systems, FDI has led to improved telecom services and contributed to higher economic growth (Norton 1992; Roller and Waverman 2001).

In many countries in Latin America, FDI was deemed necessary for improving their telecom systems. In general, the process brought higher levels of investment, significant improvements in services, greater efficiency and productivity, more operators and more products. Over the decade 1992-2002, fixed-line penetration doubled in Latin America. In the case of mobile telephony (which took off in the early 1990s), the number of subscribers rose substantially, to reach that of fixed lines subscribers in 2003.

In Argentina, the number of fixed lines doubled from 3.8 million in 1989 to almost 8 million in 1999, and the number of public telephones rose from 1,300 booths to over 170,000. Productivity improved from almost 92 lines per worker to around 400 lines per worker

(Gerchunoff et al. 2003). In Peru, investment was significant and services expanded and improved noticeably. There was an improvement in residential and public telephony penetration: the density of public phones climbed from 0.35 to 4.5 for every 1,000 residents between 1993 and 2003, and fixed lines from 3.2 to 6.9 per 100 residents between 1994 and March 2004.^a

However, the picture is not one of unalloyed benefits. Competition problems emerged in several cases. In mobiles, bidding for licences resulted in oligopolistic competition; in fixed-line services, State monopolies were frequently turned into foreign-owned quasi-monopolies with long exclusivity periods. Prices sometimes rose because of reductions in subsidies.

When FDI took place without competition, or when competition was delayed, the incentive for investors to improve capacity (e.g. line construction) was reduced. In Argentina, Mexico and Venezuela, there was a sharp increase in telephone line construction immediately after privatization, only to fall later to below the regional average.^b In these cases, while telecom enterprises were transformed from loss-making, subsidized entities into tax-paying firms, part of their profitability arose from monopoly positions and captive regulators. In Argentina, the privatization of Entel did not result in lower service prices (Abeles 2002), and in Brazil, greater efficiency was accompanied by higher prices (Anuatti-Neto et al. 2003).

Source: UNCTAD, based on Mortimore 2003.

^a Organismo Supervisor de Inversión Privada en Telecomunicaciones, www.osiptel.gob.pe.

^b The experience of Costa Rica and Uruguay demonstrate that a fair amount of modernization can be achieved without privatization and FDI, on condition that the Government can successfully acquire the capital and technology required.

the complex networks and skills to which TNCs have access. Some of these new services, as in logistics management or insurance risk management, can be important for enabling a country to compete in international markets.

FDI can also spur local service providers to become more competitive and, by demonstration effects and skill diffusion, help them improve efficiency. Where service provision calls for large investments, as in basic infrastructure, FDI can help bridge the investment gap in developing countries. Furthermore, the entry of flagship service TNCs can improve the investment image of a host country, helping it to attract other investors.

However, these benefits may only be realized if conditions in a host economy are appropriate. A number of services are inherently monopolistic, while others are prone to systemic risk and require strong supervision and governance structures. In addition, there are risks that are associated with social or cultural impacts, the crowding out of local firms or the deprivation of services to poorer groups. Thus, services FDI entails three kinds of risk:

- *Systemic risk* exists where the absence of effective regulation can expose a host economy to significant economic instability. For instance, in financial services, the entry of foreign financial institutions might undermine the ability of national authorities to exercise control over international capital movements into and out of their countries (Cornford 1993; Cornford and Brandon 1999; Montgomery 2003). Also, the risk of volatility in foreign-exchange flows may rise with the entry of international financial service providers. Furthermore, there is a possibility of contagion effects from foreign crises in the home market or third-country markets that are transmitted via the presence of foreign banks (CGFS 2004; Clarke et al. 2003; Hawkins and Mihaljek 2001; Peek and Rosengren 2000). On the other hand, if the alternative to TNC participation in a host economy is reliance on the international capital market or borrowing, the risk of volatility in capital flows and contagion may be even larger. The possibility of contagion through cross-border lending by foreign banks has been observed in several cases, but so far contagion through foreign-bank affiliates has been less well studied. As the

Asian financial crisis demonstrated, the costs of instability can be high. The problem is not necessarily one of foreign banks as such — domestic banks can also intermediate international capital flows and, under certain conditions, contribute to domestic financial instability. But a large foreign presence may exacerbate volatility.³¹

- *Structural risk* can arise from services FDI in activities with large inherent monopolistic elements. Where the regulatory apparatus needed to manage privatization and regulate utilities is insufficient, State-owned monopolies may turn into private ones and impose high costs on an economy, even if they are run more efficiently. Some developing countries are short on the skills needed to negotiate appropriate deals and provide such a regulatory apparatus; as examples show, this can create hostility to further FDI in privatization (box II.13). In some cases, there may not be many service TNCs to choose from: the global water industry for example is dominated by three large corporate groups that are among the largest TNCs in the world (box III.9). The potential for structural risk calls for an institutional upgrading in the regulation of markets.
- *Contingent risks* can arise from services FDI in socially or culturally sensitive areas, causing unintended harm. Changes to consumption patterns by the entry of efficient retail TNCs is a case in point. For example, in Thailand, their entry has led to the disappearance of many local markets and street stalls and has affected traditional consumer habits (Hewison 1996; Robison and Goodman 1996). The takeover of media by foreign firms may be inherently unacceptable in some cases, especially where market concentration is high. There may be inequities in the distribution of essential services provided by foreign affiliates if left to market forces, unless governments ensure that remedial measures are taken. Foreign service providers may crowd out local providers if factor markets favour foreign firms in, for example, providing access to capital or skills. It is, therefore, important for host-country governments to be clear about what they seek and what they can expect from foreign affiliates in such industries.

Box III.16. The pluses and minuses of TNB participation

Positive impacts. The participation of TNBs may benefit the banking system of a host economy in various ways:

- TNBs may bring in additional capital and recapitalize, restructure and rehabilitate distressed domestic banks in the host economy.
- Through other direct means, they may strengthen the domestic banking system's health and resilience. They may be better capitalized than domestic banks, have better risk-management practices, allocate credit more efficiently or make available financial instruments for hedging risk. Not only can this directly strengthen the domestic banking system, it can also improve credit allocation and improve economic efficiency.
- They may directly introduce new banking products and technology.
- TNB entry can stimulate increased competition in a host-country's banking market, which may improve the efficiency of domestic banks and the quality and diversity of banking services, and perhaps lower prices.
- TNB entry can stimulate indirect effects (spillovers) on domestic banks in their operational methods, for example by causing domestic banks to improve their risk-management and credit allocation practices.
- TNB entry can prompt a strengthening of the market infrastructure (such as improved legal, accounting, disclosure or auditing standards). Their entry may also lead to improved regulation and supervision in countries where these are weak.
- To the extent that TNBs are well diversified, they may directly improve the stability of the banking system through their more internationally diversified portfolios.
- Due to greater diversification, TNBs may be less sensitive to local shocks, and as a result they may have more stable lending patterns; a domestic bank, on the other hand, might be forced to reduce credit in response to an economic shock.
- To the extent that financial support is forthcoming from parent banks (and perhaps in some cases – notably for branches – even indirectly via the regulators of the parent banks through lender-of-last-resort facilities), TNBs

can more easily access funding from international financial markets, if needed, and can provide stability in a crisis.

Negative impacts. TNB participation can also weaken the domestic banking system or create problems for a host economy in various ways:

- TNB entry can affect the degree of concentration of the banking industry and market contestability.
- In countries with a weak regulatory framework and poorly prepared bank supervisors, the regulation of TNBs may be difficult.
- TNBs may target the largest and most creditworthy clients and crowd out domestic banks from the most creditworthy customer base.
- If domestic banks are unable to compete effectively with TNBs, they may respond by taking on high-risk business, which could undermine their health and that of the domestic banking system, particularly where bank supervision is weak.
- TNBs may ration credit to SMEs, making it difficult, in some cases, for the latter to obtain credit.
- TNBs may be less amenable to monetary policy via “moral suasion”.
- TNBs may shift funds between markets, even in an abrupt manner, reflecting perceived risk-adjusted returns; this could cause relatively volatile credit patterns if risks and returns in different markets change quickly.
- Profit repatriation by TNBs may place pressure on the balance-of-payments of host countries.
- TNBs may reduce local operations or withdraw from a host-country market because the parent bank may “cut and run” during a crisis in a host country, rather than act as a source of stability.
- TNB entry may expose a host-country's banking system and a host economy to contagion from crises and wider economic and financial developments abroad.
- TNB entry might reduce the ability of national authorities to exercise control over international capital movements to and from the host country.

Source: UNCTAD, based on the literature cited in footnote 22 of this chapter.

Banking provides a good illustration of the diverse effects that must be taken into account when assessing the overall impact of FDI in services in a host country (box III.16). To identify and assess these various effects, and arrive at a policy response that maximizes the benefits from services FDI and minimizes the negative impacts, is not easy.

The challenge of balancing various effects and objectives also characterizes privatizations. What is the evidence of the impact of FDI in privatization? Privatized firms, regardless of their ownership, tend to become more efficient and profitable, increase investment spending and improve their financial health (Megginson and Netter 2001). Furthermore, evidence from economies in transition, distinguishing foreign from domestic privatizations, shows that foreign ownership was associated with greater post-privatization improvements than was domestic ownership.³²

However, higher profitability is not synonymous with increased economic efficiency if firms operate in an uncompetitive environment, or if they can capture the regulators. Nor does it mean that social objectives are met. Utilities providing basic services such as electricity, water or telecoms are particularly sensitive in these respects, and the provision of these services to the poorer or more remote segments of a community requires special policies and contractual commitments (chapter V).

These difficult cases should not, however, distract from the fact that services FDI is becoming an important element of systemic competitiveness. The implications of this for the process and pace of development, even more than with other kinds of FDI, have to be considered carefully. The special nature of some services, particularly in basic utilities and socially or culturally sensitive areas, means that free markets cannot be left to work efficiently by themselves. Strong, independent and competent regulatory structures are vital if the potential economic benefits of FDI are to be realized. It is not easy for developing countries to build such structures. Regulatory agencies need specialized skills and information and the capacity to adapt continuously to rapidly evolving conditions of markets, technology and corporate strategies. They also need to be able to draw upon the experiences of regulators in other parts of the world and to experiment with them in their own contexts. Moreover, while an evaluation of the economic benefits of any kind of FDI has to be set against the value of maintaining diversity of institutions or belief systems, this dilemma is more marked in services FDI. This is because of the greater human element in services and because a number of services take the form of public goods: the “externalities” of services are thus likely to be more important than those of goods. Hence, much depends on policies at the national and international levels to maximize the positive effects of services FDI and minimize its negative ones – an issue taken up in chapters V and VI.

Notes

- ¹ On a balance-of-payments basis, including sales between residents and non-residents (whether by cross-border sale or by temporary movement of buyers or providers). Balance-of-payments data on services trade compiled by the IMF cover the following: transportation, travel, communication services, construction services, insurance services, financial services, computer and information services, royalties and licence fees, other business services, personal, cultural and recreational services and government services (IMF 1993).
- ² In this volume, the term “tradability” refers to the ability to supply services across borders, i.e. it is based on the traditional concept of cross-border trade of services from one country to another. For the purpose of the General Agreement on Trade in Services (GATS), however, “trade” includes not only cross-border trade, but also consumption abroad (by a service consumer moving to another member’s territory to obtain a service), commercial presence (by a service supplier

of one member establishing a presence in another territory to provide a service) and the presence of natural persons (by persons of one member entering temporarily the territory of another to supply a service). See WTO “The General Agreement in Services (GATS): objectives, coverage and disciplines”, at <http://www.wto.org/English>.

- ³ The growing importance of FDI in services was noted in the mid-1980s by the United Nations Centre on Transnational Corporations (UNCTC) in a number of studies. For the first comprehensive analysis of FDI in services, see UNCTC 1989a. Two other studies focused specifically on conceptual and theoretical issues (Dunning 1989), and on impact and policy issues for developing countries (UNCTC 1989b). Other studies by UNCTC and UNCTAD followed; see <http://unctc.unctad.org>.
- ⁴ Aggregated FDI data on business services should be interpreted with caution, as their coverage in countries varies considerably. For example, real estate may

include not only services of real estate agencies but also fixed assets (buildings). Some economies include holding companies, which greatly inflate the value of FDI. A case in point is Hong Kong (China), which accounts for 27% of the world stock of inward FDI in business services, owing largely to the inclusion of holding companies.

⁵ Especially in the United States, where Japanese FDI stock jumped from \$1 billion in 1985 to \$15 billion in 1990.

⁶ The share of developing countries in world outward FDI stock in manufacturing during this period rose only from 1% to 4%.

⁷ But it is difficult to say whether the full liberalization of FDI in air transportation would result in much higher FDI. For example, in the hotel industry, many developing countries in the past had a strong preference for control of the physical assets in their territories. They thus preferred local ownership, sometimes in minority joint ventures with foreign investors, which led to the proliferation of non-equity arrangements. Nowadays, most countries have lifted restrictions and seek not only the presence but also the capital investment of international hotel chains. Although a more liberal investment climate gives companies a greater choice of modes of entry, the preferred mode continues to be non-equity arrangements in a number of industries. Thus, one would have to take a closer look at ownership-specific advantages of airlines before making a judgment about the impact of FDI liberalization on the modes of entry in this industry.

⁸ Based on data from World Bank 2004b.

⁹ Conversely, service TNCs can establish manufacturing affiliates abroad. This is especially the case with United States' wholesale trading TNCs: in 1999, 72% of the gross product of their majority-owned foreign affiliates was in manufacturing and only 13% in wholesale trade services. The same applies to the Japanese *sogo shosha* (box III.13).

¹⁰ According to data from their respective annual reports, roughly half of their sales were in services.

¹¹ The restructuring resulted in a series of national M&As among the largest Japanese banks, leading to the creation of four major financial groups: Mizuho, Sumitomo Mitsui, UFJ and Tokyo-Mitsubishi. In July 2004, UFJ and Mitsubishi Tokyo Financial Group (MTFG) announced discussions on a possible merger.

¹² Cross-border M&As occur in waves. They intensify during economic upturns and weaken during recessions. The M&A boom of the late 1980s ended with the recession of the early 1990s. In the second half of the 1990s, M&As rebounded, producing an M&A boom on an unprecedented scale. They then halved in value during the economic downturn of 2001-2003.

¹³ As discussed in chapter I, the Transnationality Index (TNI) of a company is a measure of the relative importance of foreign affiliate activity in a TNC's total activity. UNCTAD's TNI is a composite measure of the average of a TNC's foreign assets, employment and sales, relative to its total assets, employment and sales, respectively. But the Index can also be calculated for other variables, such as the number of foreign affiliates relative to total affiliates.

¹⁴ The reverse processes can also take place, i.e. service production can be internalized, by being undertaken

in-house. However, the overall trend is in favour of externalization.

¹⁵ These cover six types of services (Dunning 1993, p. 46): (i) those the sales of which depend on the presence of people, goods or other services located in the country of use (hotels, restaurants, car hire, construction development, motion picture production, real estate, news agencies); (ii) transport facilities; (iii) most telecommunication and public utilities; (iv) warehousing, wholesaling and retailing services; (v) most public administration and social and community-related services; and (vi) services that require face-to-face contact between buyer and seller.

¹⁶ Past *WIRs* have documented the emergence of such networks in manufacturing industries; examples include Ford's network in Europe (*WIR93*), Toyota's network in Asia (*WIR96*, *WIR01*) and Honda's inter-regional network (*WIR96*).

¹⁷ This is the category that includes most tradable services; in 2002, it accounted for more than 40% of total outward and inward transactions in services.

¹⁸ Zimny and Mallampally 2002, p. 108.

¹⁹ For a full discussion of FDI impacts in general, see in particular *WIR99*, but also *WIR97* (for the impact of FDI on market structure and competition), *WIR01* (on linkages) and *WIR02* (on export competitiveness).

²⁰ The financial needs of some infrastructure services can be high owing to the capital-intensity nature of the industry concerned (as in electricity or fixed-line telecommunications). In others, such as corporate or business services, capital investment needs are much smaller (see chapter IV).

²¹ These additional resources may be as large as the FDI inflows themselves – see *WIR99*, p. 160.

²² Ahumada and Marshall 2001; Akbar and McBride 2004; Aleem and Kasekende 2001; Barajas et al. 2000; Baudino et al. 2004; Beck 2000; Berger et al. 1999; Berger et al. 2000; Berger et al. 2001; Bonin and Abel 2000; Bonin et al. 2004; Brownbridge 1998; Brownbridge et al. 1998; Brownbridge et al. 1996; Caprio 1996; Caprio et al. 2001; Cardenas et al. 2003; Carse 2001; CGFS 2004; Chirwa and Mlachila 2004; Chua 2003; Claessens and Glaessner 1998; Claessens and Jansen 2000; Claessens and Laeven 2003; Claessens et al. 2001; Clarke et al. 2000; Clarke et al. 2002; Clarke et al. 2003, 2004; Coppel and Davies 2003; Cornford 1990, 1993; Cornford and Brandon 1999; Crystal et al. 2001; Dages et al. 2000; Daumont et al. 2004; de Carvalho 1998, 2000; de Freitas and Prates 2000; de Nicolo et al. 2003; de Paula 2002, 2003; de Paula and Alves 2003; Demirguç-Kunt and Huizinga 1999; Denizer 2000; Dobson and Jacquet 1998; Drakos 2003; ECLAC 2003b; Galac and Kraft 2000; Galindo et al. 2003; Gallego et al. 2002; Gelos and Roldos 2004; Goldberg 2003; Goldstein and Turner 1996; Hapitan 2001; Hasan and Marton 2003; Hausmann and Gavin 1996; Hawkins and Mihaljek 2001; Honohan 2000; IMF 2000, 2001; Jenkins 2000; Kim 2002; Kim and Lee 2004; Kiraly et al. 2000; Kireyev 2002; Kono and Schuknecht 2000; Kraft 2002; Kraft et al. 2002; Laeven 1999; Lensink and Hermes 2004; Levine 2001; Loong 2004; McKinsey Global Institute 2003; Majnoni et al. 2003; Manzano and Neri 2001; Martinez Peria and Mody 2004; Mathieson and Roldos 2001; Mero and Valentinyi 2003; Milo 2001; Mishkin 1997, 1999, 2001;

- Montgomery 2003; Montreevat 2000; Murinde and Tefula 2003; Park 2003; Pastor et al. 2000; Peek and Rosengren 1997, 2000; Pomerleano and Vojta 2001; Stiglitz 1994; Studart 2000; Tamirisa et al. 2000; Tinghuan 2001; UNCTAD 1996a; Unite and Sullivan 2003; Uribe 2001; Vander Stichele 2003; Xiaochuan 2004; Yacaman 2001.
- ²³ For a discussion of these issues, see, e.g. Bonin and Abel 2000; Clarke et al. 2000; Denizler 2000; Drakos 2003; ECLAC 2003b; Kiraly et al. 2000; Loong 2004, Kraft 2002; Majnoni et al. 2003b; Martinez Peria and Mody 2004; McKinsey Global Institute 2003.
- ²⁴ For further discussion and evidence, see, e.g. Berger et al. 2001; Brownbridge 1998; CGFS 2004; Clarke et al. 2002, 2004; de Freitas and Prates 2000; Hawkins and Mihaljek 2001; IMF 2000; Kraft 2002; Laeven 1999; Pomerleano and Vojta 2001; Yacaman 2001.
- ²⁵ A universal service fund supports investment in areas (or for the benefit of social groups) that are not commercially attractive. Such funds do not replace market forces, but supplement them to assure supply to targeted consumers.
- ²⁶ In Mexico, for example, the three domestic hypermarket chains have repeatedly taken a number of steps in response to competition from Wal-Mart, which bought Cifra – the country's largest and strongest retailer – seven years ago. They overhauled their purchasing and pricing strategies, revamped their stores, introduced new products and invested in computer systems and distribution centres. They are also planning a joint purchasing company that could strengthen their negotiating power with suppliers (*International Herald Tribune*, 10-11 July 2004, p. 13).
- ²⁷ See UNCTC 1989b, pp. 17-22, for a discussion of technology transfer in the insurance, banking and hotel industries.
- ²⁸ In Turkey, for instance, staff quality increased following foreign bank entry, as they often send locally recruited staff to their training centres abroad and provide training of other kinds. More recently, both foreign and local banks have been competing actively for well-trained graduates (Denizer 2000).
- ²⁹ For example, in CEE, where State-owned enterprises accounted for half or more of total employment prior to the beginning of transition, privatization involving cross-border investors (as well as domestic ones), and the restructuring that followed, led to large employment cuts in the enterprises acquired. A 1999 UNCTAD survey of the pre- and post-privatization performance of 23 major companies acquired by foreign investors in seven countries of CEE found that employment in them fell before as well as after privatization (Kalotay and Hunya 2000). Also, according to the ILO (ILO, 2001b), restructuring, which typically accompanies M&As in financial services, frequently resulted in the elimination of jobs and a shift from traditional full-time to part-time work.
- ³⁰ It has been estimated that, in the case of mobile telecommunications, the cumulative value added and employment of first-rank suppliers were nearly four and five times higher, respectively, than those of telecom operators in France during the period 1991-2002 (Orange 2003). The downstream effects of investment in telecommunications – often a precondition for production activity in modern economies – are likely to be even larger.
- ³¹ Regulation can help to deal with this problem. For example, volatility can be discouraged through instruments such as those used in the 1990s by Chile and Colombia (and currently in Argentina), namely the requirement to keep a proportion of capital inflows as non-remunerated deposits in the Central bank for a certain period of time before capital is allowed to be repatriated.
- ³² According to Mihályi (2001), privatization in Hungary simply did not produce the expected results without the involvement of TNCs.

Annex to chapter III. What are services? Classifying invisibles

Value-adding activities in an economy result in the production of goods, services or a combination of the two. Services are usually perceived as intangible, invisible, perishable and requiring simultaneous production and consumption, while goods are tangible, visible and storable, and do not require direct interaction between producers and consumers. But a conceptual distinction between goods and services is not as straightforward as this characterization suggests. First, some services have elements of tangibility (e.g. a consultant's printed report), visibility (theatre) and storability (voice-mail). Second, most goods are intended to provide a service or function. Third, there are few "pure" goods or services: nearly all goods require non-factor services for their production, most services require physical assets and intermediate goods and, at the point of sale, most goods and services are jointly and simultaneously supplied – airline travel requires aircraft and other equipment, and cars need to be marketed and distributed.

These and other complications make it difficult to formulate a clear-cut definition of services. No commonly accepted definition exists. Analyses of services generally adopt a pragmatic approach by simply listing activities that they consider part of the services sector, acknowledging the fact that, as production becomes more complex, the boundaries between economic sectors become more and more blurred. Often, a residual approach is used – all activities not included in the primary and secondary sectors are classified as services. As a result, some activities (e.g. construction, repair, public utilities such as electricity, gas, water supply) are sometimes classified in the secondary sector and at other times in services.

Regardless of the definition or precise coverage of services, for analytical purposes, they can be classified in a number of ways. One broad classification is that of consumer (final) and producer (intermediate) services. Another is to group them into distribution services (transport, storage, retail, wholesale trade), producer services (banking, finance, insurance, real estate, engineering, architectural, accounting, legal),

social services (education, health, welfare and religious services, postal services, governmental services) and personal services (domestic, repair, barber and beauty shops, hotels, restaurants, entertainment) (Browning and Singelmann 1975). Services can also be classified according to their factor- and knowledge-intensity: capital-intensive (such as electricity, telecommunications and transport), human-capital-intensive (e.g. call centres) or knowledge-intensive (insurance, professional business services).

For the purpose of the discussion in *WIRO4*, services comprise all economic activities included under the "tertiary sector" in the United Nations International Standard Industrial Classification (ISIC) (Rev. 3.1) (United Nations, Statistics Division 2002).^a The broad categories of services in this classification include electricity, gas and water supply; construction; wholesale and retail trade; hotels and restaurants; transport (e.g. railway, water, air, pipeline); storage and warehousing; post and telecommunications; financial institutions (banks and other institutions providing financial services); insurance; real estate; business services; machinery and equipment rental and leasing; public administration and defence; sanitary and social services; social and related community services (including education, research and scientific institutions, medical, professional and labour associations, radio and television broadcasting, entertainment services); and personal and household services (repairs, laundry, shopping services).

The United Nations Statistical Classifications Section is, however, embarking on its fourth revision of the ISIC, for use from 2007. Many of the proposed changes reflect technological developments, as well as the effects of deregulation, liberalization and privatization of activities that were formally held under State monopoly. For example, suggested changes that have implications for services include the creation of two separate categories for electricity and water (currently grouped together); a new information and communication category, with second-tier groupings for telecommunications, broadcasting and Internet providers (currently

grouped under a sub-set of “transport, storage and communications”); and two new business service categories.

The Central Product Classification (CPC), developed by the United Nations more recently, provides a greater level of disaggregation than the ISIC (United Nations, Statistics Divisions 1998). It focuses on products instead of activities and identifies more than 600 service products. It is used not only as the reference for the identification of services under the General Agreement on Trade in Services (GATS), but also to describe the services

components in the balance of payments as recommended in the IMF’s *Balance of Payments Manual* (IMF 1993). Major services categories in the CPC include transport services; communications services; construction services; insurance; financial services; computer and information services; merchandising and other related-services; miscellaneous business, professional and technical services; legal, accounting, management consulting and public relations; personal, cultural and recreational services; agricultural, mining and on-site processing services; and government services.

^a This classification is used for the classification of GDP data under the United Nations System of National Accounts (SNA), which is followed by most national accounting systems.

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