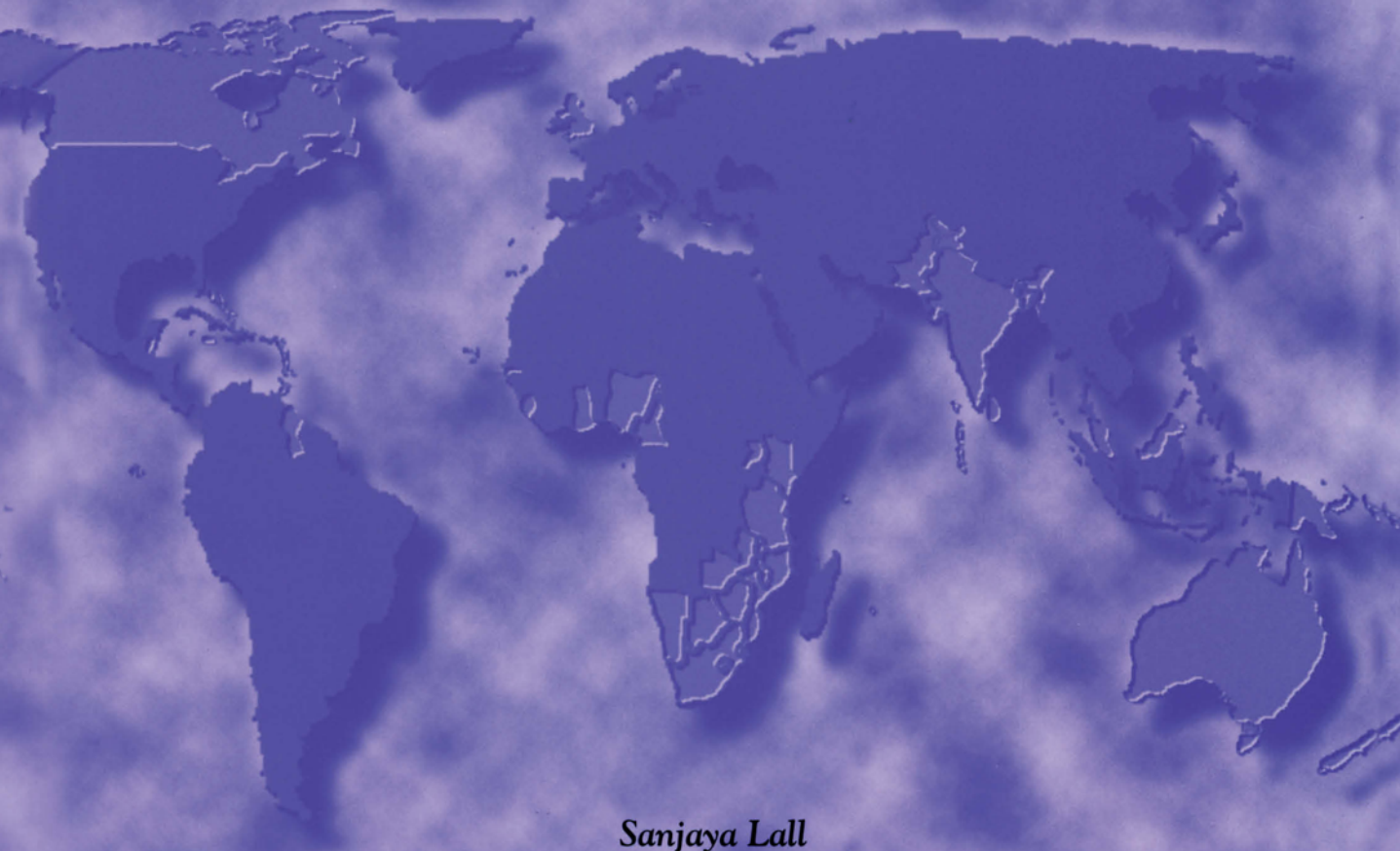


# Attracting Foreign Investment

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New Trends, Sources and Policies



*Sanjaya Lall*



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*Sanjaya Lall*



COMMONWEALTH SECRETARIAT

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# Foreword

In the 1980s and 1990s, there was a major surge in foreign direct investment to the developing world and a rapid liberalisation of trade and investment policies in individual developing economies. This expansion of foreign investment has been driven by traditional developed country multinationals as well as new sources like developing country multinational enterprises, small and medium enterprises, newly privatised public enterprises and a variety of other contractual forms. Each of these forms provides new opportunities for developing countries to acquire capital technology, management expertise, and marketing access. There is a pressing need for developing countries to examine their comparative advantages to induce foreign investment and gear up their promotion strategies to reap the benefits from increasing globalisation of foreign investment flows.

The Commonwealth Secretariat's policy development work on foreign direct investment has long been concerned with the issue of improving foreign investment promotion strategies in member countries. In this vein, we asked Sanjaya Lall, University Lecturer in Development Economics at the University of Oxford, to prepare a paper which examined recent trends in foreign direct investment in developing countries, analysed the determinants of foreign direct investment inflows, assessed the contribution made by new forms of foreign investment and provided policy suggestions on how to attract such investment. I hope that the paper will inform member countries on the opportunities offered by both traditional and new sources of foreign investment and guidance on appropriate policies to increase inward investment.

Rumman Faruqi  
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# Abbreviations

ACP	African, Caribbean and Pacific (States); the developing country signatories of successive Lomé Conventions	MFA	MultiFibre Arrangement (for management of trade in textile products)
ACS	Association of Caribbean States	MFN	most favoured nation (under GATT trade rules)
BIT	bilateral investment treaty	MTN	multilateral trade negotiations
CAP	Common Agricultural Policy of the European Union	NAFTA	North American Free Trade Agreement
CARIBCAN	Canada's Preferential Trade Scheme for the Commonwealth Caribbean	NIEs	newly industrialised economies (equivalent to NICs)
CARICOM	Caribbean Community	NGMTS	Negotiating Group on Maritime Transport Services (to restart the unfinished UR negotiations)
CARIFTA	Caribbean Free Trade Area	NTB	non-tariff barrier
CBERA	Caribbean Basin Economic Recovery Act	OECD	Organization for Economic Co-operation and Development
CBI	Caribbean Basin Initiative (which led to the CBERA)	OECS	Organization of Eastern Caribbean States (comprising Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines)
CET	common external tariff	OFA	Oils and Fats Agreement (of the OECS)
DMEs	developed market economies (effectively the members of the OECD)	Quad countries	Canada, European Union, Japan, United States
EC	European Community (renamed EU: European Union)	RUNS	Rural-Urban North-South
ECCM	Eastern Caribbean Common Market	SAP	structural adjustment programme
ECLAC	Economic Commission for Latin America and the Caribbean	SITC	Standard International Trade Classification
EDF	European Development Fund (the development agency of the EU)	STABEX	System for the Stabilisation of Export Earnings (for the ACP States under the Lomé Conventions)
EFTA	European Free Trade Association	SYSMIN	System for Stabilising Minerals (for the ACP States under the Lomé Conventions)
EPZ	external processing zone (generally equivalent to an FTZ)	TNCs	trans-national corporations
EU	European Union	TRIMs	trade related investment measures (subject to negotiation within UR)
FDI	foreign direct investment	TRIPs	trade-related intellectual property (issues) (subject to negotiation within UR)
FTA	free trade area	UNCTAD	United Nations Conference on Trade and Development
GAL	Guaranteed Access Level (for textiles or apparel under the CBERA)	UR	Uruguay Round of Multilateral Trade Negotiations
GATS	General Agreement on Trade in Services	US	United States of America
GATT	General Agreement on Tariffs and Trade	WTO	World Trade Organisation (successor body to GATT)
GDP	gross domestic product	WINBAN	Lobby group for the Windward Islands' banana producers. Replaced by WIBDECO
GOJ	Government of Jamaica		
GSP	Generalized System of Preferences		
IMF	International Monetary Fund		
IPA	intellectual property agreement		
IPR	intellectual property rights		
JAMPRO	Jamaica Promotions Corporation (for export promotion)		
JCTU	Jamaica Confederation of Trade Unions		
LDC	least developed country (a list of LDCs is defined by the UN)		

# Introduction

This study deals with ways of enhancing the flow of foreign direct investment (FDI) to developing countries, with particular reference to those in the Commonwealth.<sup>1</sup> It describes recent trends in FDI flows to the developing world, and places these in the context of developments in the global changes in technology, policies to trade and investment, strategies of multinational enterprises (MNEs), growth of markets and regional groupings and the evolution of the international financial system and capital markets.

The study of FDI is assuming particular importance in the decade of the 1990s. There has been a renewed surge of private investment flows to the developing world, comprising both portfolio and direct investment. At the same time there has been a marked growth of competitiveness in parts of the developing world. These structural shifts have been accompanied by (and have partly caused be) shift in policies in developing

countries towards liberalisation of trade and investment regimes and a cutting back of the role of the state in the ownership of productive assets and in the conduct of economic affairs. Technological progress has led to a shrinking of global 'economic space' and to new strategies by foreign investors to rationalise and integrate their operations across countries. The scope and sources of FDI itself have broadened, with investors emerging from many developing countries and from new sources in developed ones.

There is thus a pressing need to re-examine and update investment promotion strategies in developing countries. While the traditional multinational enterprises continue to dominate global investment flows, the new winds that are sweeping the international economy call for fresh approaches on the part of host developing economies. This study is a first step in that direction.

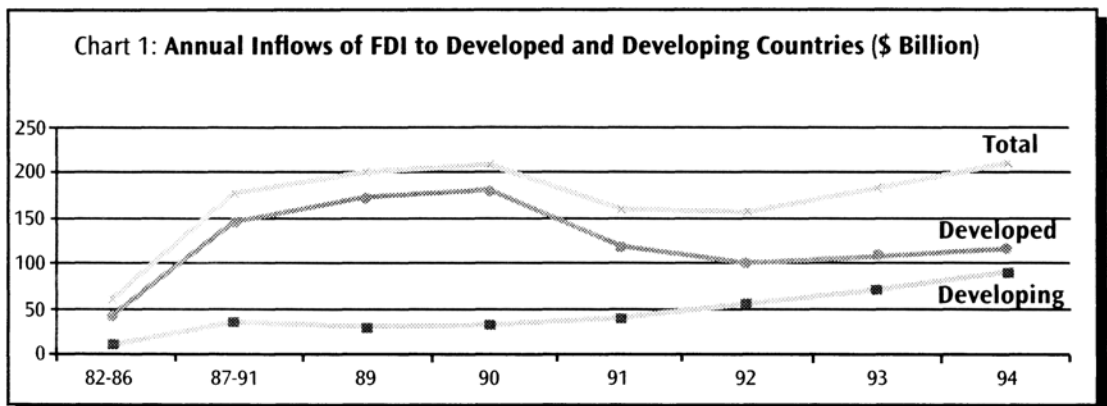
## Global Trends in FDI

The current decade is witnessing the growing significance of foreign investments in the world economy and a rapid liberalisation in policies in developing countries towards trade and investment. Multinational enterprises (defined as all firms with overseas investments, regardless of size, spread or share of equity) account for ever increasing shares of world output, trade and technology. In 1991, it is estimated that MNEs and their affiliates generated total sales of \$4.8 trillion and intra-firm trade of \$1.5 trillion. This can be compared to total world trade in goods and services of \$4.5 trillion, including intra-firm trade (\$3 trillion excluding it).<sup>2</sup> The stock of FDI continues to grow faster than world GDP, domestic investment and trade.<sup>3</sup> This is true of developing countries as a group – FDI flows into the developing world grew at 4 percentage points faster than their exports of goods and services in 1986-90, and at 21 percentage points faster in 1991.<sup>4</sup>

In terms of overall trends, one of the most significant recent features of FDI is the rapid and sustained rise in flows to the developing world.<sup>5</sup> After a period of relative stagnation in the wake of the debt crisis and the ensuing recession up to

the mid-1980s (in 1980-85 FDI to developing countries actually declined by 4% per annum), investment in the developing world revived strongly. Over the latter part of the 1980s, it rose by 17% per annum, with a further acceleration after 1990. According to the forthcoming World Investment Report 1995, total FDI to developing countries reached a record figure of \$85 billion in 1994, an increase of 21.4% over the previous year. This rise followed increases (in current dollars) of 37% in 1992-93, 32% in 1991-92 and 25% in 1990-91. The value of inflows to developing countries rose by 166% in the first 4 years of the decade, a period when FDI to the developed world declined by 34%. The distribution of investment flows between the developed, developing and formerly socialist countries are shown in Chart 1.

FDI flows to different regions of the developing world during 1985-1992 are shown in Table 1. The rise of investment interest in developing countries is striking not only because of the large sums involved but also because it reverses a decline in their share of total flows. This share had declined from the earlier peak of around



one-third in the 1970s to one-quarter by 1980. It fell further to 16% in 1986-90, a period when FDI in the developed world rose rapidly (23% per annum). In the 1990s, by contrast, there has been a sharp decline of inflows into the developed countries. In 1991, FDI in the OECD countries fell by 31%, and in 1992 by a further 16%. In the subsequent two years flows have revived, by 7% in 1993 and 9% in 1993, both lagging behind the rise in developing countries.

As a consequence, the share of developing countries reached its former peak of 33% in 1992, and went on to reach 36% in 1993 and 41% in 1994. In current dollars, the value of FDI in the developing world was equal to that of inflows into the developed world in 1986. If present trends continue, direct foreign investment in the developing world may exceed that in the developed world in a few years. However, this depends very much on how flows are distributed as economic activity revives in the latter: FDI flows tend to be highly volatile in the short term and are very sensitive to business cycles in the major OECD countries. What is clear is that there are major structural shifts under way in the pattern of production (and trade) in favour of certain developing countries that should lead to a continued shift in investments towards the developing world.

Given the nature of the phenomenon, with sharp cyclical movements and sensitivity to political and economic changes, it is difficult to forecast long-term FDI flows with any degree of precision or confidence. Nevertheless, many attempts are made to model and predict such flows. An econometric forecasting exercise by UNCTAD (1993.b) is worth reporting.<sup>7</sup> This exercise suggests that, assuming continued liberalisation and reasonable rates of economic growth (5-6% per annum for the developing world as a whole), FDI in the developing world would equal that in the developed world by 2020 – rather longer than a simple extrapolation of current trends suggests.

According to UNCTAD (1993.b), each

### Box 1: A Long-Term Projection of FDI

The UN Transnational Corporations and Management Division used a single-equation regression model for FDI inflows during 1972-88.<sup>6</sup> FDI inflows were explained by lagged GNP, GNP growth, domestic investment-GNP ratio, exchange rate and variability of the exchange rate. Region-specific variables were added for Latin America (trade as proportion of GNP and level of debt) and Africa (dummy for sudden jumps in FDI). 0

Three forecasts were made, based on: (a) extrapolations of growth rates for 1972-86, (b) UN projections from Project Link, and (c) IMF and World Bank projections for average growth rates. The projected annual growth rates of inward FDI, in constant 1990 dollars, for 1989-95 were as follows:

Regions	a	b	c
Asia	11.3	11.6	11.8
L. America 1	7.9	15.6	12.2
Africa	6.3	16.3	16.1

The projections b and c, based on model Link and IMF/WB assumptions about GNP growth, suggest that Asia would have slower growth rates of FDI than Latin America or Africa. However, some of these expectations are clearly not borne out either by subsequent growth or by FDI performance. Well over half the period covered by the analysis has now elapsed, and East Asia has continued to outperform other regions. In addition, its competitiveness has risen faster. Africa in particular has failed to respond to policy reforms, and FDI has continued to bypass most of the continent. Moreover, expectations of continued liberalisation may not be well founded for all developing countries.

**Table 1: Aggregate FDI inflows to Developing Countries, 1985-92**  
(US \$ million and %)

	1985	1986	1987	1988
All developing countries	11,526.7	11,647.2	13,909.3	21,994.3
of which Commonwealth	1,786.8	1,227.2	2,093.8	2,316.3
percent	15.5	10.5	15.1	10.5
Low-income countries	4,107.2	3,898.6	4,978.6	6,113.9
of which Commonwealth	851.0	458.4	1,147.1	1,039.8
percent	20.7	11.8	23.0	17.0
Lower-middle income	3,357.5	2,647.9	3,041.4	4,881.3
of which Commonwealth	823.4	645.5	716.3	1,025.6
percent	24.5	24.4	23.6	21.0
Upper-middle income	4,062.0	5,100.7	5,889.3	10,999.2
of which Commonwealth	112.4	123.4	230.4	250.9
percent	2.8	2.4	3.9	2.3
Memo items:				
Hong Kong	—	996.0	3,298.0	2,675.0
Singapore	1,047.0	1,710.0	2,836.0	3,655.0
Sub-Saharan Africa	876.6	671.4	1,351.8	1,226.2
percent of total LDCs	7.6	5.8	9.7	5.6
of which Commonwealth	616.6	226.5	972.1	655.9
percent of region	70.3	33.7	71.9	53.5
East Asia and Pacific	3,183.5	3,872.8	5,200.6	8,553.7
percent of total LDCs	27.6	33.3	37.4	38.9
of which Commonwealth	783.7	580.8	537.4	887.2
percent of region	24.6	15.0	10.3	10.4
Europe and Central Asia	854.0	871.9	1,295.4	2,238.8
percent of total LDCs	7.4	7.5	9.3	10.2
of which Commonwealth	317.2	350.5	377.8	521.7
percent of region	37.1	40.2	29.2	23.3
Middle East and N Africa	2,206.4	2,212.0	(93.7)	1,456.3
percent of total LDCs	19.1	19.0	(0.7)	6.6
of which Commonwealth	—	—	—	—
percent of region	—	—	—	—
South Asia	317.2	350.5	377.8	521.7
percent of total LDCs	2.8	3.0	2.7	2.4
of which Commonwealth	317.2	350.5	377.8	521.7
percent of region	100.0	100.0	100.0	100.0
L. America, Caribbean	4,089.0	3,668.6	5,777.5	7,997.6
percent of total LDCs	35.5	31.5	41.5	36.4
of which Commonwealth	52.0	47.4	187.2	210.8
percent of region	1.3	1.3	3.2	2.6
<b>Total NICs</b>	<b>1,281.0</b>	<b>3,467.0</b>	<b>7,450.0</b>	<b>8,160.0</b>

1989	1990	1991	1992
25,813.5	28,915.1	37,370.0	45,721.8
5,274.6	4,411.1	6,000.6	6,124.4
20.4	15.3	16.1	13.4
8,249.2	6,756.8	7,469.1	14,972.4
2,762.8	1,320.8	1,175.3	1,460.8
33.5	19.5	15.7	9.8
7,140.9	7,988.8	11,699.9	12,985.5
2,136.2	2,725.4	4,569.8	4,403.0
29.9	34.1	39.1	33.9
10,423.5	14,169.5	18,201.0	17,764.0
375.6	364.9	255.5	260.7
3.6	2.6	1.4	1.5
1,076.0	783.0	—	—
2,773.0	5,263.0	4,325.0	5,635.0
2,664.7	866.1	1,525.5	1,481.9
10.3	3.0	4.1	3.2
2,348.5	1,082.8	816.8	1,073.4
88.1	125.0	53.5	72.4
10,678.3	12,038.3	14,918.2	20,831.2
41.4	41.6	39.9	45.6
1,886.2	2,358.6	4,110.0	4,119.2
17.7	19.6	27.6	19.8
3,471.7	4,644.6	6,842.0	7,240.0
13.4	16.1	18.3	15.8
584.3	395.6	532.4	523.0
16.8	8.5	7.8	7.2
1,331.7	3,172.2	1,000.1	1,353.2
5.2	11.0	2.7	3.0
—	—	—	—
—	—	—	—
584.3	395.6	532.4	523.0
2.3	1.4	1.4	1.1
584.3	395.6	532.4	523.0
100.0	100.0	100.0	100.0
7,082.8	7,798.3	12,551.8	14,292.4
27.4	27.0	33.6	31.3
403.8	528.5	541.5	408.8
5.7	6.8	4.3	2.9
<b>6,211.0</b>	<b>8,091.0</b>	<b>6,712.0</b>	<b>7,064.0</b>

group would reach an FDI figure (in constant 1990 dollars) of \$400 billion in 2020, when foreign investments would account for 6% of total investments in the developing world and 7% in the developed countries (up from 3% and 4% respectively in 1990). These forecasts are based on simplifying assumptions about future policy reforms, growth, capital-output ratios, exchange rates and the response of FDI to these. They ignore issues of competitiveness and shifts in industrial location between regions and countries, and seem unduly optimistic about FDI in Africa. The main features of the analysis are reported in Box 1, which also notes the drawbacks of these projections.

As far as the composition of FDI is concerned, the longer-term trend for the decline in the share of the primary sector was reversed in the 1980s.<sup>8</sup> Driven by investments in petroleum and mining, the share of the FDI stock in the primary sector in developing countries, which had fallen to 21 percent in 1975, rose to 24 percent in 1985, thereafter declining to 22 percent in 1990. The share of manufacturing in the stock of developing country FDI fell steadily over this period, from 56 percent in 1975 to 49 percent in 1990. Within manufacturing, however, the higher technology and skill activities gained in the developing world while resource- and labour-intensive activities declined in significance. This shift has been particularly marked in the NIEs of East Asia, where investors moved rapidly out of labour-intensive into capital- and technology-intensive activities.

The emerging pattern of FDI reflects the pace and nature of technological progress, and affects the direction of FDI flows, benefiting host countries that had a relatively good base of technical and managerial skills, well-developed infrastructures and supporting systems of local suppliers and subcontractors.<sup>9</sup> These changes in FDI by the OECD countries were accompanied by the rapid growth of “developing country multinational enterprises” from the more industrialised developing countries. These started with the

relocation of simple, labour-intensive industries from the NIEs to low wage countries, but soon moved into more complex activities and into a large range of host countries, including developed ones. The pioneering developing country multinational enterprises have now been joined by a variety of investors from a large number of other developing countries, operating overseas in tourism, finance, trade, real estate and other primary sectors apart from manufacturing (see below).

Over the long term, FDI in services has gained at the expense of manufacturing in global investment flows. This reflects the pattern of structural change, technological changes in services and related infrastructure, changes in corporate strategies and the liberalisation of many service sectors. Established industrial multinational enterprises have moved into service activities, and a host of traditionally home-bound service firms have set up affiliates in important markets overseas. Banking and finance have spearheaded the growth of service FDI, followed by insurance, transport, telecommunications, tourism, construction, advertising, retailing and information technology. The growth of service FDI is particularly marked in the developed world. Take the major overseas investors, for instance: 51% of the USA's overseas investment in 1992 was in services, compared to 41% in 1985; for the UK, 46% and 35%, for Japan, 66% and 52%, for France 46% and 47% and for Germany, 56% and 53%.<sup>10</sup> However, there are signs that service FDI in some developing countries has also risen as a result of recent policy liberalisation. This is particularly marked in Latin America, where much of the revival of foreign investment inflows has been in banking, telecommunications, hotels, retailing and similar activities. Privatisation has also played a very important role in FDI in Latin America (and Eastern Europe), far more so than other developing regions. This will be taken up at more length below.

In Asia, the bulk of FDI still concentrates on

manufacturing, testifying to the faster development of the industrial sector, better export performance and greater industrial and technological capabilities built up there. This difference in investment patterns deserves more interest than it seems to have received, since it may have differing implications for the development of the two regions. To the extent that the growth of manufactured exports and industrial competitiveness is of special significance to long-term growth and structural change, the pattern of FDI seems to bode better for Asia than for Latin America. However, this interesting issue goes beyond the scope of this paper, and will not be explored here.

The recent growth of FDI has witnessed the continued growth of a variety of 'new forms' of foreign investment.<sup>11</sup> These new forms involve contractual and ownership relationships in which the foreign investor does not hold the majority equity share. In some cases, the relationship may not involve any equity at all, and its duration may be limited to a one-off transaction. Apart from minority joint ventures, new forms of FDI include licensing agreements, management and marketing contracts, franchising, turnkey projects, subcontracting and OEM (original equipment manufacture) arrangements, and BOO and BOT (build-own-operate and build-operate-transfer) contracts for utilities and infrastructure projects. Most of these forms are not new, of course, but their significance has continued to grow as buyers or host countries have become more capable, smaller investors have entered the international arena, governments have sought to encourage domestic ownership of assets, and competing sources of technology and skills have emerged in maturing technologies.

In contrast, BOT and BOO are genuinely new forms of investment (in most cases the projects are handled jointly by local consortiums and by foreign technology suppliers and financiers) in developed as well as developing countries. Their spread has been boosted by the urge of many governments to privatise public

enterprises, improve the functioning of utilities, improve the environment for private enterprise, raise the large volumes of finance involved while reducing pressures on the official budget.<sup>12</sup> Some developing countries seem to be moving faster in this area than developed ones; Malaysia, for instance, is pushing ahead in BOT schemes in the power sector, airports, railways, sewerage and so on.<sup>13</sup> This subject is taken up again under the section on 'new forms' of FDI.

Along with the growth of new forms, the increasing liberalisation of FDI regimes gives investors greater freedom than before to choose ownership forms on economic and commercial grounds. 'Classic' forms of ownership, with complete or majority control, are clearly preferred by some multinational enterprises. This is true of certain services and in manufacturing in activities that involve fast-changing and advanced technologies. The multinational enterprises that prefer clear control tend to be large firms and those with strategies of 'deep integration', moving towards greater global integration of operations, with supplies, resources and R&D distributed in a tightly linked network across various countries.<sup>14</sup> However, even large MNEs often opt for new forms in more mature technologies, in entering countries with difficult entry conditions, and in establishing supply relationships (along Japanese lines) with long-term arrangements in which they can share technology and innovation costs. The rising costs of innovation have also led MNEs to form "strategic alliances" with each other across national boundaries.<sup>15</sup> This makes it more difficult and expensive for newcomers from developing countries to gain access to some new technologies at arm's length, and makes some form of accommodation with multinationals imperative for progress in those technologies.<sup>16</sup>

To conclude, multinational activity is increasing rapidly in the developing world. It is taking new forms in a changing global environment. This environment is marked by rapid technical progress, closer economic ties between nations,

more liberal rules for trade, the emergence of new trading blocs and alliances, and more welcoming environments for the private sector and multinational enterprises.<sup>17</sup> Multinational enterprises are at the forefront of much of this technological advance and the shrinking of economic space, and are adapting their own strategies to the organisational and other needs of globalisation. New organisational forms and management techniques are producing new configurations of comparative advantage for countries and 'ownership' advantages of companies.<sup>18</sup> Host and home governments are trying to come to terms with the irresistible advance of international production, currently by moving towards wholesale deregulation and liberalisation. To some extent this means that international regulation of MNEs

has not kept pace with the advance of international production.<sup>19</sup>

New sources and forms of FDI are constantly appearing, in the developed as well as the developing worlds. The attraction of multinational enterprises to developing countries is taking different dimensions from two or three decades ago, when large protected markets, cheap unskilled labour and the exploitation of natural resources provided the main drive. Increasingly the sustained attraction of FDI into competitive and higher value-added activities requires disciplined and productive labour, high levels of skill, efficient world-class infrastructure, and a supportive network of suppliers, rather than the possession of cheap labour or even exploitable natural resources.<sup>20</sup>

## Distribution of FDI in the Developing World

The 1980s and early 1990s witnessed large changes in the geographical allocation of FDI flows. As noted, overall flows to the developing world declined in the first part of the 1980s, then recovered strongly; its growth has accelerated in the 1990s. At the regional level, the share of Asia and the Pacific in developing countries' inflows increased substantially, from 30 percent in 1985 to over 45 percent in 1992. Latin America and the Caribbean suffered declines in shares, from a peak 44 percent in 1987 to 30 percent in 1990-92.<sup>21</sup> Flows to Africa (including North Africa) increased in the second half of the 1980s, but from a very low base, and again declined in the early 1990s. In 1991, the region received just over 4 percent of FDI to the developing world.<sup>22</sup>

The relative shares of the main regions are shown for the beginning and end years in Chart 2<sup>23</sup>. The Commonwealth developing countries are also shown, though the individual countries

are also parts of the different geographical regions. The share of these countries rose marginally from 11 percent in 1982 to 14 percent in 1992, while the volume of FDI inflows rose from \$2.5 billion to \$6.1 billion (in current terms). MNE interest continued to concentrate in a few more advanced developing countries, and this concentration has increased in recent years. The ten largest recipients in the developing world accounted for 76% of total flows in 1992, up from around 70% in the preceding 10 years (but still below the peak of 81% reached in 1981).<sup>24</sup>

This is partly due to the impressive growth in FDI into China, which attracted negligible amounts in 1981 but by 1992 accounted for one quarter of all inflows to developing countries.<sup>25</sup> It is expected that if India, the other large economy in the region that is seriously 'underinvested' by foreign companies, continues with liberalisation and is able to boost economic growth, there will be a massive increase in FDI there also.<sup>26</sup>

**Chart 2: Percentage Shares of Regions in Total FDI to Developing Countries 1982 - 1992**

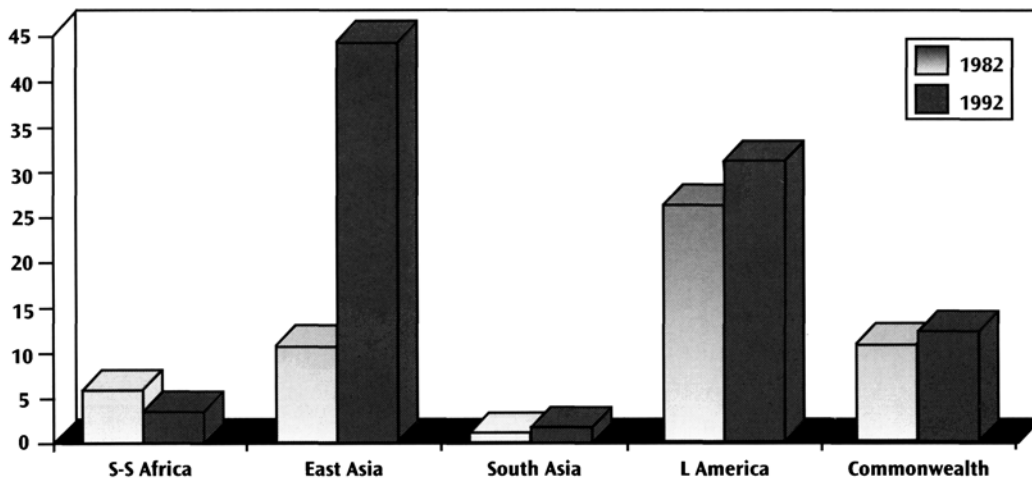


Table 2: **Regional Origin of Inward FDI in Selected CDCs<sup>27</sup> (%)**

	1985			1988		
	Developed areas	Developing areas	Former socialist	Developed areas	Developing areas	Former socialist
<b>Flows</b>						
Bangladesh	96.35	3.65	—	92.35	7.61	—
India	76.52	8.38	—	89.08	10.63	0.29
Malaysia	—	—	—	61.04	38.92	0.04
Pakistan	56.92	43.08	—	87.23	13.15	0.01
Papua New Guinea	100	—	—	98.04	1.78	—
Sri Lanka	54.99	45.01	—	68.67	31.34	—
<b>Stocks</b>						
Bangladesh	86.30	13.69	—	100	—	—
India	85.65	10.37	0.05	85.65	8.63	0.22
Malaysia	60.99	39.01	—	59.23	40.77	—
Pakistan	64.88	16.10	3.50	63.82	27.19	3.21
Papua New Guinea	99.72	0.28	—	99.64	0.35	—
Sri Lanka	49.85	50.15	—	50.89	49.11	—
Jamaica	55.89	43.81	—	—	—	—

The 47 least developed countries have been, and continue to be, marginal to FDI flows. In 1992 such flows declined by 15% to a total of \$300 million, accounting for only 0.6% of total flows to developing countries. Sub-Saharan Africa, in particular, received very little FDI despite widespread moves to liberalise foreign investment regimes and offer attractive incentives. The only exceptions were the traditional attractors of investment into the oil sector. Of the others, even countries undergoing strong structural adjustment programmes failed to increase inward investment inflows. The reasons for this are considered later.

Turning now to Commonwealth developing countries (CDCs), the pattern of FDI generally follows the basic pattern for developing countries. Data were collected for 39 of the 42 developing countries in the Commonwealth area – figures on Nauru, Tuvalu and Western Samoa were not available. Of the CDCs in the sample, 18 are low-income countries, 14 lower-middle income,

and 7 upper-middle income. A summary of the data for the main CDCs is given in Table 2.

Over 1982-92, CDCs accounted for an annual average of 14 percent of FDI to developing countries. By far the largest recipient was Malaysia: its share was over 30 percent of total flows to CDCs in the second half of the 1980s, and 64 percent in 1990-92. Following Malaysia in the early 1990s were: Nigeria (12 percent), Pakistan (5 percent), India (4 percent), Jamaica, and Trinidad and Tobago (both with about 2 percent). Among the Pacific Islands, Papua New Guinea emerged as the major recipient of FDI, primarily concentrated in minerals and in petroleum exploration and development. At the other end was Zimbabwe, with negative inflows – disinvestment – for most of the 1980s.

Two characteristics of the CDCs partly explain the relative low weight of the Commonwealth economies (excluding Malaysia) in total FDI to the developing world. First, almost half (36) are located in Africa; and, second, a

large number are very small economies, notably islands in the Caribbean and Pacific. The patterns of relative FDI flow appears different if gauged by each country's ratio of FDI to GDP. It is in fact the small island economies that record

the highest ratios in the 1980s and early 1990s. In particular, in the period 1990-92, average FDI inflows to St. Lucia and to St. Kitts and Nevis were close to one quarter of GDP. In comparison, the ratio for Malaysia was 8 percent.

# Economic Factors

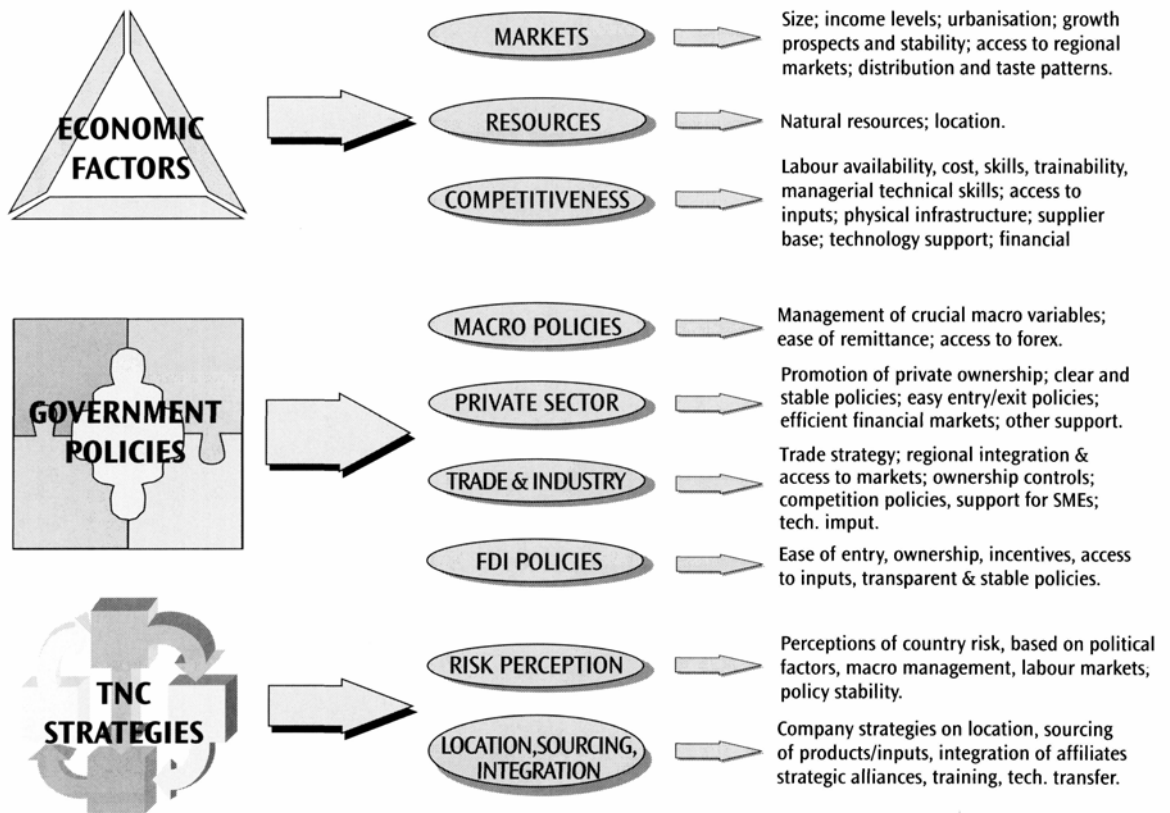
## 4.1 Introduction

Given the impact of technical change, the extent and pattern of FDI in the developing world can be explained by three sets of factors: economic attractiveness of host countries, the policy framework and its implementation by host governments and the strategies of multinational enterprises (see Figure 1).<sup>28</sup>

## 4.2 Markets and Resources

The growing internationalisation of production and trade liberalisation mean that world markets are growing in significance and international competitiveness looms larger as a determinant of FDI. However, it is still true in the interim that large markets (or access to large trading blocs, considered later) remain an important factor in

**Figure 1: Determinants of FDI in Developing Host Countries**



attracting certain types of FDI that are mainly geared to local markets. The ability of China to attract such large amounts of FDI (apart from export-oriented investments from Hong Kong and Taiwan) is due in part to the size of its domestic market, and the prospects for India to attract growing MNE interest is based on this factor. The growth of investments in the South East Asian region is partly due to the growth of intra-regional trade and the prospects for the regional market as a whole.

While large domestic markets provide a particular attraction to foreign investors, experience shows that small economies can also generate a lot of FDI. Small states like Hong Kong and Singapore have been able to attract some of the largest amounts of FDI in the developing world, by specialising in entrepot trade and certain manufacturing activities aimed at export markets. This is not an easy strategy, since this involves either a favourable location or a base of skills and infrastructure that can enable export activity to take place. There are few small economies with this combination of advantages, and without them small economies may find it difficult to sustain large investment inflows. However, even if others cannot do a Hong Kong, there are important lessons to be learnt in order to improve existing prospects – human capital development, good infrastructure, open door policies to FDI, liberal trade strategies and stable government policies.

The resource base of the economy is important for attracting MNEs, but only a few resources (mainly petroleum and some minerals) are now powerful magnets for FDI. In the resource base may also be counted the location of the economy – countries that are fortunate enough to be close to major developed country markets or in a dynamically growing region can, *ceteris paribus*, expect to attract more export-oriented multinational enterprises. This applies, for instance, to Mexico in the context of the North American Free Trade Agreement, and to Asian countries in the ambit of Japan and NIEs.

### 4.3 Competitiveness

The factors that determine competitiveness and efficiency are increasingly significant in drawing FDI into manufacturing and services, as technologies continue to develop and the intensity of competition increases in trade and investment.<sup>29</sup> The cost of “raw” labour retains some importance, but its role in overall cost competitiveness is falling over time as skills and technical efficiency become more important to productivity, quality and flexibility.<sup>30</sup> In contrast to two decades ago, the increasing openness of economies means that all tradable activities have to be operated near ‘best practice’ levels of efficiency.

The supply of managerial, financial and technical skills is now crucially important, even for ‘simple’ activities like garment manufacture for export markets. While MNEs can provide many high-level managerial and engineering skills from abroad, this is expensive and does not compensate for a lack of skills in the shop-floor and technical workforce. Thus, a host country that has larger supplies of trained and trainable labour (that is, with the education and discipline to absorb new skills) is likely to attract more and “higher quality” FDI than others. The role of a skill base is far more significant for activities with more complex technologies, especially those in the engineering sector, like electrical and electronic products, machinery or transport equipment. In these industries, with very demanding needs of operator and supervisory skills, sophisticated production management and quality control and close interaction with other firms, there is a pressing need for numerate workers, large numbers of technicians and supervisors, and for growing proportions of university trained engineering and managerial staff. In addition, there is a need for constant training and retraining of existing employees in new skills and information. Countries that can supply these skill and training needs are thus better placed to participate in international production.

In addition, with the adoption of ‘lean’ man-

ufacturing techniques, a local base of competitive suppliers also becomes of significance to attracting FDI in industries that are highly 'linkage intensive'. These are the engineering activities noted above that also require a diverse range of technical skills. Here the availability of a range of local upstream industries and small and medium subcontractors is vital to flexibility and cost competitiveness. The significance of this is rising as multinationals introduce management techniques like total-quality-control and just-in-time deliveries to their affiliates in order to become cost efficient. Moreover, the existence of a strong local supplier base allows the host economy to capture more beneficial spillover effects from MNEs and lowers the initial cost to foreign investors of setting up facilities there. Thus there are strong complementarities between domestic and foreign private investments, and despite obvious areas in which they compete there is generally a need to promote both. MNEs now often induce their own suppliers from the developed countries to invest along with them in countries that lack a sufficient supply base, as is happening in Malaysia, but this also requires a good local base of skilled labour and training facilities.<sup>31</sup> Those countries that have well developed supplier industries (like Taiwan) are able to draw more high value-added and technological-

ly advanced FDI. By contrast, countries with poor skill endowments find it increasingly difficult to attract FDI into linkage-intensive activities, and succeed only in getting final stage assembly with low local value added.

The importance of access to inputs at world prices and good physical infrastructure for attracting FDI into internationally competitive activities is self-evident. What is perhaps less known is the need for a good technology infrastructure for sophisticated FDI. A capable technology support system, with good standards, quality assurance and metrology facilities, institutions able to undertake contract research and provide an information base, can allow foreign affiliates to undertake more advanced technological tasks and raise the capabilities of local suppliers and competitors. This can in turn help attract FDI that uses more advanced technologies and transfers more technology-intensive tasks to affiliates.

An efficient national financial system is perhaps of less importance to multinational enterprises than to local firms, but its role in economic dynamism generally is growing over time. Moreover, a strong local financial sector and a flourishing and well-run capital market creates a better "image" in international capital markets, allow local firms to raise capital abroad, and can attract financial sector FDI.

## Policy Needs for Attracting FDI

### 5.1 Introduction

This chapter deals with the various policy needs for attracting FDI. Perhaps the most crucial one is political stability, since without a minimal level of stability and predictability in the political sphere no investor would set up facilities that have to yield their returns over the long term. However, this need not be dealt with in this study, which is mainly concerned with the economic aspects of FDI. In addition to basic stability, there is a need for a welcoming regime for FDI in particular. The need to offer stable, transparent and non-discriminatory regimes for foreign investors is universally acknowledged.<sup>32</sup> Both these factors are so evident that they need not be analysed at great length here. In addition, another paper for the Commonwealth Secretariat will discuss in detail the promotional aspects of FDI policy. Nevertheless, it may be useful in this context to remark on the need for efficient FDI promotion policies. Investment promotion can be an expensive proposition. Different countries show widely different degrees of success with their promotion policies. A study published by the IFC discusses how investment promotion can be done efficiently, and recommends carefully crafted and targeted strategies to attract the right kind of investor to the right kind of activities without giving excessive subsidies or mounting very expensive advertising campaigns.<sup>33</sup>

Many developing countries have tried to attract FDI in the past by giving large investment incentives: tax concessions or holidays or subsidising investments. Substantial econometric and firm-level research suggests, however, that the real impact of such incentives on long-term investments is negligible. Serious investors pay

more attention to the underlying long-term economic situation rather than to tax concessions that run out in a relatively short time.<sup>34</sup> The best tax regime to attract FDI is one that offers relatively low and stable overall corporate tax rates in a context in which private investment is welcomed and facilitated, rather than one in which there are many special or discretionary concessions offered to particular investors. In other words, the real effective tax rate should be competitive, predictable and transparent, and deviations from it should be kept to a minimum to ensure that resource allocation is not distorted. It is always tempting for a particular country to offer higher incentives in order to improve its relative position vis-à-vis countries with similar economic conditions (and MNEs will not ignore a concession that is on offer). For this reason, it is tempting for their competitors to offer similar concessions. This does not raise the overall level of FDI inflows but merely imposes a large cost to the treasuries of the host economies. The only solution is to evolve regional co-operation in the design of tax incentives, while offering attractive effective tax regimes.

While the best way to ensure efficient allocation of FDI is to have the right policy framework which gives efficient signals to investors, there may be a case for targeting or promoting foreign entry into specific sectors or activities. These may offer special spillover or dynamic benefits to host countries, in terms of creating employment, transferring crucial technologies, diffusing skills or raising exports, and may not attract sufficient investment interest in the absence of special measures. Targeting economies on promotion resources and enables host countries to extract most from MNEs in

terms of the special technological and other advantages that they offer. However, effective targeting requires high quality manpower in the promotion agencies and appropriate supply-side policies to ensure that the targeted investors can be attracted. As with all instruments of selective intervention, it should be handled carefully and with proper monitoring and safeguards.

## 5.2 Macroeconomic Policies and Privatisation

Stable and conducive macroeconomic policies are as important for attracting FDI as for ensuring healthy overall development. A relatively well-managed macro economy, with realistic exchange and interest rates, low rates of inflation and manageable external debt inspires confidence that productive investments will be able to operate properly and yield due rewards. For foreign investors particularly important are policies on the repatriation of profits and capital for foreign investors, and access to foreign exchange for the import of intermediates, raw materials and technology. Even though some high inflation countries (like Brazil) have attracted substantial FDI in the past, they also offered substantial natural resources, large markets and good growth prospects. This combination is now rare. Countries with unstable macro-policies carry risks of recession and balance-of-payments restrictions, and in a world of intensifying competition for FDI may lose investments to other countries.

One specific policy that is directly relevant to attracting FDI is the use of debt-equity swaps by heavily indebted countries, often linked to privatisation programmes. In the late 1980s such swaps were a major factor in explaining FDI in Latin America, accounting for as much as 80% of inflows in Chile in 1985-89, nearly 60% in Brazil and Venezuela, and between 20-30% in Mexico and Argentina. The privatisation of over 400 medium- and large-sized state-owned enterprises in developing countries in the period 1988-92 has generated over US \$49 billion in sales,

usually distributed among small or medium transactions. Privatisation accounted for about 7 percent of total FDI inflows over the same period, with marked regional variations. As Miller and Sumlinski (1994) note,

*“During 1988-92, foreign sources provided about \$18.5 billion, or 30 percent of total privatisation financing during this period. Of this amount, more than a quarter went to various Eastern European countries... However, owing to its much greater importance in overall privatisation activity, Latin America also attracted the most foreign funding, amounting to nearly two-thirds of the total... Privatisations also accounted for a substantial proportion of total FDI during this period, more than 10 percent. This figure varied considerably across regions, however, being much more important in Europe and Latin America than in other areas... In East Asia, FDI flows overall were so large that financing for privatisations, although significant, pale by comparison.” (p. 9).*

Privatisation involving multinational enterprises has tended to concentrate in large scale industries, and increasingly in services, such as public utilities and banking. Among the latter, the incidence of privatisation has probably been greatest in telecommunications. In the Commonwealth area, countries with foreign equity ownership in privatised telecommunication firms include Malaysia, Pakistan, Solomon Islands and Vanuatu in Asia, Barbados, Belize, Guyana, Jamaica, St. Kitts and Nevis, and Trinidad and Tobago in the Caribbean, and Nigeria, Sierra Leone and Togo in Africa.

Privatisation programmes have been particularly successful in attracting investment flows in Latin America and the Caribbean, where the public sector had traditionally played a larger role in the economy. During the period 1990-91, the share of privatisation in total FDI inflows

was 75 percent in Venezuela, 54 percent in Argentina, and 17 percent in Mexico.<sup>35</sup> In the Commonwealth area, Jamaica undertook a massive privatisation of some 90 percent of its state-owned enterprises, of which almost one quarter involved foreign participation; it is estimated that this programme accounted for about 40 percent of new FDI inflows to Jamaica during 1987-90.<sup>36</sup>

Privatisations have allowed MNEs to expand their activities in the region to sectors where their presence had previously been insignificant, such as in telecommunications and aviation. Multi-national enterprises from developing countries as well have in some cases taken part in privatisations, notably those carried out in other developing economies. Examples are the participation of

Chilean firms in the privatisation of major companies in Argentina since 1991, and India's investment in Mexico.<sup>37</sup> The amount of FDI generated by privatisations is shown in Table 3.

In Africa, privatisation is on the policy agenda of many countries, but only a few, such as Ghana, Madagascar and Senegal, have made significant progress in this direction. A major reason for this has been the lack of a realistic assessment of the requirements needed to carry out a successful privatisation – sufficient financial and human resources, developed capital markets,<sup>38</sup> viable public enterprises, transparency of the process, and policy initiatives in promoting private investment. Progress has been faster in South and East Asia, though the mature stage of

**Table 3: FDI in Privatisation, 1988-92**  
(US \$ millions and % of total FDI)

Region	1988	1989	1990	1991	1992	1988-92
<b>North Africa and Middle East</b>						
FDI from privatisation	—	1	—	3	22	27
Share of FDI	—	0.1	—	0.5	1.0	0.4
<b>Sub-Saharan Africa</b>						
FDI from privatisation	—	14	38	3	44	99
Share of FDI	—	0.6	6.0	0.2	3.0	1.0
<b>East Asia and the Pacific</b>						
FDI from privatisation	—	—	—	75	302	377
Share of FDI	—	—	—	0.6	2.0	0.7
<b>South Asia</b>						
FDI from privatisation	—	0.1	11	4	37	52
Share of FDI	—	0.0	4.0	1.0	9.0	3.0
<b>L. America and Caribbean</b>						
FDI from privatisation	214	157	2,136	3,300	2,312	8,199
Share of FDI	3.0	2.0	28.0	26.0	17.0	16.0
<b>All developing regions</b>						
FDI from privatisation	214	172	2,185	3,385	2,717	8,673
Share of FDI	1.0	1.0	10.0	11.0	7.0	7.0
<b>Memo item:</b>						
Central and Eastern Europe	—	422	489	1,017	2,411	5,238
FDI from privatisation	—	39.0	34.0	51.0	41.0	43
Share of FDI						

Source: UNCTAD (1994.a)

privatising has yet to occur. Pakistan, for example, launched a massive privatisation program involving state disinvestment in banking, power generation, telecommunications and railways. Major sources of FDI were developed country MNEs, with some investment coming from Saudi Arabian and Korean investors.

In East Asia, Malaysia has led the trend, with the privatisation of the national air carrier, a shipping line, telecommunications and electricity. The sale of government assets has mainly taken place through the local stock exchange, and has involved a number of foreign multinational enterprises, although the country has statutory limitations on the share of foreign ownership of privatised assets.<sup>39</sup> The Philippines showed a slower progress towards state-divestiture, but a significant degree of foreign participation; it is estimated that for the period 1987-90 foreign inflows for privatisation accounted for nearly one third of total private foreign capital inflows.<sup>40</sup> This is by its nature a one-shot measure, and its significance to Commonwealth countries has been limited. Moreover, with increasing adjustment in developing countries in the 1990s, and the return of the debt problem into manageable proportions, the swaps lost part of their attractiveness, though it remained an important privatisation modality in some countries, particularly Brazil and Chile. The privatisation of infrastructure and related flows of FDI into BOO/BOT schemes is of growing importance in many developing countries, as noted earlier; this is taken up later.

### 5.3 Policies Towards the Private Sector

The most important signals that a host government can give to prospective investors is that the country welcomes private enterprise in general. These policies include general openness to market forces and the private sector, and the rapid and efficient implementation of the 'rules of the game' (legal and accounting frameworks) that govern market transactions. They may also

include more specific policies to support the private sector and strengthen the supply side of private enterprises (by such measures as improving the financial system, skill base and information and technology institutions).

In general, economies that provide market-oriented environments for the private sector as a whole, with liberal conditions for entry, growth and exit, and set clear, transparent and stable

#### Box 2: Domestic Private and Foreign Investment

A recent report by the IFC on trends in private investment in developing countries notes that "FDI providers look for many of the same factors that influence domestic private investors."<sup>41</sup> It goes on to compare total private investment with FDI for 118 countries, and finds that there is a significant and positive statistical correlation between the two, suggesting that "when the investment climate is positive, both domestic and foreign investors are likely to respond." There is thus a strong complementarity between the two, and promoting local private enterprise can attract foreign investment. Given the similarity of reactions between local and foreign private investors, the attraction of FDI requires that policies be non-discriminatory (by national origin).

However, the report also notes that many countries encourage one rather than the other. In these cases the two can be substitutes for each other. This form of discrimination is increasingly uncommon, and most developing countries realise that it is not in their best economic interests to have discriminatory rules. Thus, many governments that had such policies in the past (such as Japan and Korea) have now changed their rules, partly to conform to emerging international consensus and partly to allow their own multinationals to operate more easily overseas.

rules for enterprises to follow, send positive strong signals to multinational enterprises (see Box 2). In addition, a regime that has an efficient and 'businesslike' attitude to making and implementing policies is the one most attractive to foreign as well as local firms. The economic complementarities between local and foreign firms also necessitate that both be encouraged to operate according to market forces with the minimum of government interventions in their resource allocation decisions.

#### 5.4 Trade and Industrial Strategies

Trade and industrial strategies provide the incentive structure for manufacturing activity, and guide the allocation of resources by multinational and local enterprises. As far as trade strategies are concerned, the importance of outward oriented trade strategies is now universally accepted. There is also a consensus that they provide the best setting for multinational enterprises to operate in efficiently. While import-substitution provided the main drive to FDI in the early days of industrial development, the most sustained growth of investments in recent years has been into economies that were export-oriented. The benefits of highly interventionist, inward-oriented policies are now regarded as far outweighed by their costs to efficiency, competitiveness and dynamism. Thus, more liberal trade regimes are now accepted as the best for promoting investments, because exposure to export markets is recognised as providing the best set of signals for resource allocation and for the development of efficient practices and capabilities.

While the issue of the proper role of infant industry protection in an outward-oriented setting is still strongly debated,<sup>42</sup> even the proponents of industrial policy agree that the general thrust of the trade regime should be outward, and that protection should be (by the standards of 'classic' import-substitution regimes) low, very selective and limited in duration. The new GATT agreement has moved the developing

world firmly towards freer trade, and the "Washington consensus" is steadily reinforcing this trend. There is thus little doubt that outward-looking policies will be the main environment for FDI policies, perhaps with a judicious role for some infant industry promotion, involving a few activities that are in the countries' future comparative advantage (which entail high 'learning' costs and create externalities, and which would not, because of the risks and costs involved, receive sufficient investment under free market conditions). The experience of the larger East Asian NIEs in attracting FDI suggests that the combination of such interventions to promote infant industries in the context of export-orientation served to attract high quality FDI in a virtuous circle of investment, growth, exports and industrial upgrading. It should also be noted that interventions to promote new activities were accompanied by a closely integrated set of measures on the supply side, to provide new skills, information and technical support, channel finance on concessional terms, and give extensive assistance with export marketing.

This sort of policy was significantly different from policy interventions in import-substituting regimes. Here protection was granted across the board and for unlimited periods, and led to widespread inefficiency. Industrial development was often spearheaded by public enterprises which lacked the human resources and autonomy to be efficient, and generally created large economic costs. Such regimes did sometimes succeed in attracting FDI, at least in the initial period, but much of the investment went into activities that were geared to small and protected domestic markets and could not become competitive in world markets.<sup>43</sup> The East Asian experience suggests that a very different pattern of support for private enterprise, with strong pressures to enter export markets and constantly upgrade technology and efficiency, can generate a far more desirable pattern of growth and FDI.

The scope for this sort of industrial policy is, however, much more limited now under the

emerging “rules of the game”. The World Trade Organisation and the multilateral institutions, and most major trading nations, would not countenance extensive protection or subsidisation that affected trade patterns. It is also very difficult to mount effective industrial policies, and there is considerable risk of ‘government failure’ in developing countries. Where administrative capabilities are limited and bureaucracies are not autonomous, it would be advisable to conform to liberal policies rather than to engage in the promotion of activities that will become costly drains on the economy. The growth of integrated international production also places its own limits on the exercise of industrial policy. Policies that cut off access to international markets and investment, even temporarily, may retard access to the latest technologies and so damage long-term growth prospects.

The liberalisation of trade has other advantages apart from resource allocation. It can act as a signal to the investment community of a broader process of adjustment and liberalisation towards the private sector in general. It can indicate that highly protected, inefficient activities are to be restructured or got rid of, and that resources are to move into competitive exporting or import substitution activities. It suggests that the private, including multinational, enterprises are to be accorded a freer hand in investing and operating. This seems to have been the case in Latin America. Here adjustment programmes, where accompanied by credible stabilisation of macroeconomic aggregates and by privatisation, have been successful in restoring FDI inflows. However, these flows have gone more into services and infrastructure rather than into manufacturing, reflecting the relative lag of the region’s competitiveness vis a vis East and South East Asia.

In Sub-Saharan Africa, in contrast to the other regions, structural adjustment has not been able to assure the investment community of the region’s attractiveness. Adjustment and stabilisation have often not been carried through fully, and implementation of reforms has been poor.<sup>44</sup>

Deregulation has not been carried far enough, and the pace of privatisation is the slowest in the developing world. The bureaucracy retains considerable control over economic life, and there is considerable rent-seeking behaviour in many countries. The “soft infrastructure” for foreign investments – the rules of the game for foreign investors, comprising rules, regulations, accounting standards, and so on – remains unsatisfactory: this raises the costs and uncertainties of operation for MNEs relative to competing countries. In addition, political attitudes to the private sector remain ambivalent. This shows up not so much as the risk of expropriation, which is now very high and can be insured against by such agencies as MIGA, but in likely delays, constraints to growth and employment strategies and in general dealings with the government.

Even if African countries brought the rules of the game to the levels of other developing countries, there remain some structural constraints to their ability to sustain competitive investments in many manufacturing industries. These constraints assume particular importance now because of the liberal trading environment in which economic activity is to be conducted, with low levels of protection against international competition. They arise from supply side variables, in particular skill levels and weak institutional structures in many African countries,<sup>45</sup> exacerbated by a neglect of the physical infrastructure, which is tending to lag behind competing developing countries. Thus, despite the fact that much of Africa now offers lower wages than most developing regions, there is little movement of labour-intensive manufacturing to Sub-Saharan Africa.

The formation of regional trading blocs is often proposed as a means of, among other things, attracting FDI. Such blocs can have positive effects on the attraction of FDI to countries that do not have large domestic markets, at least as far as certain forms of investment (those not geared to serving export markets) are concerned. Apart from attracting MNEs by increasing the

size of the market, regional arrangements like those being implemented in South America can allow multinationals to invest in order to rationalise existing production facilities across participating countries.<sup>46</sup> In fact, where domestic markets are small and fragmented by distance and poor infrastructure, regional integration may be the only way to attract domestic market-oriented investments with scale economies. This has clear significance for African countries. It must be remembered that, the whole of Sub-Saharan Africa has a market of the size of Benelux in terms of purchasing power. This is spread over enormous distances with poor inter-connections in terms of transport, communication and other market links. Effective integration among groups of African countries would greatly improve their chances of securing FDI, if this were supported by improvements in physical infrastructure.

Regional blocs may have negative consequences for countries that are excluded from them. If blocs offer substantial privileges to enterprises that locate within them (say, by common tariff barriers) countries in the region that are outside the them would tend to lose FDI. This, for instance, is the risk facing countries in the Caribbean as NAFTA takes shape, and Mexico threatens to divert FDI from other developing countries in the region.

Various types of intercountry arrangements have characterised the growth of regional markets in dynamic parts of the world. Four general forms can be distinguished (in order of the degree of integration among the participants): free trade area, custom union, common market, and economic union. The major contemporary regional groupings are listed according to these categories in Appendix Table 3. Some regional arrangements, particularly the most recent ones, have been specifically designed to achieve the unification of member countries' policies towards FDI.<sup>47</sup> Probably the least successful efforts at economic integration have taken place in Africa and the Middle East, mainly due

to wide cultural differences, and economic and political turmoil.<sup>48</sup> In addition, in Africa many protocols that were agreed upon to promote regional integration were not implemented, and over time non-tariff barriers have increased rather than decreased. Regional trade in Sub-Saharan Africa remains very limited, and the lack of appropriate infrastructure to permit trade and investment remains a major barrier to integration. Yet without greater integration many countries cannot offer large enough markets to attract sustained inflows of FDI.

In South East Asia, regional trade and investment have grown dynamically more as a result of income and export growth and market liberalisation rather than deliberate integration efforts. There are nevertheless several integration efforts under way. ASEAN has been going for a long time, but, because of its emphasis on planning and the public sector, has not had much tangible results. A far more ambitious effort, in the shape of the Asian Free Trade Area, is now under active consideration, and may be a reality in the next decade or two.

More limited approaches to regional integration have already been adopted in South East Asia, with the leadership role played by private enterprise. The concept of "Growth Triangles", where selected regions of neighbouring countries are formed into a quasi-union and linked by infrastructure, is catching the imagination of policy makers in South-East and East Asia. Among the main objectives of such triangles is the stimulation of FDI from participants as well as from other countries.<sup>49</sup> Examples are: the SIJORI Growth Triangle, set up in 1988, representing investment co-operation among Singapore, the Southern Malaysian State of Johor, and Western Indonesia's Batam Island; the Northern Growth Triangle among Northern Malaysia, Southern Thailand and Northern Sumatra in Indonesia, still in the planning stage; the Baht Zone in the border area of Thailand, Laos, Cambodia and Vietnam, also in the planning stage; the Greater South China Economic Zone

which groups Hong Kong, Taiwan, parts of China and Macao, still a concept; the Yellow Sea Economic Zone including parts of China, North and South Korea, similar to the previous one.

Of these, the SIJORI growth triangle is the only one that has been going for some time.<sup>50</sup> It has been successful in attracting FDI in significant amounts to the Indonesia part of the triangle. The driving force has been Singapore, established reputation with the international investment community, superb infrastructure, and its pressing need for lower cost land and labour. Singapore firms have themselves invested in the less developed parts of the triangle, while a number of other investors have been attracted to those areas because of their connections with Singapore.<sup>51</sup> Significant FDI has also gone into Johor in Malaysia, but this was growing in any case and it is difficult to attribute it to the formation of the triangle.

Industrial policies are also important in attracting FDI. Most of the elements of industrial policy have already been noted earlier: entry, exit and growth policies, ownership requirements, labour market policies, technology support, and so on. In general, moves to market-oriented, liberal and non-discriminatory policies are associated with greater FDI inflows. However, this does not obviate the need for appropriate regulations to ensure competitive behaviour, supply-side policies to improve capabilities and competitiveness, targeted FDI promotion strategies to attract appropriate forms of foreign investment, and support for the development of small and medium local enterprises that suffer particularly from market deficiencies.

Technology import policies also fall under the heading of industrial policies. International tech-

nology markets are highly imperfect, and local firms often find it expensive and difficult to collect the information needed to identify the best sources of technology and to bargain effectively with suppliers. Multinational enterprises do not, by definition, face this problem, but developing countries often feel that the technologies transferred are not of the latest vintage (some also feel that it is too modern and so inappropriate to local tastes and factor endowments), that only operational know-how is transferred rather than the more complex and valuable design and research functions, and that the transfer is hemmed in by restrictive conditions imposed by the parent company.

Despite these arguments for government intervention, however, experience of technology policies in many parts of the developing world has shown that the best way to manage the process is not to intervene in great detail or to have rigid regulations on technology transactions. Firms should be allowed fairly liberal imports of new technologies according to their perceptions of market forces, but they should be supported by the provision of information by the government on sources and costs of technology. This is the strategy adopted by Japan and the NIEs, and it seems to have been very successful. In contrast, very stringent controls on technology imports, as exercised by India, have resulted in reducing the quantity and quality of technology inflows and in growing technology lags, and have also tended to deter FDI inflows. The pattern of recent FDI flows supports the conclusion that liberal policies on technology, which tend to go hand in hand with more liberal policies in general, serve to attract more and better foreign investments.

## MNE Strategies

### 6.1 Introduction

Given the economic considerations affecting the allocation of FDI, strategies of multinational enterprises on investment in developing countries are an independent influence on FDI flows. Such strategies are determined by a number of factors, which cannot be analysed in this study. However, there are two that need to be noted in the present context. The first is the firms' perceptions of the risk of investing in particular countries. The second is their corporate approaches to various aspects of international operation.

### 6.2 Country Risk

Let us start with risk. How does the international investment community rate the attractiveness and risk of investing in the various regions of the developing world? Apart from the "revealed preference" that is actually shown in past investment patterns, it may be relevant to look at published assessments of country risk that the business community in the OECD refer to. The assessment of country risk is something of an industry by itself, though most its results are confidential to firms or circulated on a limited (and very costly) basis. In such assessments, the risk element is necessarily evaluated by a subjective weighting of a number of factors, made up of a mixture of political and economic variables, that may affect future profitability and sustainability of operations in any given country. Most rely on a few selected indicators of performance, while some use replies given by corporate executives. By their nature, all are of limited predictive value, but they do reflect the kind of information and 'image' on the basis of which initial international investment decisions tend to be made

(final decisions of course require detailed evaluations and feasibility studies).

Table 4 shows the risk assessment for developing countries in 1993 carried out by Euromoney, one of the most comprehensive published risk assessments related to foreign investments. This is a ranking of 170 countries, conducted annually, and is based on economic performance, political risk, foreign debt and debt in default, credit rating, access to bank lending and short-term finance, and access to capital markets (rather than on subjective answers given by company executives). Each country is given marks out of a total of 100, with higher marks indicating better investment potential.

It should be noted that the risk ranking as given above is not necessarily directly related to how much FDI individual countries are getting – it is more an amalgam of indicators of economic performance in the recent past. The leading places in the developing world are held by Asian countries, followed by Latin America. Africa in general comes behind the other regions in these rankings. The leading country, South Africa, is 49th in the world league, but is clearly an exceptional case. Most countries in Sub-Saharan Africa come low on the list.

### 6.3 Integration and Sourcing Strategies

The recent World Investment Report 1994 highlights the process of emerging "deep integration" that increasingly characterises MNE operations in sophisticated services, high technology industries and in engineering activities that have significant scale economies and are actively traded. It contrasts this with traditional strategies of stand-alone affiliates and "simple integration",

**Table 4: 1993 Risk Rankings of Developing Countries by Euromoney<sup>52</sup>**

<b>Rank, Country</b>	<b>Points</b>	<b>Rank, Country</b>	<b>Points</b>
12. Singapore	93.69	94. Gambia	36.24
15. Taiwan	91.95	95. Libya	35.45
22. Hong Kong	85.22	96. Panama	34.78
26. Rep. of Korea	81.65	97. Honduras	34.39
28. Malaysia	78.52	98. Djibouti	34.34
32. Thailand	75.25	99. Namibia	34.29
38. China	71.52	100. Senegal	33.97
41. Chile	68.75	101. Nigeria	33.60
42. Indonesia	68.48	102. Bhutan	33.04
44. Turkey	64.09	103. Vietnam	32.84
47. Colombia	60.68	104. Nepal	32.82
48. Mexico	60.37	105. Malawi	32.58
49. South Africa	60.04	106. Mali	32.10
50. Tunisia	58.10	107. Cameroon	31.63
51. Botswana	57.34	108. Guinea	31.45
52. Uruguay	54.41	109. Yemen	31.33
53. India	54.33	110. Burkina Faso	31.32
54. Barbados	53.25	111. Grenada	31.28
55. Argentina	50.46	112. Niger	31.01
56. Morocco	50.20	114. Benin	30.98
57. Papua New Guinea	50.02	116. Lebanon	30.11
58. Belize	49.93	117. Peru	29.85
59. Venezuela	48.96	118. C. African Republic	29.64
60. Fiji	47.72	119. Antigua & Barbados	29.26
62. Philippines	47.32	120. Madagascar	29.25
64. Trinidad and Tobago	46.86	121. Burundi	28.99
65. Jordan	46.03	123. Rwanda	28.90
66. Iran	45.84	124. Cote d'Ivoire	28.70
67. Mauritius	45.67	126. Chad	28.45
68. Pakistan	45.03	128. Togo	27.84
69. Zimbabwe	45.02	131. Haiti	26.29
70. Ghana	44.99	133. Myanmar	25.94
71. Costa Rica	44.72	134. Guinea-Bissau	25.72
73. Egypt	43.80	135. Tanzania	25.15
74. Paraguay	43.58	136. Zambia	24.91
75. Sri Lanka	43.20	140. Uganda	24.22
77. Brazil	42.61	141. Ethiopia	23.82
78. Vanuatu	42.22	143. Angola	23.68
79. Algeria	40.86	145. Mauritania	22.90
80. Syria	40.85	150. Sao Tome, Principe	21.93
81. Kenya	40.40	152. Sierra Leone	21.06
82. Seychelles	39.49	154. Congo	20.54
83. St Lucia	39.08	156. Guyana	19.08
84. El Salvador	38.93	157. Zaire	18.89

Rank, Country	Points	Rank, Country	Points
85. Bolivia	38.55	158. Mozambique	18.87
86. Gabon	38.40	161. Afghanistan	17.11
87. Guatemala	38.07	162. Cambodia	16.21
88. Lesotho	37.86	164. Iraq	15.67
89. Dominican Republic	37.59	166. Liberia	14.76
95. Libya	37.49	167. Nicaragua	12.02
91. Bangladesh	36.98	168. Sudan	10.98
92. Ecuador	36.81	169. Somalia	10.56
93. St Vincent	36.81	170. Cuba	9.47

in which only part of the production chain is integrated (Figure 2). Traditional strategies still predominate in many industries in which MNEs operate, and there are large differences between firms in their attitudes to integration; however, it is the emerging trends that are worth noting.

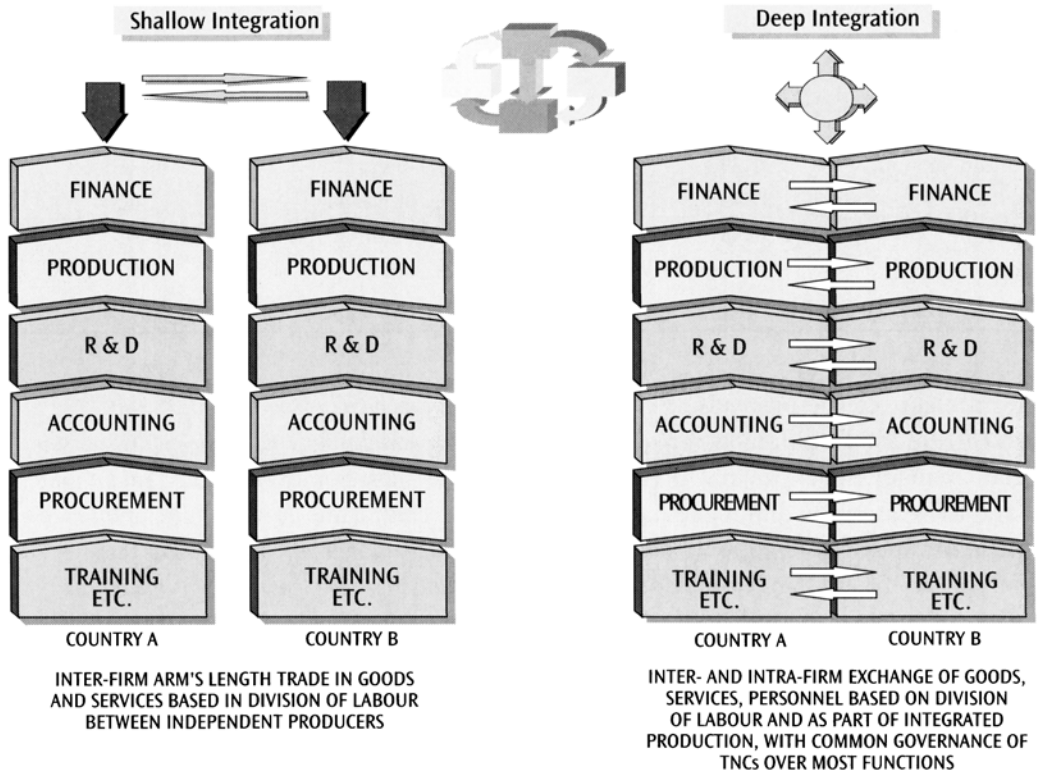
The WIR 1994 argues, with considerable persuasion, that it is in the most dynamic industries that deep integration strategies are gaining at the expense of more traditional strategies. There are many reasons for this, most of them to do with technological change and intensifying competition. This change may have sweeping and important implications for the international economy, at a time when more developing countries are choosing to participate more fully in trade and investment.

*“Transnationals corporations are pursuing complex integration strategies in response to competitive pressures in the expectation of greater efficiency. The overall size of the integrated international production system that is emerging is difficult to gauge, but a number of indications suggest that the emergence of transnational corporations that are visibly global in their operations in industries such as automobiles, microelectronics, consumer electronics, household appliances, office machinery, instruments, pharmaceuticals and financial services... In these industries, the value-added chain is, in whole or in part,*

*geographically fragmented; but the individual functions of the chain, whether internalised or externalised, remain under the control and co-ordination of the major transnational corporations. In these industries, the leading firms have – or strive to have – a direct presence in each of the three Triad members. Within those areas, production and distribution are being rationalised and restructured, particularly where, as in the case of the European Union, internal barriers to the flow of factors, as well as intermediate and final products, are being dismantled.... In the process, the nature of the world economy is undergoing a profound change: from being a collection of independent national economies linked primarily through markets, the world economy is becoming, for the first time, an international production system, integrated increasingly through numerous parts of the value-added chain of production.”<sup>53</sup>*

What are the implications of this emerging structure for the location and sourcing decisions of multinational enterprises in developing countries? “The result is a broader range of opportunities for host countries to attract MNE activities, but also higher requirements in terms of human resources and infrastructure as well as open frameworks for trade and investment.”<sup>54</sup> Clearly, at this stage it is the developed countries

Figure 2: Types of Integration between Multinational Parents and Affiliates



and the more developed NIEs that are best placed to participate in the system. Other developing countries can participate to a greater or lesser extent depending on their ability to furnish the competitive factors that allow the activities involved to be carried out at world levels of efficiency. In an open trade and investment system, the ability to attract MNE production, increase exports, create local linkages and foster greater training for local employees would depend on making all these profitable relative to alternative locations. To quote from an earlier World Investment Report,

*“These developments make it more important than ever for developing countries to build up their own human and physical infrastructure. In addition to providing the basis for industrialisation and development of the domestic economy, it*

*would allow national enterprises to join up with transnational corporations on a more equal basis. It would raise the quality and sophistication of the FDI a host country could attract, and would strengthen the prospects for technology acquisition. It would also enable host developing countries to build up supplier capabilities that are sometimes a precondition for the location of MNE activities and which, moreover, add to the economic and technological spillovers from foreign affiliates. The building up of such capabilities has been an essential feature of developing countries, including those in Asia and Latin America, that have succeeded in restructuring both their international and domestic production sectors towards higher-value-added activities.”<sup>55</sup>*

The risk of the emerging order of integrated MNE activities is that countries that are unable to furnish the bare essentials for competitive production may be further marginalised to international investment flows. The pattern of overall FDI flows suggests that this is already happening to some extent. If data were available for FDI flows by high skill and high technology activities, the dynamic edge of production and trade, the trends would be far more obvious. The skewness of FDI will thus continue.

To conclude, these trends in technology, investment, competitiveness and MNE strategies

appear to be mutually reinforcing. The end result is the uneven pattern of FDI flows that recent years have witnessed. Liberalisation of FDI policies will certainly help the lesser developed countries to attract multinational enterprises, but by itself is unlikely to dynamise the process of foreign investment and development. The inflow of FDI and economic development can interact in mutually beneficial ways if the host country can furnish, not just the policy regime, but also the incentives, capabilities and institutions that development demands.<sup>56</sup>

## Policy Reform

### 7.1 Introduction

The range of FDI policies in the developing world is still very large. While there has been a general move towards liberalisation over the last decade, the starting points have been so different that current policy postures still show marked differences. Thus, many developing countries still have very restrictive conditions for MNE entry, while others have moved to completely open door policies. This chapter considers briefly the main policy trends in Africa, Latin America and Asia in recent years.<sup>57</sup> It ends with a note on some international treaties governing FDI.

### 7.2 Sub-Saharan Africa

Starting from a relatively small base of foreign investments and a relatively uncongenial environment for multinational enterprises, African countries have exhibited the most rapid policy and legislative changes in this field. A number of countries have revised existing laws to remove or reduce foreign ownership limitations, often as part of broader structural adjustment packages introduced by the World Bank. Many now permit liberal profit and capital repatriation, have free markets in foreign exchange and provide various incentives to foreign investors. They have simplified approval procedures, started promotion programmes and set up “one-stop shops”. Between 1982 and 1987 about half of all African countries either introduced investment codes or changed existing codes to attract FDI; this number increased further by decade end and subsequently, and included countries like Ethiopia and Mozambique that have been ideologically averse to FDI.

Many countries still restrict FDI in certain key industries – either totally or up to a certain

equity percentage – but the trend has been one of liberalisation. Ghana’s 1985 Investment Code, for example, reduced the number of industries closed to FDI from 24 to 2. In Namibia, the 1990 Foreign Investment Act, while clearly encouraging joint ventures with local partners, did not introduce restrictions on 100 percent foreign ownership. Similarly, Nigeria removed regulations limiting foreign ownership in a number of industries to 40 percent in 1989. Although the measure is not retroactive, new FDIs in all enterprises with the exception of banking, insurance, oil processing and mining are now authorised to full ownership. Numerous African countries set up approval and promotion facilities such as the National Investment Board in the Gambia, the Ghana Investment Centre, the Investment Promotion Centre of Kenya, the Nigerian Investment Promotion Centre, and the National Investment Promotion Office of Zaire.

Fiscal incentives in the form of concessions on the rate of corporate taxes and import and export duties are applied virtually across the whole region, and are in some cases (e.g. Tanzania and Zaire) negotiable with the government on a case-by-case basis. Such concessions tend to vary by industry and type of investment, essentially reflecting government priorities and development strategy. For example, Kenya gives special incentives to FDI in lesser developed areas, Lesotho in labour-intensive manufacturing, and both Kenya and Uganda in agro-processing. In addition, tax-free export-processing zones have been established in Botswana, Ghana, Kenya and Mauritius, and are planned in Comoros, Malawi, Namibia, Nigeria and Zimbabwe. With the only exception of Mauritius, such experiments have had rather

limited success so far. This may be traced to a number of factors, such as low labour productivity and insufficient skills, slow and bureaucratic procedures, inadequate infrastructure and risky political regimes.

In addition to the necessary reform in investment regulations, the 1980s saw an extensive review of sectoral laws, so as to bring them in line with the general trend of FDI policy liberalisation. In Africa, this trend has been particularly significant in the minerals and oil sector. New legislation governing mining exploration, for example, was enacted in Ghana, Kenya, Nigeria, Tanzania, Uganda, and Zambia. The new policy reflected in these laws is that adequate public interest controls can be achieved by the government in its capacity as a regulator.

However, as the earlier section showed, FDI has been slow to respond to Sub-Saharan Africa's policy reforms. The region continued to lose its share of global investment flows, and the FDI that did go there was highly concentrated in the nine oil-rich countries, which accounted for over 70 percent of inflows to Africa.<sup>58</sup> There was relatively little privatisation and debt-equity swaps, factors that accounted for substantial inflows to Latin America. The poor economic performance of the region, continuing unrest and political uncertainty, weak and often deteriorating infrastructure, hesitant reforms on trade and industry, poor macro management, low levels of education and technological capabilities and deficiencies in local entrepreneurship, all contributed to the region's lag.<sup>59</sup>

It should be noted, however, that privatisation could be used to stimulate FDI into Africa in the future. There are many public enterprises that governments can place on the market, and the most likely buyers will be foreign investors. The important ingredient is to create favourable conditions for privatisation, and to set up a regulatory structure within which privatised utilities can operate in the national interest. Similarly, debt-equity swaps can be used to encourage privatisation as they were in Latin America,

reducing the value of the local debt for the buyer. This would help to make the enterprises more viable and so ultimately reduce the burden they place on the state budget.

### 7.3 Latin America and the Caribbean

FDI has traditionally played a strong role in a number of Caribbean economies, notably tax heavens and offshore business centres. Their policies were very favourable to foreign investors: almost no direct taxes or exchange controls, and guaranteed confidentiality in business transactions. These policies were primarily geared towards attracting investors in banking and in tourism, and were very successful in this.

Other Caribbean CDCs had more restrictive policies to FDI, like those in many other developing countries, and started to move to more liberal FDI regimes during the 1970s. The liberalisation process accelerated during the 80s and 90s, and the number of industries closed to FDI is now very limited. The few remaining restrictions are for such cases as atomic energy (Trinidad and Tobago), inland public transport (Belize, Trinidad and Tobago), and fishing (Belize). Entry authorisation requirements have been eliminated in the majority of countries, with the notable exception of Belize, where prior authorisation is needed to be able to operate in the country, and to benefit from incentive schemes. Most limitations to the remittance of profits and the repatriation of capital have been abolished.

The effort to reduce bureaucratic procedures for the approval of FDI projects has led to the establishment of a number of one-stop shop facilities, especially in the largest countries. Examples are the Jamaica Promotion Corporation, and the Industrial Development Corporation in Trinidad and Tobago. As regards fiscal incentives, a number of countries in the region offer foreign investors preferential tax and custom treatment vis à vis domestic investors. In Belize, for example, fiscal and custom incentives may be granted to foreign investors on a case-by-case

basis, primarily according to the contribution of the MNE to local value added. Similarly, tax and tariffs exemptions are sometimes used to guide investment towards priority activities. For example, in Trinidad and Tobago the Hotel Development Law offers fiscal incentives to companies investing in the hotel industry.

The Latin American region was the main recipient of FDI in the developing world until the debt crisis of the 1980s, and suffered sharply declining investment inflows as a consequence. Since 1988, however, many countries have reversed this decline and have enjoyed sustained increases in inflows of FDI. A number of factors have contributed to the re-emergence of this region as an important (though no longer predominant) destination for FDI. An important one was clearly the fading away of the debt problem and improved macroeconomic management in many of the economies, leading to a revival of growth and exports. There was also widespread liberalisation of policies in the context of structural adjustment, with large scale privatisation of state-owned enterprises, lowering of import restrictions, opening up of infrastructure to private investors, swapping of external debt into equity and a sustained effort to improve conditions for, and attract more, foreign investment. The effects of privatisation on FDI have been noted earlier.

There are two important points to note about FDI policies in Latin America. First, the formation of regional trading blocs and other agreements has been an increasingly important feature of the economic scene. The most important policy here has been Mexico's participation in the North American Free Trade Agreement (NAFTA). NAFTA has provisions to increase investment flows within the region, and devotes a great deal of attention to provisions for the regulation of investment, including portfolio investment, certain loans and other contracts. It ensures national treatment for foreign investors, including MNEs from countries outside NAFTA under certain conditions.<sup>60</sup> It prohibits the im-

position of performance requirements (such as export or import requirements, local content, domestic purchasing, trade balancing, licensing of technology, exclusive sales, exchange control requirements) on multinational enterprises, and also prevents such measures from being linked to the granting of subsidies or other incentives. It does, however, permit the granting of incentives for worker training and promotion of R&D. No restrictions on the nationality of senior managements are permitted, though countries may require that the majority of the Board of Directors be of a particular nationality. It permits free transfers of all kinds at prevailing market rates of exchange. It also liberalises various sectoral restrictions and removes most trade barriers over time.

Apart from NAFTA, there are a number of other intra-regional links being established, while a number of other countries have expressed the wish to join NAFTA. During 1985-93, as many as thirty three trade and investment related agreements were concluded in the region. Prominent among these was Mercosur, covering the southern countries of the continent and Brazil; the others were of more limited coverage. Partly as a response, and partly due to emerging economic forces, intra-Latin American trade and investment have in fact increased recently. Some industries led by multinational enterprises, most importantly automobiles, are rationalising production across countries, leading to greater trade and specialisation. These policy trends portend an increasingly open environment for FDI and trade, with growing integration within the region.

As noted earlier, however, the formation of regional blocs, especially NAFTA, may have adverse consequences for host countries that are outside the blocs, like those in the Commonwealth Caribbean. There is an offsetting arrangement in the form of the Caribbean Basin Initiative, which was launched in 1983 and made permanent in 1990. This provides duty free access to the US market for all products of the region (with the exception of those from Cuba), and includes tax incentives to US enter-

prises to invest in new plant and equipment in the region. It is not clear, however, if this will be enough to fully compensate for the advantages to foreign investors offered within NAFTA.

The second notable feature of recent FDI in Latin America is, as noted above, that much of the investment inflow has gone into services and infrastructure rather than into manufacturing. Investments in manufacturing have gone mainly into restructuring existing activities that started as import-substitutes and have matured behind protective barriers into internationally competitive industries – the main example is the automobile industry in Mexico. Some have also gone into downstream processing of natural resources for export, such as fruit, fish and forest products in Chile.<sup>61</sup> This form of FDI has yielded major benefits to the region, especially to its service industries, but the pattern is very different from that in Asia, where FDI has concentrated on manufacturing industry and in countries like Taiwan, Malaysia and Thailand has upgraded rapidly to high value-added and high technology activities for export. The Asian economies have not liberalised their economies as rapidly or sweepingly as in Latin America, and have retained tools of industrial policy to guide their dynamic comparative advantages. The Asian NIEs have performed much better than their Latin American counterparts because they have been able to use such policy to diversify and deepen their economies, and to extract greater benefits from FDI.<sup>62</sup>

#### 7.4 Asia

The general move to liberalisation on foreign investment is also evident in Asia, set in a highly variegated set of national development strategies. The region has emerged as the developing world's most dynamic region and as a destination for FDI. In 1992 it attracted nearly \$30 billion of the total of \$52 billion of FDI going to the developing world. FDI to the region grew by a massive 45 percent in 1992, with much of the surge accounted for by investments in China (\$11

#### Box 3: Recent FDI Policies in India

The liberalisation of the Indian economy has been accompanied by improvements to the FDI regime. From 1991, projects with up to 51% foreign ownership received automatic approval in 34 priority industries, and local content provisions were withdrawn. In the next two years further liberalisation was announced. The Foreign Exchange Regulation Act was amended to accord foreign investors national treatment. Full foreign ownership was allowed on a case-by-case basis. Multinational enterprises were allowed into infrastructure projects like power, roads, bridges and the operation of telecommunication services. Technology imports were liberalised, with agreements involving payments below certain limits granted automatic approval. Import duties were lowered on various goods, and the rupee was made convertible on the current account. Several incentives to FDI were announced. As a result, several major multinational enterprises launched operations in India, including some that had left the country earlier. Actual inflows of FDI are expected to reach \$2 billion by 1995, as realisations of approved investments rise. The investment climate has also improved dramatically for portfolio investors, and the inflow of funds to the stock market has been very large.

There is still room for considerable liberalisation of FDI rules, and multinationals express concern at the complexity of regulatory controls and bureaucratic interventions. The infrastructure is weak, and the low base of education may pose skill problems in the longer term. Trade policies also need considerable relaxation to bring them into line with the more dynamic economies of East Asia. Tax rates are still relatively high. However, there is general consensus that the prospects for FDI in India are bright, and that if present trends to liberalisation continue the economy could draw investments at something approaching rates seen in China.

*Source: UNCTAD (1994.a).*

billion in 1992 and an estimated \$26 billion in 1993); however, even excluding China, the increase in 1992 came to 15 percent.<sup>63</sup> Countries like India, Pakistan and Sri Lanka that were traditionally hostile to FDI are opening up and becoming attractive to investors, though in India much of the interest is currently in portfolio investments.<sup>64</sup>

The policy frameworks of Malaysia and India illustrate the difference in attitudes on FDI. Malaysia has been very keen to attract investment, particularly in manufacturing, but also in agriculture and tourism. Restrictions on foreign ownership have been relaxed, and wholly-foreign ownership is now allowed upon approval. FDI promotion policies have included the development of more than 160 industrial estates with the essential infrastructural facilities, and highly attractive incentive schemes. These measures have complemented a favourable exchange rate policy, and the availability of relatively skilled manpower. India has traditionally been hostile to FDI and has pursued a nationalistic approach to industrial development. However, Indian policies have been liberalised considerably recently, as shown in Box 3.

Other countries in South Asia have been more open to FDI. In Sri Lanka, all restrictions on currency transactions were removed in 1993. Bangladesh has been the most dynamic in promoting FDI, with a simplification of bureaucratic procedures for the approval of new investment (a one-stop centre is now in place), the establishment of export processing zones, and full foreign ownership allowed upon approval. Pakistan and Sri Lanka have encouraged investment in high-technology and export-oriented ventures – including the establishment of export-processing zones – and Pakistan now has totally open door policies on FDI.

Much of recent FDI into Asia has gone into manufacturing rather than into services and infrastructure, and only a small part (under 1 percent) has come from privatisation. However, infrastructure is now set to be a major growth area

for FDI (with large amounts coming from within the region itself), and service industries are also attracting increasing amounts of foreign interest as entry policies become more liberal. A very large part of MNE operations in Asia went into export-oriented industries, and within these there was considerable upgrading of activities into sophisticated products and components.

## 7.5 International Treaties in the Commonwealth

As part of their policy to improve their investment climate and attract FDI, Commonwealth countries have concluded a number of multilateral conventions and bilateral investment promotion and protection treaties. These treaties are a very important part of the international rules of the game for foreign investment flows, and can provide insurance against certain forms of non-commercial risk, incentives for investing in designated areas, information to prospective investors and access to markets. The setting up of MIGA under the auspices of the World Bank has been a major step forward in providing multilateral support for FDI, and individual capital exporting countries have their own schemes to promote and protect their overseas investors.

The emphasis of African CDCs has been primarily on multilateral treaties, especially those aimed at resolving investment disputes (the Washington Convention) and for insuring investors against non-commercial risk incurred in operating in unstable environments (MIGA).<sup>65</sup> Also well accepted were the New York Convention, for the settlement of claims and disputes arising in FDI operations, and the Paris Convention, which provides protection for patents and other intellectual property rights across national borders.

Countries in Asia and the Pacific region have signed multilateral treaties, but their emphasis has been more on bilateral agreements. This may partly reflect the lower risk attached to these economies by investors (see the earlier section on

risk perceptions). The overwhelming majority of bilateral treaties have been with developed market countries, although the number of agreements with other developing countries has been increasing, at least on the part of Asian CDCs. African countries are still primarily aimed at attracting developed countries investment, with a few exceptions such as the treaty between Mauritius and India<sup>66</sup> or Ghana and Romania. Notable is also that many African CDCs, such as

Kenya, Malawi, Swaziland, Tanzania and Zambia, do not have separate bilateral investment agreements with the United Kingdom.

The small countries in the Commonwealth Caribbean have shown little enthusiasm for signing either multilateral or bilateral agreements (with the exception of MIGA). However, the US-sponsored Caribbean Basin Initiative, noted above, is of great significance to them and may compensate for the lack of other initiatives.

## Developing Country Multinational Enterprises

### 8.1 Background

The growth of one "new form" of FDI, the emergence and spread of developing country multinational enterprises (DCMNEs), has aroused considerable interest in the international investment literature.<sup>67</sup> The WIR 1994 contains a useful compilation of data, from the IMF and UNCTAD's own data base on FDI, on outward investment flows and stocks by selected developing countries and regions (Table 5). It shows that in 1992, the developing world as a whole accounted for \$9.2 billion of overseas investment, 5.3% of global investment, compared to 1.9% over 1982-87. The developing world accounted for 3.2% of the world stock of FDI in 1992, up from 0.7% in 1980. According

to UNCTAD (1994) there were some 3000 multinational enterprises originating in the developing world, though this estimates excludes several major countries and there are certainly many more developing world firms with overseas investments.

These data suggest that while DCMNEs are still small in global terms, their growth is very dynamic. However, the table shows that FDI from the developing world is highly concentrated in a relatively few countries. While intra-developing world investment has grown in every region, its pace, spread and industrial diversification in recent years have been driven by Asian economies, with their export growth and spread of competitive advantages.

Table 5: **Outward Investment by Developing Countries** (\$ mill. and %)

Region	Annual FDI Outflows (%)			Outward FDI stock 1992
	1982-87 average	1990	1992	
Total developing	1321 (100)	9592 (100)	9151 (100)	62418 (100)
All Africa	79 (6.0)	190 (2.0)	93 (1.0)	1736 (2.8)
o/w SSA <sup>68</sup>	20 (1.5)	24 (0.3)	58 (0.6)	418 (0.7)
Latin America <sup>69</sup>	294 (22.3)	1042 (10.9)	286 (3.1)	6281 (10.1)
o/w Argentina	- 5 (- 0.4)	—	—	n.a.
Brazil	161 (12.2)	665 (6.9)	146 (1.6)	3557 (5.7)
Chile	n.a.	n.a.	n.a.	713 (1.1)
Colombia	37 (2.8)	16 (0.2)	50 (0.5)	476 (0.8)
Venezuela	89 (6.7)	355 (3.7)	84 (0.9)	1323 (2.1)
West Asia	150 (11.4)	- 19 (- 0.2)	543 (5.9)	2713 (4.3)
South/East Asia <sup>70</sup>	812 (61.5)	8388 (87.4)	8221 (89.8)	51681 (82.8)
o/w China	333 (25.2)	830 (8.6)	4000 (43.7)	7401 (11.9)
Hong Kong	n.a.	n.a.	n.a.	14015 (22.5)
Korea	106 (8.0)	820 (8.5)	1047 (11.4)	4576 (7.3)
Singapore	178 (13.5)	1352 (14.1)	1347 (14.7)	6565 (10.5)
Taiwan	162 (12.3)	5243 (54.7)	1701 (18.6)	16443 (26.3)
Thailand	29 (2.2)	140 (1.5)	136 (1.5)	701 (1.1)

Source: UNCTAD (1994.a), Annex Tables 2 and 4.

Because of its relative stagnation in growth and intra-regional economic activity over much of the 1980s, Latin America exported relatively little FDI. However, as trade and investment have started to grow again, their enterprises are playing a growing role in international investment. Multinational enterprises from Latin America have a long tradition (the first DCMNE came from Argentina in the early part of this century), and some have widespread networks in the continent. Many are now also entering the USA to acquire firms in related activities, access the market and acquire new technologies.<sup>71</sup>

As may be expected, Africa shows very little outward FDI activity. Sub-Saharan Africa in particular accounts for less than 1 percent of FDI generated in the developing world. Note, however, that there are no data on FDI flows from South Africa, which has a large network of international operations in countries that maintained economic relations during apartheid. Given its relative economic size and level of development, South Africa may be expected to become an important source of FDI in the region. However, the South Africa economy has itself been sheltered so long that it is difficult to predict where its competitive edge lies and how far its multinational enterprises will be able to compete in a more liberal setting. There are also a number of prominent business families of Asian origin in East Africa with widespread investments in the region (and in West Africa). Again, their investments are probably not captured by the available data.

## 8.2 Asian Multinationals

First, a look at some data on intra-regional FDI by developing countries in Asia (Table 6). The figures in the table, while not complete, illustrate the vitality of this form of FDI. In many large recipients of FDI in East and South East Asia – China, Malaysia, Thailand, Indonesia and the Philippines – the largest or second largest single investor is another Asian developing country, usually one of

the Four Tigers of East Asia.<sup>72</sup>

The most outstanding case is China, where 65% or more of the foreign investment stock comes from Asian developing countries. The preponderant proportion of this appears in the official figures as Hong Kong investments, but the figures also contain significant Taiwanese capital and perhaps investments by other countries operating through Hong Kong. It may also include 'round tripping' by Chinese enterprises bringing capital back to China.<sup>73</sup>

The new NIEs, Indonesia, Thailand and Malaysia (and the Philippines), have become important staging posts for enterprises from the Tigers, relocating labour intensive operations to lower wage areas. In Pakistan and Bangladesh the main developing country investors are from West Asia rather than from the NIEs, with interests more in real estate and tourism rather than manufacturing. However, the growth of the Bangladeshi garments industry and exports has been fuelled by investments from East Asia, mainly Hong Kong and Korea.

Many Asian developing country investors also have very substantial investments in the OECD countries. For instance, it is estimated that Taiwan's investment in the developed world accounted for 50 to 60 percent of its overseas investments; the comparable figure for Korea is 55 percent. For Hong Kong and Singapore less than 50 percent is held in the OECD countries, but the figures are pure estimates.<sup>78</sup>

Hong Kong and Taiwan are the largest overseas investors in developing Asia, together accounting for nearly half of the developing world's stock of foreign investments. Data on these two countries are especially unreliable, since a lot of foreign investment activity is unreported; however, there is no reason to doubt the magnitude of their international presence. Their industrial structures, populated by large numbers of small and medium enterprises specialised in the export of labour-intensive manufactures, have forced a massive relocation of activities to lower cost countries, especially China (see

**Table 6: FDI from Developing Countries in Asia by Host Country**

Host Country	FDI inflows from other developing countries in Asia (% of total FDI inflows)		FDI stocks from Asian developing countries (% of total FDI stocks)
	1985-87	1988-90	Latest available year
Bangladesh	4	7	15 <sup>74</sup>
China	65	60	65
Hong Kong	1 (1986-89) <sup>75</sup>	n.a.	17
India	1	3	5
Indonesia	20	32	18
Korea	5	3	4
Malaysia	19	42	41
Pakistan	15 (1985-88) <sup>76</sup>	n.a.	27 <sup>77</sup>
Philippines	7	9	10
Singapore	12	12	5
Sri Lanka	36	n.a.	36
Taiwan	11	15	28
Thailand	17	32	21

Sources: UNCTAD, *World Investment Report 1993*, P. 49, and UN CTC, *World Investment Directory 1992*

below).<sup>79</sup> Hong Kong now employs nearly 3 million workers in mainland China in export-oriented assembly activities, and its enterprises are active there in a variety of service and infrastructure activities. Hong Kong garments firms are operating in practically every low wage Asian economy that is exporting garments (with the possible exception of India), and as far away as Mauritius, Central America and South Europe.

Small and medium Taiwanese exporters have also spread various labour-intensive activities overseas, with active support and encouragement from a government anxious to use up its massive foreign exchange reserves and to upgrade the domestic industrial structure. Until recently, Taiwanese companies were forbidden to invest in China and so had to recourse to indirect means. This restriction was been lifted in 1991, and, by 1993, Taiwanese companies had an investment stock of \$19 billion in China, while by 1994 pledged new Taiwanese investment in the mainland exceeded \$20 billion.<sup>80</sup> Unlike Hong Kong, however, Taiwan has some large enterprises with ample financial resources and a technological edge in high-technology and skill-intensive industries – these are investing overseas to serve

growing local markets and also to place the simpler processes in low cost locations.

For instance, Acer, one of the world's largest producers of laptop computers and accessories, has set up operations in Malaysia and the USA, and is exploring options elsewhere.<sup>81</sup> Taiwanese TV and video manufacturers, like Tatung, are active in SE Asia as well as Europe. Taiwanese chemical firms are contemplating enormous investments in China to escape environmental controls at home. Taiwan's largest food processor, President Foods Group, has "ambitions of becoming the world's largest food conglomerate" and has four factories in South-East Asia as well targeting mainland China.<sup>82</sup>

Singapore is also a major investor overseas, but its scope is generally more limited to neighbouring countries and to a narrower range of activities. Its activities in Indonesia's Batam island in the context of the "Sijori growth triangle" have already been noted. In line with the prominent role that the state plays in the economic life of this free trade economy, some of its largest overseas investors are government owned, and many of its largest foreign ventures are designed and co-ordinated by the government.<sup>83</sup> Singapore Telecom

has installed one of the world's most advanced systems at home, and is starting (still on a small scale) to look overseas: it has invested in the UK and in the Sijori triangle, and is planning a large investment in the Philippines. A consortium of firms, under government direction, is developing a large industrial area in China. As a regional financial and trading centre, Singapore also serves multinational enterprises from other countries (including developing countries) as a launching pad for their operations in the region.

These three NIEs illustrate the importance of the "Chinese connection" in a lot of intra-Asian FDI. There is a vast network of family and commercial connections between the Chinese business communities that dominate industry and services in the different countries of the region. The low 'transactions costs' implicit in familiarity and trust (what the Chinese call *guanxi*), backed by enormous financial, entrepreneurial and skill resources, clearly provide an edge to multinational enterprises from the community.<sup>84</sup> Asian MNEs are often dominated by family groups that strike deals with each other, often keeping the most lucrative deals secret. This makes it difficult to gauge their true size and impact. Many Asian groups have interests in resource-based and real estate projects, including hotels and resort development. In activities where they lack a technological edge, they tend to seek alliances with developed country firms (telecommunications is a good example). Most are in fact concentrated in low-technology activities where little R&D is needed, drawing strength from internal capital markets provided by the family network.

However, the "Chinese connection" does not give an exclusive competitive edge, and there are many other sources of FDI in Asia. Korea is one of these, with the largest presence in technologically advanced and capital-intensive activities. It is presently a smaller investor than the other Asian Tigers, though it is significant in terms of the sums involved. It has not had the large balance-of-payments surpluses of Taiwan that would allow its government to encourage overseas investment. Nor has it had the loca-

tional advantages of Hong Kong for offloading its assembly industries. At the same time, its deeper and heavier industrial structure has meant that there has been less economic pressure on it to relocate to low wage areas. Its overseas investment activity thus tends to resemble more that of a developed country, especially Japan, to transfer relatively advanced technologies and skills and to tap local markets, than one like Hong Kong, which is forced to look for low cost locations as its domestic industry winds down.<sup>85</sup>

Though relatively late starters in the overseas investment game, Korean multinational

#### **Box 4: Korean Investment Potential in Africa**

The Republic of Korea does not have diplomatic relations with Zimbabwe, but this is not holding back the entry of its leading firms. The chaebol Daewoo is setting up a regional office in Harare as a hub to do business there and in neighbouring countries.<sup>86</sup> It has had talks with four of Zimbabwe's largest private companies as well as two public sector firms, to license its technology and to set up joint ventures. Apart from tapping local markets, the firm wants to export the country's agricultural and mineral resources. It is offering its telecom technology to the post and telegraph utility to upgrade the country's phone, fax and telex services to the rest of the world. It has reached a preliminary agreement with a company in South Africa to build a colour TV tube plant there.

Daewoo is the company credited with sparking off the rapid growth of the Bangladesh garment industry, by taking local workers to Korea for training and helping them to set up their own factories for export.

Its rival Korean chaebol Hyundai is also setting up an office in Zimbabwe, and may buy an assembly plant there to make its trucks and cars for the regional market.

enterprises have enormous technological and financial 'muscle' compared to most other DCMNEs. The bulk of Korean overseas investment comes out of a small number of conglomerates, the chaebol. Their geographical and industrial spread is generally wider, and they tend to be in much more complex and 'heavy' activities, than investors from other Asian countries. Korean automobile manufacturers, for instance, have opened assembly plants in North America and in various parts of Asia, and are exploring East Europe and Africa (see Box 4), the most advanced developing country firms in this highly complex industry. A recent Daewoo investment in the UK to build a video cassette recorder plant (near Belfast) has attracted considerable attention in the British press in recent months.<sup>87</sup> This plant has received considerable incentives from the Industrial Development Board for Northern Ireland, and will create 450 jobs in this sophisticated industry.

Furthermore, despite the lack of a Chinese connection, Korean firms are launching large projects in China.<sup>88</sup> They are investing, not only in Asia and Africa but also in Latin America, the former Soviet Union and Mongolia. They are often risk-taking than their Japanese counterparts, as in East Europe. A recent report on Vietnam notes that Korean firms are among the leading investors there (though trailing Hong Kong and Taiwan); its chaebol are planning motor assembly, TV picture tube, container, chemical, equipment and other plants there.<sup>89</sup>

Firms from the "new NIEs", though with a more limited base of technology, have also accumulated skills in some areas of manufacturing and services. Some are therefore emerging as important overseas investors. San Miguel of the Philippines has long been established as a true international operator, but has a number of smaller followers.<sup>90</sup> Large Malaysian, Indonesian and Thai firms are also setting up major foreign operations, mainly in neighbouring countries, but with a strong interest in China. In 1993, the largest foreign investing country in Malaysia's

**Box 5: Some Multinational enterprises from Asian countries**

The CP (Charoen Pokphand) group of Thailand, founded by an overseas Chinese, is the country's largest food processing company, and has investments in several neighbouring countries. It is also becoming one of the largest foreign investors in China, and its assets there are reckoned at \$1.3 billion. Apart from food related businesses, it also has a motorcycle plant in Shanghai. World-wide CP has 200 companies with revenues in 1992 of \$4 billion.<sup>91</sup>

Malaysia's Hong Leong, originally a branch of Hong Leong Singapore, has been grown much larger than its parent. It has over 60 affiliates and subsidiaries within Malaysia and owns the third largest bank in Hong Kong, property groups in Singapore and Philippines, and is setting up plants to make air conditioners, tiles and motorcycles in China. It is exploring manufacturing opportunities in Vietnam, Thailand and Indonesia.<sup>92</sup>

Several Indian manufacturing firms are active overseas.<sup>93</sup> Ranbaxy Laboratories of India has operations in Hong Kong, Malaysia, Nigeria and Thailand, and is setting up in China. Aditya Birla's group has over 20 ventures in South East Asia, including Vietnam; it is the world's largest producer of rayon fibre, the second largest of palm oil and the sixth largest of carbon black. It is planning new ventures in Burma, Egypt and E. Europe. Ballarpur Industries has Thai and Indonesian paper operations. IFB Industries has a manufacturing base in the UK. Arvind Mills has textile operations in Mauritius and Sri Lanka, and has set up an alliance with a German firm. TELCO has a truck assembly operation in Malaysia and a precision tool making facility in Singapore, where it also runs one of the prestigious training centres for specialised skills.

textile industry was Indonesia, which has firms operating complex synthetic fibre plants in Ireland and elsewhere.

Indian enterprises have also been important actors overseas for some time, as its large business houses looked for sites that allowed them to escape some of the stifling constraints of government policy before recent liberalisation. They were generally oriented to the domestic markets of the host countries, though there were exceptions, and spanned a range of simple to complex activities. The recent liberalisation is encouraging them to look overseas with a different orientation, based more on serving world markets. Indian multinationals resemble those of Korea more than of the other NIEs, but they lack the financial and technological resources of the chaebol. They also have some "Indian connections" overseas, especially in the business communities of East Africa. The latter often draw on this connection for technical expertise and capital. These connections could be deepened and exploited more to benefit the host economies. Host governments should make a special effort to welcome and facilitate these investments in view of the advantages they offer to local industry.

Box 5 gives some examples of multinational enterprises from Malaysia, Thailand and India. The universe of firms with active interests abroad is, of course, very much larger, but these cases give some flavour of the extent and nature of the internationalisation process now under way. The examples focus mainly on manufacturing, but there is an enormous amount of investment in plantations and services like hotels, banking, real estate, trade, transport and consulting.

Interestingly, China, currently the largest recipient of FDI, has emerged as a major overseas investor, despite the communist regime and the non-private ownership of the enterprises investing abroad. According to the available, possibly patchy, data, Chinese enterprises had invested in 79 countries by 1988, with over 240 affiliates in Asia, over 80 in Africa, more than 50 in Europe,

about 40 in Australia and over 20 in the Americas.<sup>94</sup> The numbers are bound to be substantially larger today.

A large proportion of Chinese overseas ventures were engaged in manufacturing (chemicals, metallurgy, paper, coal and oil, equipment of various kinds and paper), but there were also resource extraction and agricultural ventures, banks and transport firms involved. In Singapore, for example, there are over 90 Chinese affiliates, mostly in the financial sector, raising hard currency resources to do business in the thriving region.<sup>95</sup> Chinese firms are very prominent in Hong Kong, with a variety of trading, financial, real estate and other interests. Many Chinese firms are seeking open or 'backdoor' listings in stock exchanges in Hong Kong and the developed countries.<sup>96</sup>

In industry, many of China's overseas investments are in 'heavy' activities like steel making, equipment and chemicals. As may be expected, the Chinese consumer goods industry is relatively weak and does not have the ownership advantages to compete overseas at this stage. It is possible, however, that with the massive inflow of technology and skills in this sector in export-oriented activities from Hong Kong and Taiwan, local enterprises will develop advantages and start overseas operations.

### 8.3 Contribution of DCMNEs

The growth of DCMNEs is of great significance to policy makers seeking to attract FDI into their countries. But what exactly is the nature of their contribution to the host economy? This section ends with a note on this contribution, focusing on MNEs in manufacturing.

The potential contribution of DC multinational enterprises to the host economy, in general terms, depends largely on the nature of their 'ownership advantages'. Many analysts suggest that such enterprises are small or medium sized firms, specialised in simple, labour-intensive technologies, producing undifferentiated products

and using adapted technologies that are not a match for the advanced technologies of the large multinational enterprises from the developed world. There is clearly a class of DCMNEs that conforms to this picture. However, there is a large, and growing, class of enterprises that does not.

To simplify greatly, there are two categories of DCMNEs in industry: the 'classic' investors noted above, and the 'new' investors that were much more like developed country firms.<sup>97</sup> The latter were large firms with professional managements and complex organisations, which possessed and deployed advanced capital-intensive technologies, conducted R&D, had branded products and could often compete with developed country MNEs on their home ground. The ownership advantages of both lay in the way in which they had developed the capabilities that allowed them to operate competitively. The capabilities of the 'classic' set lay in their ability to transfer simple technology that they had absorbed and adapted to developing countries, and, in the case of export-oriented firms, to provide high levels of production management and quality control and contacts with export markets. That of the 'new' DCMNEs lay in a more prolonged and difficult process of developing and deepening technological capabilities in complex technologies.

Some debate has ranged in the literature on the sources of ownership advantages of DCMNEs. The early analysts, from a business school perspective,<sup>98</sup> focused on 'classic' investors and saw the process as a product cycle phenomenon, with technology slowly percolating down to less developed countries as it matured. The process was costless and passive, and there was little original or different in the capabilities that developing world firms accumulated with industrialisation. Other analysts, based in the economic analysis of technology development,<sup>99</sup> saw the process as an active, conscious,

and often risky and costly, one of investing in capability development, with developing country firms gaining unique ownership advantages in the process.

The growing volume of recent research on industrial development suggests that the latter explanation has more validity. As a comprehensive recent study on the subject concludes,

*"The analysis of the technological advantages of Third World MNEs across a wide range of industries suggests a rapid pace of industrial development accompanied by the existence and accumulation of indigenous technological capability, especially in those sectors in which indigenous firms have accumulated production experience ... The existence and accumulation of indigenous technological capability therefore becomes an important cause and effect of the growth of international production networks and the process of industrial restructuring. The existence of indigenous technological capability influences the ability to engage in international production..."<sup>100</sup>*

The contribution of the two broad types of investors may be expected to be different. The 'classic' small, low technology investor can contribute to employment generation, transfer of appropriate technologies, local sourcing of inputs and personnel and, in relevant activities, increased export earnings based on cheap labour. The 'new' investor will be very much like a developed country MNE, transferring advanced technologies and skills, retaining greater linkages overseas, using capital-intensive facilities and increasingly integrating operations across countries as liberalisation takes hold.

## Other “New Forms” of FDI

### 9.1 New Multinational Enterprises from Developed Countries

#### 9.1a Small and Medium Enterprises

Small and medium-sized enterprises in the developed world are playing an increasing role in the allocation of international production to developing countries. UNCTAD (1993.c) recently published a study on SME multinational enterprises. It noted two main features of such firms from the developed countries. First, their FDI was small in value but large in relation to the number of affiliates. Even in Japan, which has the largest number of small and medium multinationals, the share of total FDI was less than 20 percent in the mid-1980s. In the USA, small and investors accounted for only 3 percent of foreign assets. Second, because of information gaps and imperfections, small and medium MNEs are more likely to invest in other developed countries rather than in developing countries. Less than 10 percent of their affiliates were located in the latter, compared to well over 20 percent for large multinationals.

SME MNEs from the smaller European countries like Denmark, Sweden, Ireland, Finland and Switzerland tended to have more foreign affiliates than the average (of 2.5 affiliates per MNE), in contrast to counterparts from very large economies like the USA. Most overseas investment by SMEs was relatively recent, with Japanese and European firms investing mainly in the 1980s and early 1990s. As far as developing countries are concerned, Japanese firms tended to concentrate in Asia (see below), US firms in Latin America and European ones in South and East Asia and, more recently, Latin America. There was practically no interest in Africa, reflecting the perception of high costs

and risks of doing business there and the shortage of information on opportunities. Manufacturing firms had gone transnational earlier than service firms, with high technology firms leading the movement. Within manufacturing, firms in equipment manufacture were more prone to go overseas than others. SME investors were also very active in selling their technologies at arm's length to developing countries.

Japanese small- and medium-sized enterprises have been the most active in developing countries, and deserve some more discussion.<sup>101</sup> Their transnationalisation was given a fillip by the rapid appreciation of the yen, from ¥252 per dollar in 1985 to ¥112 at end-1993, and to below ¥100 today. This has had four effects on Japanese firms: (i) falling domestic value of export receipts, (ii) deteriorating price competitiveness in the export markets, (iii) intensified foreign competition in the domestic market, and (iv) reduced cost of FDI when calculated in yen.<sup>102</sup>

The very first wave of Japanese overseas investment overseas, in the 1960s, was led by small and medium firms seeking low wage bases overseas. In the 1970s and 1980s, it became dominated by large manufacturers, seeking natural resources, production sites in or near large export markets, and low cost assembly sites for labour-intensive processes in South East Asia. The current wave is led by support industries which produce parts and machinery for the big manufacturers and are finding it increasingly expensive to supply components from their home base. These often launch FDI at the request of the parent firm. Adachi (1992) shows that, from being stagnant in the early 1980s, the number of FDI projects undertaken by SMEs increased from 315 cases in 1985, to 1,625 in 1988, mainly in machinery, miscellaneous goods, textiles, and

metals. SMEs in the manufacturing sector accounted for about 45 percent of the growth.

While N. America has been the largest single destination for Japanese SMEs, over 40 percent of their total FDI is concentrated in Asia, in particular in S E Asia. Within this region, there is a clear shift from the established NIEs to the new NIEs, mainly because of international currency realignments and rising wages. China is also increasingly favoured as a host economy for FDI because of its readily available cheap labour and its huge domestic market. The ASEAN countries, on the other hand, have benefited from their increasing growth-generated domestic absorption, which often more than offset the relatively more expensive labour force.

The new wave of Japanese investment is likely to mean that fewer manufacturing plants are simple assembly points for parts imported from Japan. This is expected to improve the transfer of technology to the region, that so far has been notably slow. The change is likely to be most noticeable in those industries where the rising yen has made domestic suppliers non competitive—for instance in the car industry. More radically, some R&D facilities are also being moved from Japan. Hitachi, for example, intends to concentrate its product development and marketing in Malaysia, which has so far served simply as a manufacturing base. However, ‘key’ technologies will continue to be developed in Japan.

While SME MNEs remain relatively small players in the global FDI scene, their importance should not be underestimated in the long-term. They are bound to become more international as the world economic space continues to shrink. They offer additional resources to host countries. In addition, they have some specific advantages. Some are able to offer highly specialised and advanced technologies, especially in the area of machinery manufacture; one of their most important contributions may be that they can become component suppliers and subcontractors to larger MNEs (as noted, this is already happening in South East Asia). Some can offer simpler tech-

nologies and can diffuse skills and know-how to local enterprises more readily than large multinational enterprises. Others can offer specialised services – in fact, a significant part of the recent growth in service FDI comes from enterprises that are relatively small by the standards of the typical manufacturing multinational (though they may be among the largest firms in their own activities). These service MNEs can provide employment, create skills, and raise the flexibility and competitiveness of the host economy.

### *9.1b Newly Privatised Public Enterprises*

As far as the other new form of investment from developed countries – the newly privatised public enterprises – are concerned, there is little available by way of systematic research. However, anecdotal information suggests that many of these firms, with large reserves of cash, surplus capacity in relation to their traditional home markets and aggressive new managements, are seeking to “go global” as a way to expand. The industries involved are mainly in the areas of transport, airport management, communications, power generation and transmission, sewage disposal and treatment, and environment. It could soon include activities like health services, education, postal services and even civil service management.

The process of internationalisation has started. For instance, in the telecommunications industry, British Telecom has sparked off a struggle for strategic international alliances in order to boost its global competitiveness.<sup>103</sup> It has taken a 20 percent stake in MCI, and the two are jointly setting up a company to sell services to multinational enterprises. In return, French and German companies have set up their own joint venture; the Dutch, Swedish and Swiss companies have formed a consortium; and AT&T has announced its own world strategy. Others are waiting in the sidelines. Similarly, British Gas is eager to expand its multinational activities, using its large financial reserves and accumulated technology and skills to develop the gas-related infrastructure of developing countries. Many such companies

have excess capacity in their domestic economies, and liberalisation at home is inducing them to look to global markets for growth and profitability.

These developments are just beginning to take shape in the developed world, and they have important implications for developing countries seeking FDI. They promise to open up new and large avenues for the transfer of investment and technology in critical areas of infrastructure and utilities. By increasing international competition, they would allow developing countries to get newer technologies, more financing and better terms than before. These deals could range from arm's length purchases of facilities and equipment to licensing and management arrangements, BOT contracts, and full direct investment with long-term ownership.

Policy makers in developing countries should become more fully aware of the enormous potential that is being opened up in the sphere of newly-privatised enterprises. They should analyse carefully the conditions that they need to offer to obtain a share of the FDI and technology that is starting to flow from these giant enterprises. Apart from the usual requirements for attracting FDI, the entry of privatised firms into utilities and infrastructure would require the framing of an appropriate regulatory and pricing system that meets the needs of the investors as well as the host economy. It would also require that domestic suppliers of the relevant services, generally state monopolies unused to competition, are opened up to market forces to the extent possible, and that the appropriate ministries become more 'businesslike' in their treatment of the activities concerned.

## 9.2 New Contractual Forms

Entry to overseas markets by multinational enterprises has been facilitated by a new array of cost-savings and risk-reducing investment techniques, allowing foreign companies to take effective control and expand production abroad

without majority equity stakes (i.e. ownership control) in the venture. Such techniques include joint ventures, international sub-contracting deals, licensing arrangements, franchising, management contracts, turnkey and product-in-hand operations, and production- and risk-sharing agreements.<sup>104</sup> These new forms of investment (NFIs) reduce the start-up and working capital costs of investment, limit multinational enterprises' exposure to political and commercial risks, and allow them to circumvent administrative barriers to market entry – such as foreign ownership limitations – without losing competitive strength.

During the 1980s NFIs spread to become an important part of international corporate strategies in developing countries. Statistics on FDI unfortunately tend not to reflect the volumes and patterns of use of NFI, primarily due to difficulties in assigning values to the international flow of tangible and intangible assets that constitute NFI. Scattered evidence, however, shows growth in the number and variety of NFI-type arrangements. For example, sub-contracting and design licensing have been widely used for foreign investment in particular sub-sectors, notably the automobile industry. The pioneering experience of Japan, which has been signing such arrangements throughout East Asia since the 1960s, has been followed more recently by other countries, notably the United States. US capital has been increasingly involved in the maquiladora industry in Mexico, largely through joint ventures (Sklair 1989). Initially developed by US multinationals as assembly centres for the purpose of labour-cost savings, and dominated by garments, Mexican maquiladoras evolved in the 1980s into a channel for the transfer of mature technology (including the upgrading of labour force), particularly in the automotive, electric and electronic industry.

Among the most promising recent approaches to bridging the gap between private financing of export-oriented manufacturing, and of infrastructure or other projects with long gestation periods, are BOT and BOO schemes. Multilateral

agencies, particularly the World Bank and the regional development banks,<sup>105</sup> are devoting much attention to this new form of financing, as a way of alleviating the burden on public finances, savings and foreign exchanges in developing countries, improving essential infrastructure, as well as encouraging better risk sharing, accountability, monitoring and management. In a BOT financing scheme, a private consortium raises cash for a large project, usually in infrastructure, which it builds and operates for a fixed term at an agreed rate of return, until it is transferred to the state. Due to problems with ownership transfer to the public sector, the BOT principle is increasingly being substituted by one where the private sector “build-own-operate” (BOO), retaining an equity and operating interest over the long term.

BOT/BOO schemes generally need some mechanism to cover foreign exchange risk. Because most infrastructure projects typically generate local currency revenues, such mechanisms assure foreign investors that the foreign exchange equivalent value of the project’s revenue stream is maintained. Fundamentally, two issues are involved:

- ❖ **Convertibility:** whether authorisation for conversion in foreign exchange will be granted to cover debt service and equity payments, or whether such payments will be constrained because foreign exchange is rationed; and
- ❖ **Exchange Rate Depreciation:** whether the exchange rate will be maintained at levels that is adequate to service foreign debt and equity.

All mechanisms to cope with exchange risk generally involve official agencies, such as the central bank, the export-import bank, or the government, and use contractual relationships as a risk management tool. Normal exchange hedging techniques are also used, but the long-term nature of the involvement means that additional measures are often called for. Central banks may

guarantee against convertibility risks by ensuring that sufficient foreign exchange will be placed in a priority account for the foreign debt (although this strategy is not macroeconomically desirable), to be serviced even if the host country suffers a balance of payments crisis. Governments can provide guarantees against adverse foreign exchange movements, for instance, by building foreign exchange exposure into tariff adjustments. Another approach, applicable to economies that are highly dollarised and to companies that deal with international customers (like some telecommunications, ports and airports), is to levy charges to customers in US dollars.<sup>106</sup> It should be noted that these arrangements are not, and should not be, intended to guarantee against normal commercial risk, and the normal precautions of completion clauses and performance should be in force.

There is no doubt, however, that BOO and BOT schemes involve some economic, technical, institutional and political complexities. These are sometimes considered major constraints to the widespread use of this type of infrastructure finance.<sup>107</sup> Macroeconomic stability and access to foreign exchange to service debt and equity are important prerequisites, as well as a well-functioning legal system, a pricing and regulatory framework that protects the investor as well as the national interest, and strong negotiating capabilities within the government. Developed local capital markets are also crucial in enabling the private sector to participate in the financing. Augenblick and Custer (1990) have argued that when host countries have structural bottlenecks, traditional external borrowing (e.g. for a turnkey project) might be a more viable option. “Nevertheless, the fact remains that many projects considered essential could not be built without BOT financing schemes because governments do not have the budgetary resources or the borrowing capacity to build.”<sup>108</sup>

The example of the US\$ 1.8 billion Hub River thermal energy project in Pakistan illustrates this point. The agreement, between the Pakistani government, local and foreign debt and

equity investment, and the World Bank, commits the government to protect the foreign counterpart against sovereign risk, while leaving project risk with all lenders and investors. It also provides a mechanism through which foreign lenders and equity investors are guaranteed repayment even though the investment output – in this case electricity – does not directly earn foreign exchange. Pakistan has to undertake to service the debt out of its general foreign exchange earnings, with part of them being especially dedicated to the project.

The rapid increase in demand for private sector involvement in infrastructure projects through BOT schemes confirm the potential of this form of financing. Countries in East Asia and the Pacific region have been the biggest user of BOTs. As noted earlier, Malaysia is using BOT schemes on a very large scale basis, more extensively than other countries in the region.<sup>109</sup> Other cases are found in Hong Kong (the Eastern Harbour Crossing), China (the Shajiao power plant and a railway project), and Pakistan (above). India is a relative new-comer to this mechanism, but is promising to become a major user (see Box 6). Outside Asia, developing countries with significant inflows of capital for BOT projects on a per capita basis are Argentina, Belize, and Panama.

It is interesting to note that BOT/BOO operations are not only the preserve of large MNEs from the developed world. Box 6 describes a private Hong Kong firm which is a major player in this area. The ability of a developing world firm to provide such projects is impressive in itself; it also fits into the prospects for increasing intra-developing country investment discussed above. The entrepreneur behind this firm, Gordon Wu, has become an almost legendary figure in Asia, and is sought by institutions like the World Bank and the Asian Development Bank to launch large infrastructure projects, particularly in the power sector.

It is evident, therefore, that BOT type of projects are going to be of major significance in many developing countries in the near future,

#### **Box 6: Hopewell Holdings' BOT/BOO Projects**

Hopewell Holdings of Hong Kong, run by Gordon Wu, has already built several power plants in China and the Philippines. According to a recent report,<sup>110</sup> under its power subsidiary CEPA (Consolidated Electric Power Asia), it has a \$526 million plant in operation in China, with 50% equity share, and three smaller plants in the Philippines, with shares from 50 to 100%. It is currently constructing a \$1.9 billion power plant in China (with 27% equity) and another for nearly \$1 billion (49%) in the Philippines. It had now reached preliminary agreements to construct more generating plants in Indonesia (100%, for \$2 billion)<sup>111</sup>, China (\$2.3 billion, equity share unknown) and the Philippines (\$1.6 billion, 100%). If the last deal goes ahead the firm will become the largest foreign investor in the Philippines.

Apart from power generation, Hopewell is also building a super-highway in Thailand, which has been delayed in construction.

CEPA has more recently signed BOT deals in India and Pakistan to build and manage power stations worth about \$19.5 billion over ten years, and is scouting the subcontinent for more. The India connection was brought about through the World Bank. However, apart from its plans in Shenzhen, it has mothballed BOT plans for power stations in China because of caps (of 12 to 15%) being imposed on returns on power projects.<sup>112</sup> In India the company believes it can obtain rates of return nearer to 20%, while in Pakistan, Indonesia and Philippines it can obtain returns of around 18%.

For the India projects (16 units of 660 MWs each) the company will raise funds from a variety of sources, including the IFC, commercial banks and global equity markets. Each power project may be spun off as a separate listing, raising additional funds from CEPA shareholders. CEPA itself was floated on the Hong Kong exchange in 1993 for \$769 million to provide funds for its BOT projects, at that time mainly for China.

and that their own firms can play a large role in setting them up. As with other such schemes, it is imperative for host governments to create an

appropriate environment for such investments to take place and to develop their own capabilities to negotiate and handle the projects.

## Policy Implications

The policy implications of this analysis for attracting and using FDI for development have been touched on throughout the study. It is now time to draw them together clearly. Needless to say, policies must be placed in the context of technological change, new organisational forms and emerging strategies of global integration as noted above. They must also take into account the changing policy climate in developing countries: sweeping liberalisation of policies, freer trade, greater reliance on the private sector and a generally reduced role for the government in economic life. As a result, all economies will be increasingly tightly linked together and multinational enterprises will play a growing role in organising certain forms of production, trade and delivery of services.

This may be an attractive world for countries that are already involved in international production and benefiting from it. It may be a rather forbidding world for others, that are marginal to international production and technological change, and currently lack the wherewithal to participate even if they want to. The policies of the former should be geared to smoothing their path to fuller integration into the world economy and to ensuring that they extract the maximum benefit from it. Those of the latter should be geared to improving the basic supply-side factors that would allow them to start the integration process and to benefit from MNE activity.

There are certain elements of economic and FDI related policies that are applicable to all developing countries. However, there have to be differences in emphasis and strategy according to the level of economic development of the country and its existing participation in international production: these differences can be

illustrated for three sets of countries according to their levels of development. The “advanced” countries would be the NIEs or near-NIEs, countries with relatively complex industrial structures, large manufactured exports and a fairly large MNE presence in advanced manufacturing and service activities. The “least developed” countries, at the other extreme, would be those with high reliance on a few primary commodities, a small and simple manufacturing base with low local linkages, little participation in manufactured trade and a low MNE presence (mainly in resource based activities). The others fall in the “middle level” in between these two.

Table 7 sets out the policy needs for all countries together and for the three groups. The entries are fairly self-evident and do not need much explanation. A great deal of emphasis is placed on the improvement of the supply-side factors that determine the competitiveness and basic economic attractiveness of the host economy, since this is what will finally decide its participation in the international production system.

As the table indicates, there are certain basic policy needs for encouraging FDI. In brief, these are:

- ❖ Stable and well-managed macroeconomy
- ❖ Disciplined and flexible labour force with wages that reflect true market conditions
- ❖ Adequate and competitive physical infrastructure
- ❖ Skill development at all levels, with emphasis on management and technology
- ❖ Low, stable and transparent effective tax rates

**Table 7: Policies for Promoting FDI by Level of Development**

<b>Countries</b>	<b>Economic Policies</b>	<b>FDI Policies</b>
All	Stable, well managed macroeconomy. Flexible and disciplined labour markets. Skill development and training. Lead role for private sector, with public sector reform as needed. Adequate infrastructure. Export-oriented trade strategies. Market oriented domestic industrial policies, easy entry/ exit. Efficient financial markets. Low effective tax rates.	Stable, transparent, non-discriminatory and predictable policies. Easy repatriation of profits and capital. Flexible, efficient and honest administration. Low effective tax rates with few exceptions. Expropriation only in extreme cases, with no national discrimination and fair compensation. Fair dispute settlement procedures with international arbitration.
Advanced	World-class infrastructure, especially in communications and IT. Provision of high level technical, scientific and managerial skills, with targeted investments in development of skills needed for emerging technologies. Free use of expatriate skills for particular needs. Selective tools for promoting infant industries. Exploitation of possibilities for regional integration or association. Stronger technology support system; promotion of ISO 9000 standards and contract R&D. Better incentives for indigenous R&D. Stronger basic research capabilities in technology institutes, linkages with industry. Improved local supplier base, in particular SMEs. Local financial system more linked to world capital markets. Venture capital financing for innovation.	Targeted promotion strategies to attract multinational enterprises into high technology and high skill activities, including advanced financial and other services. Selectively applied incentives for raising local content and undertaking local R&D, using foreign personnel if needed. Attraction of supplier MNEs in components and equipment. Encouragement of foreign banks and other services. Promotion of strategic alliances between local and foreign firms. Encouragement for MNE participation in local science and technology system, and in provision of advanced training to local employees. MNE participation in privatisation and BOO/BOT schemes. Encourage local firms to go transnational, and to cooperate with other MNEs in third countries.
Middle Level	Improved infrastructure, especially transport, communications, power, water and sewage. Promotion private participation in infrastructure. Labour markets more flexible and disciplined, with wages reflecting economic conditions. Improved supply of medium and high level technical, engineering and management skills. Vocational training made relevant to industrial needs, improved incentives for in-firm training. Controlled trade liberalisation, with appropriate supply side measures and strong incentives for exporting. Improved technology support for quality, design, energy and material saving. Liberalisation of technology imports. Improved financial system, start venture capital schemes. Promotion of SMEs and subcontracting. Improve and extend EPZs and industrial estates.	Liberalised FDI entry, including services and infrastructure. Targeted promotion strategy aimed at more advanced activities and most promising sources of export development, including multinationals from other developing countries. Simplify and faster FDI approval procedures, stronger support and information services to prospective investors. Encouragement of local linkages and use of local services. Attraction of foreign component supplier to invest. Incentives for technology upgrading and training, starting local design activity. Inducements to MNEs to set up local training centres and take employees overseas for training. Encouragement to leading local firms to explore investments overseas.

Least Developed	<p>Better basic infrastructure, with private financing. Improved access to MNEs to natural resource base. Development of essential technical skills, especially at supervisory and technical levels. Improved enrolments in secondary and vocational education, engineering and management education at tertiary level. Strong and clear signal to encourage local private sector. Stronger extension services for SMEs, with basic support for quality control and testing. Liberalised trade and improved export processing facilities. Maximisation of regional trading/integration possibilities.</p>	<p>Liberalisation of FDI entry. Promotion campaign to build 'image' with MNEs, with clear signals on improved entry conditions and treatment. Stable policies and transparent, efficient implementation. Lower effective taxes and congenial investment climate. Expatriates to be allowed easy entry. Investors targeted in resource based activities, with encouragement for forward integration. Particular targeting of investors from other developing countries and NIEs in labour-intensive export-oriented activities.</p>
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- ❖ Lead role assigned to private sector, with clear legal and accounting framework
- ❖ Reform of public enterprises, with an emphasis on privatisation in which MNEs participate
- ❖ Outward-oriented trade policies
- ❖ Domestic industrial policies geared to promoting competition and free entry and exit
- ❖ Development of efficient financial and capital markets, linked to external markets
- ❖ Stable, transparent and predictable FDI policies, based on equal treatment
- ❖ Free access to foreign exchange for profit and capital remittance
- ❖ Honest, fast and businesslike administration of FDI policies and incentives
- ❖ Promotion to investors targeted to specific needs of country, based more on economic attractions and low general tax rates rather than large tax concessions
- ❖ Fair dispute settlement procedures

Apart from this set of policies to provide a conducive environment for investors, the spe-

cific benefits that MNEs can offer developing host countries can be maximised by the use of policies to strengthen local capabilities and induce MNEs to upgrade their activities.<sup>113</sup> The main considerations are spelled out in the table. The remainder of this chapter will therefore concentrate on policies to deal with the “new forms” of FDI that were discussed above. In particular, it will focus on the attraction of two sets of MNEs: SMEs from the developed countries and investors from other developing countries.

**SME MNEs:** Most SME investment from the developed world concentrates on other developed countries. Clearly, small firms face several handicaps in investing in developing countries: they lack information on investment opportunities and local conditions, they are particularly sensitive to political risk and macroeconomic uncertainties, they are unfamiliar with the different legal systems and regulations involved, they do not have the financial and human resources of large multinational enterprises, and they lack the market and personal contact that global exporters have. Thus, they tend to be rather passive in relation to developing countries, and tend to wait to be approached by prospective technology buyers or joint venture seekers. They often prefer to sell their technology at arm's length rather than undertake the

expense and risk of investing directly. They are particularly unwilling to enter into the complicated and prolonged processes of getting investment approval in many developing countries.

Apart from the obvious need to have the right policy environment, with stable and non-discriminatory policies and good market prospects, the promotion of FDI by SMEs has to address the information gaps and risk elements that are inherent to the internationalisation of small firms. Many developing host countries are already making efforts to do this. A number of countries do not require formal approval for FDI below a certain size. Several that had requirements of minimum size of foreign investments have abolished them: Malaysia, Thailand and Indonesia are good examples. Korea has reduced the minimum size requirement over time. The reduction of clearance formalities is being achieved in many countries by the setting up of one-stop agencies for FDI promotion. Apart from handling all the formalities in one place, these agencies can provide information to investors and help them in obtaining all the necessary clearances. This benefits all investors, of course, not just the small ones, but in the nature of things it is the smaller firms that stand to gain most from the provision of information and help with clearances.

Policies used by developing countries to help SMEs in general (including local firms), such as lower tax rates and credit, infrastructure and other forms of assistance on favourable terms, can also help SME MNEs if their entry is facilitated in other ways. For instance, in Singapore firms with less than S\$8 million in fixed assets, below 50 employees and 30% or more of local equity are eligible for special financial assistance; in Sri Lanka, firms with less than Rs 0.5 million in issued share (local and foreign) are exempted from corporation tax; in Malaysia, manufacturing SMEs with less than M\$ 0.2 million in shareholder's funds and less than M\$ 1 million in fixed assets are allowed certain fiscal benefits.<sup>114</sup>

When all these are taken into account, however, there still appears to be a shortage of

schemes to address the specific needs of SME investors. What seems to be needed is a more pro-active strategy on the part of host countries to seek out, target and establish direct contact with SMEs in developed countries. This is not an easy task, since by definition the contacting of prospective investors will require more effort per unit of investment than with large multinational enterprises. However, use can be made of industry or trade associations (many SMEs in the developed world are extremely well organised to lobby and promote their economic interests), and even a modest start can have a snowballing effect over time. All the usual promotional tools can be used for this: advertising, mail shots, meetings, seminars, fairs and delegations. Special effort may need to be made to find suitable joint venture partners for SME investors, again possibly by bringing industry and trade associations in contact with each other. Needless to say, however, such promotion will only be effective if the host economy is basically a desirable place to invest in and if basic rules and conditions are congenial.

**DCMultinationals:** The attraction of developing world investors faces many of the problems just mentioned, when the firms concerned are relatively small, or have been very home-bound even if they are large. Much of intra-developing world direct investment has had two ways of overcoming the information and risk deterrents: it has followed trade, and it has drawn upon information transmitted by family or ethnic connections, other investors or the government. These have, as the data showed, proved extremely effective in dynamising DCMNEs within Asia. More recently, the rise of large, sophisticated developing world investors who are taking a more global view, and who may induce their smaller suppliers to invest overseas, has reduced some the problems involved. But this does not meet the needs of the myriad other firms that could become foreign investors. And it does not meet the needs of the host countries in the least developed category that are outside the ambit of existing trade and ethnic connections with the

more advanced developing countries.

The solution would seem to lie again in an aggressive targeted promotion strategy to inform and attract specific groups of prospective investors from other developing countries. Much of the investment promotion by the least developed and middle-level countries is directed to traditional centres of investment in the OECD. It tends to ignore the NIEs and middle level countries that have large numbers of firms with the capabilities to invest and transfer technology. In addition, the 'image' of the host country is often biased and unfavourable, and FDI entry processes tend to be cumbersome and non-transparent. A great deal of effort needs to be made to improve on all these factors. Regionally co-ordi-

nated investment promotion by small countries is one way of reaping scale and scope economies.

Capital exporting countries can also help a great deal by providing information, credit and fiscal incentives to their firms to go overseas. Many countries already do this, in an effort to promote exports and improve their international competitiveness and standing. However, the efforts could probably be improved and focused better. There is clearly scope for the investment promotion agencies of home and host countries to cooperate more closely, and so to save on information collection and dissemination costs. There is also considerable scope for the harmonisation of laws and regulations, property rights, equity sharing, and other requirements related to FDI.

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# Notes

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- 2 UNCTAD (1994.a).
- 3 There are several problems in the measurement of FDI flows, discussed by Patterson (1992). These problems cannot be analysed here, and data are presented as they appear in the various leading sources.
- 4 UNCTAD (1994.a), p.16.
- 5 The developing world is defined in conventional terms here, including NIEs like Hong Kong and Singapore (which are now counted as high income countries in the WDR) as well as Mexico (which has just joined the OECD).
- 6 UNCTAD (1993.b).
- 7 A summary of the findings is also given in UNCTAD (1993.a) p. 107-109.
- 8 Data from UNCTAD (1993.a) , p. 62.
- 9 UNIDO (1990).
- 10 UNCTAD (1994.a).
- 11 See Oman (1984, 1989), UNCTAD (1993)
- 12 World Bank, World Development Report 1994, and Kirwan (1993).
- 13 Financial Times, London, 9 September, 1994, "Malaysia's planners ride the fast lane", p. 6.
- 14 UNCTAD (1993.A) .
- 15 See Culpán (1993).
- 16 See Ernst and O'Connor (1989) on the electronics industry.
- 17 See Oman (1994). On FDI policies and an analysis of the economic principles underlying them, see Julius (1990).
- 18 See Kaplinsky (1994).
- 19 Dunning (1993), Julius (1990).
- 20 See UNIDO (1990). On the general economic determinants of locational choices of multinational enterprises, see Dunning (1993).
- 21 In Latin America, Argentina, Brazil and Mexico accounted for 76 percent of total FDI to the region in the period 1985-89, and for 70 percent in 1990-92. Apart from economic reforms and better macroeconomic management, factors accounting for this pattern of FDI were the swapping of foreign debt for equity, privatisation of state-owned enterprises, and "round-tripping" mechanisms (the use of FDI as a substitute for flight capital repatriation) in these large economies.
- 22 Most FDI In Sub-Saharan Africa went to oil producing countries, notably Nigeria and Angola. The largest recipient was Nigeria, which accounted for an average share of almost 50 percent of total inward FDI during the decade to 1992, with little signs of a change in the trend.
- 23 Note that these data, from the IMF balance-of-payments statistics and World Bank's World Debt Tables, may not correspond to the data from the UNCTAD reports referred to in the previous section. However, the broad trends are similar across all sources of data, and existing discrepancies, inherent in the nature of the data, cannot be resolved here.
- 24 UNCTAD (1994.a), pp. 13-15. These ten countries, in descending order of total inward FDI over 1981-92, are as follows: China, Singapore, Mexico, Malaysia, Brazil, Hong Kong, Argentina, Thailand, Egypt, and Taiwan. They are followed by Nigeria, Indonesia, Colombia, Korea, Venezuela, Philippines and Chile.
- 25 In 1993 China's dominance rose further, with FDI inflows estimated at between \$23-26 billion. This was followed by a further 54% increase in FDI in the first half of 1994 as compared to the same period in 1993, according to data reported in *The Economist*, London, August 6, 1994, p. 65.
- 26 FDI approvals by India in 1993 came to \$2.9 billion, though actual arrivals were \$577 million (UNCTAD, 1994.a, p. 81).
- 27 Data from UNCTAD, World Investment Directory. The regional origins of FDI in these countries are not available in this source for a later year than 1988. Data for Malaysian stocks and Sri Lankan flows and stocks are for 1985 and 1987. The Jamaica data for stocks are for 1984 only.
- 28 Lecraw (1990) has an econometric investigation of various determinants of FDI patterns, in which he finds that the influences are very diverse and that most economic and political factors suggested have some discernible impact.
- 29 On the determinants of competitiveness in industry see Lall (1990).
- 30 See UNCTAD's new World Investment Report 1994 on the significance of skills to FDI.
- 31 This is documented for Malaysia by ADB (1994).
- 32 One sign of this the Guidelines recently submitted by the World Bank on the Treatment of Foreign Direct Investment. This provides a voluntary framework for the treatment of FDI, comprising what UNCTAD (1993.a) terms "a synthesis of existing instruments and the 'best practices' that tend to stimulate FDI." (p. 29).
- 33 See Wells and Wint (1990) and also Wint (1993).
- 34 Guisinger (1986) describes the results of a World Bank research project on the effectiveness of policies to attract Multinational enterprises to developing countries.
- 35 UNCTAD (1994.a).
- 36 Odle (1993).
- 37 When Mexico privatised its SICARTA S.A. steelworks in 1992, the successful bid in the US \$500 million sale was an Indian firm, ISPAT steel.
- 38 The involvement of capital markets is necessary when privatisation is carried out through public offerings, as opposed to private sales. In addition to being allocatively efficient, public offerings are more advantageous, though more costly, for the developing country, as they ought to contribute to the modernisation of local financial markets. See on this point Bouin and Michalet (1991).
- 39 Exceptions are privatised export-oriented enterprises and high-technology industries, where majority ownership is allowed.
- 40 Odle (1993).
- 41 Miller and Sumlinsky (1994), p. 4. On the similarities of responses between local and foreign firms in developed countries, see Julius (1990).
- 42 See, for instance, the World Bank's (1993) study of the Asian "miracle", and the critiques by Lall, Amsden and others in the April 1994 issue of *World Development* .
- 43 Lall (1994.a).
- 44 World Bank (1994).
- 45 On the deficiencies in African capabilities in industry see Lall (1992).
- 46 The efficiency of this depends on the height of trade barriers erected by the bloc with respect to the rest of the world if very high barriers are raised, it would have the same effects as import-substituting industrialisation, and would lead to inefficiency.
- 47 For example, MERCOSUR (created in 1992) established a schedule for harmonisation—particularly in the field of taxation, profit remittance, and treatment of the services sector. ASEAN formally established in 1993 the ASEAN Free Trade Area (AFTA),

- to be phased-in over 15 years, involving in its initial stage a series of measured tariff reductions on a range of products. NAFTA, signed in 1992, is highly comprehensive and includes the harmonisation of technical standards, competition policy and intellectual property rights, and the setting of standards of treatment of foreign Multinational enterprises in member countries. Preston and Windsor (1992) deal with the regulatory apparatus of various regional associations.
- 48 The Southern African Development Co-ordination Conference (SADCC), organised in 1980, aimed only at economic co-ordination rather than creation of a formal trade block. The 1975 Economic Community of West African States (ECOWAS), uniting 22 countries, the Preferential Trade Area (PTA) for Eastern and Southern Africa, created in 1981 and now counting 16 members, and the 1983 Economic Community of Central African States (ECCAS) have achieved very modest results.
- 49 See PITO (1992).
- 50 The early Sijori experience is reviewed in Lee (1991).
- 51 See van Grusven (1994).
- 52 Euromoney, September 1993. The rankings shown for each country are for its position in the world as a whole. The fist 11 places are held by developed countries, led by the US and Japan. Tax havens, formerly socialist countries of East Europe and oil states are excluded above.
- 53 UNCTAD (1994.a), pp. 145-46. The Triad refers to the three groupings of and around developed economies: North America, Europe and Japan.
- 54 UNCTAD (1993.a), p. 174.
- 55 UNCTAD (1993.a), p. 177.
- 56 The interplay of incentives, capabilities and institutions as determinants of industrial success are analysed in Lall (1990).
- 57 Much of the information is drawn from UNCTAD (1993, 1994).
- 58 UNCTAD (1994.A), p. 94.
- 59 See World Bank (1994) and Lall (1992).
- 60 The details of this are given in the World Investment Report 1993, p. 51.
- 61 UNCTAD (1994.A), p. 87.
- 62 Lall (1994.a).
- 63 UNCTAD (1994.a), p. 66.
- 64 See Lall (1993.a) for a review of recent FDI in South Asia.
- 65 MIGA guarantees include: (i) transfer risks arising from currency restrictions;
- (ii) loss from legislative and administrative actions, whether or not such actions constitute formal expropriation; (iii) government repudiation of contracts; and (iv) armed conflict and civil unrest.
- 67 See, for instance, Dunning (1988), Lall et al (1983), Wells (1983), UN TCMD (1993), Tolentino (1993).
- 68 Figures of Sub-Saharan Africa exclude South Africa, on which no data are available.
- 69 The data for Latin American FDI outflows do not include figures for Chile or Mexico..
- 70 The data FDI outflows for Asia do not include Hong Kong, which is one of the largest overseas investors in the region, or for Malaysia, India or Indonesia.
- 71 See Peres N'Òez (1993).
- 72 Lall (1991), UN TCMD (1993)
- 73 The preponderant proportion of this appears as Hong Kong investments. Clearly Hong Kong enterprises are major investors in China, but the figures also contain significant Taiwanese capital, and perhaps investments by other countries operating through Hong Kong. It may also include "round-tripping" by Chinese enterprises bringing capital back to China.
- 74 Includes large investments from West Asia; the stock of other Asian countries is 2%.
- 75 The Hong Kong figure for this period is very low because of a massive repatriation of capital to China in 1987.
- 76 The figure for investments from South East and East Asia is 5%; the remainder is from West Asia.
- 77 The figure for investment stock from East Asia is 4%, the remainder is from West Asia.
- 78 Lall (1991).
- 79 The relationship of the industrial structures of the NIEs with their overseas investment is analysed in Lall (1991)
- 80 Financial Times, 25 November, 1994, p. 4.
- 81 On the technological capabilities built up by leading Taiwanese computer manufacturers, see Clifford (1993).
- 82 Financial Times, 25 November, 1994, p. 4.
- 83 See Règner (1993).
- 84 See Chen (1989), and "Network Capitalism", Far Eastern Economic Review, 2 December 1993, p. 17.
- 85 Lall (1991).
- 86 Reported in the Far Eastern Economic Review, February 24, 1994, p. 70.
- 87 See, for instance, The Economist, 13 August, 1994, p. 30.
- 88 For instance, the Financial Times of 16 September, 1994, announced a \$500 million investment by Daewoo in China to make computer memory chips and other related high technology products.
- 89 "Asian investors lead the way in Vietnam", Financial Times, 24 February 1994.
- 90 Tolentino (1993).
- 91 See Goldstein (1993).
- 92 Asiamoney, November 1993, pp. 14-15.
- 93 "Globalisation: Window to the World," Business India, May 9-22, 1994, pp. 65-72.
- 94 See Ye Gang (1992).
- 95 Reported in the Far Eastern Economic Review, January 20, 1994, p. 17.
- 96 See Yu and Yip (1993-4).
- 97 See Tolentino for a comprehensive review.
- 98 Wells (1983).
- 99 Lall (1983).
- 100 Tolentino (1993), p. 370.
- 101 About 1200 Japanese SMEs are identified as Multinational enterprises, according to UNCTAD (1993.c), p. 56.
- 102 See Adachi (1992).
- 103 "A global scramble for partners", Financial Times, March 16, 1994, Survey of Information and Communications Technology, p. VII.
- 104 See in particular Oman (1984, 1989).
- 105 See in particular World Bank (1994).
- 106 Bond and Carter (1990).
- 107 Chandavarkar (1994)
- 108 Chandavarkar (1994), p. 9.
- 109 Examples are two major highway projects: the North Kalang Straits bypass and the Kuching-Kapang interchange in Sarawak.
- 110 Goldstein (1994).
- 111 According to a report in the Financial Times of 17 September, 1994, p. 3, CEPA has signed a 30 year deal with the Indonesian government to build, own and operate two 660MW plants in North Java, with generation starting in 1998.
- 112 Financial Times, 28 October, 1994.
- 113 See Julius (1990) for a comprehensive analysis of the appropriate framework for MNEs.
- 114 UNCTAD (1993.c). Ibid. Table VII.5.

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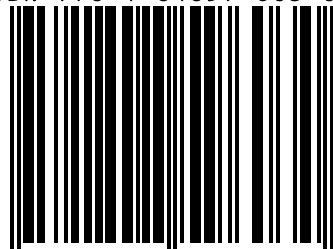
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