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FOREIGN DIRECT INVESTMENT AND DEVELOPING COUNTRIES[1]

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by

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This paper deals with recent trends in foreign direct investment (FDI) and international production[2] arising therefrom, and the impact of FDI on economic development in developing countries. Thus this paper first looks at the overall, geographical and industrial trends of FDI, highlighting the FDI picture in developing countries and then various elements of international production – e.g. the capital and technology flows, and affiliates activities such as output, sales, trade and employment in developing countries. Finally, some policy implications are made to attract and benefit more from FDI.

A. Recent FDI trends

Global and regional FDI flows

Over 900,000 foreign affiliates are in operation world-wide, established by at least 61,000 transnational corporations (TNCs), spanning virtually every country in the world and representing an FDI stock of over $7 trillion. To this, an (unknown) number of firms would have to be added that are linked to each other through non-equity relationships. While a number of these parent corporations fit the traditional notion of TNCs as big and dominant, many are small- and medium-sized enterprises.

Some of the funds required to establish foreign affiliates are made available by parent firms in the form of equity (often in a package comprising capital as well as other resources such as technology, organizational and managerial practices and marketing expertise), intra-company loans, and reinvested earnings, together defined as FDI. In addition, foreign affiliates can also be financed from loans that they obtain in the domestic capital markets of host countries or in international capital markets which are not recorded under FDI. Total investment expenditure in foreign affiliates is, therefore, higher than the value captured by FDI data. In the case of foreign affiliates set up through mergers and acquisitions (M&As) as well (which also include assets acquired in the context of privatization), it is typically not known whether cross-border M&As

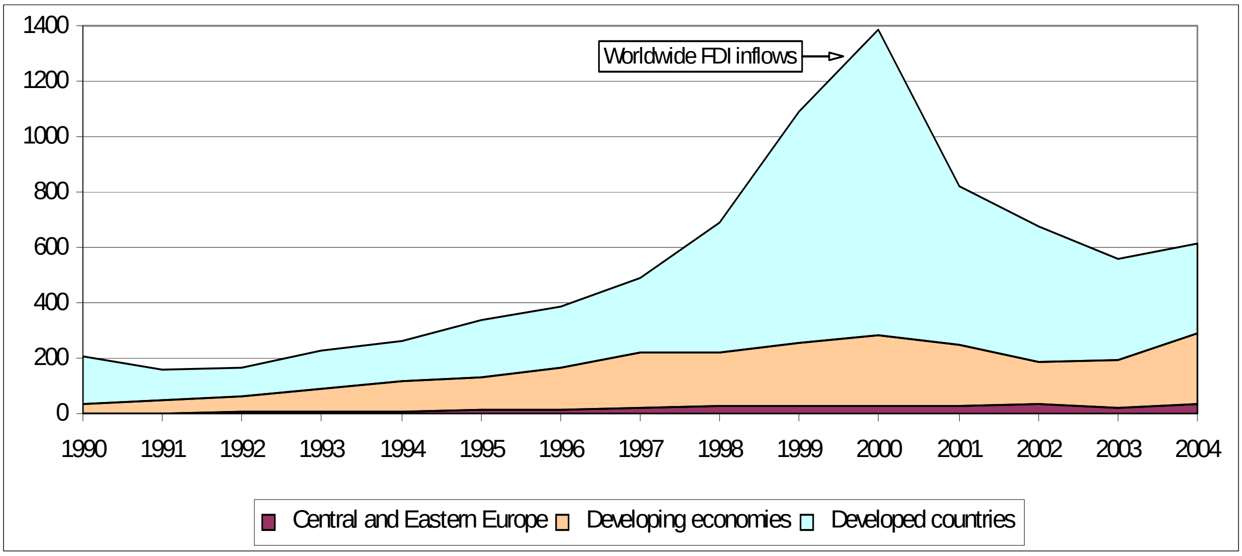
[2] International production is defined as the production of goods and services of countries that is controlled and managed by firms headquartered in other countries. Transnational corporations (TNCs) establish, under the common governance of their headquarters, international production systems in which factors of production move, to a greater or lesser extent, among units located in different countries.

are being financed by FDI only. There is not necessarily a direct correspondence between the value of cross-border M&As and that of FDI flows.[3]

Total FDI flows had grown dramatically until 2000, then stated to fall (figure 1). Global FDI inflows in 2004 rose by 6% to $612 billion, ending the FDI downturn that started in 2001. However, flows to developed countries continued to decline for the fourth consecutive year. The increase in flows to developing countries and Central and Eastern Europe (CEE)[4] helped increase global flows and compensated the decline to developed countries. Global FDI inflows remained unevenly distributed and concentrated in a few key destinations.

Figure 1. Global inflows of FDI, 1990-2004, by groups of countries

(Billions of dollars)



The prospects for global FDI inflows in 2005 are good. Flows are expected to rise further because of improving economic fundamentals that drive FDI. These include a rise in broad-based economic recovery, equity market valuations and M&As activities. Both developed and developing regions will attract an increase in flows. In developed countries, as well as

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[3] In an extreme case, for instance, FDI inflows into a country can be zero, although foreign TNCs have acquired firms worth $10 billion in that same country (by, for example, financing the acquisition from the domestic capital market).

[4] The eight countries acceded to the European Union in 2004 (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia) are included in this region.

developing economies, the traditional recipients will dominate inflows - indicating the return to norm as compared to the situation in 2003-2004. The United States, the United Kingdom and a few larger European economies will receive higher flows. China and India will receive another record level of flows ($61 billion and $6 billion, respectively), contributing to growing FDI flows to developing economies (table 1).

Table 1. FDI inflows, by host region and major host economy, 2001-2004

(Billions of dollars)

Host region/economy	2001	2002 [a]	2003 [a]	2004 [b]
World	**818**	**681**	**580**	**612**
Developed countries	**571**	**490**	**380**	**321**
European Union	**357**	**374**	**308**	**165**
Belgium	..	15	29	7
France	50	49	47	35
Germany	21	36	13	-49
Ireland	10	24	27	26
Italy	15	15	16	15
Luxembourg	..	117	92	52
Portugal	6	2	1	6
Spain	28	36	26	6
United Kingdom	53	28	21	55
Australia	4	14	8	5
Canada	27	21	7	12
Japan	6	9	6	7
United States	159	63	30	121
Developing economies	**220**	**159**	**173**	**255**
Africa	**20**	**12**	**15**	**20**
Latin America and the Caribbean	**88**	**53**	**51**	**69**
Brazil	22	17	10	16
Chile	4	2	3	6
Mexico	27	15	11	18
Asia and the Pacific	**112**	**94**	**107**	**166**
China	47	53	54	61
Hong Kong, China	24	10	14	33
India	3	3	4	6
Korea, Republic of	4	3	4	9
Singapore	15	6	11	21
Central and Eastern Europe [c]	**26**	**31**	**27**	**36**
Czech Republic	6	8	3	5
Poland	6	4	4	5
Russian Federation	2	3	7	10

Source: UNCTAD (www.unctad.org/fdistatistics) and UNCTAD's own estimates.

a Revised data.

b Preliminary estimates. See note below.

c The eight CEE countries that acceded to the EU in 2004 are included under this heading.

Note: World FDI inflows are projected on the basis of 101 economies for which data are available for part of 2004, as of 29 December 2004. Data for most economies are estimated by annualizing their three quarterly data. The proportion of inflows to these economies in total inflows to their respective region or subregion in 2003 is used to extrapolate the 2004 data for Africa, Asia and the Pacific and Central and Eastern Europe. For 2004, Latin America and the Caribbean is estimated by annualizing the three quarterly data for principal host economies and by replicating the 2003 data for the economies for which no data are available so far.

FDI inflows to *developed countries* dropped to $321 billion in 2004 as compared with $380 billion in 2003. The continued decline was due to large repayments of intra-company loans for some host countries, notably Belgium, Germany[5] and the Netherlands. Luxembourg and Spain, both major recipients of FDI in 2003, received lower inflows. However FDI inflows to the United Kingdom and the United States, two of the largest traditional host countries, recovered from a dip in flows in 2003. The increase in M&A activities and the improved intra-company loans situation in these two countries helped.

FDI in developing economies: leading the recovery

Developing economies led the recovery in global FDI flows in 2004 with inflows of $255 billion, 48% higher than the previous year and a historic high, making it further the single most important component of private capital flows to developing countries (box 1). Improved policy environment and stronger economic condition contributed to the developing economies situation. The performance of each developing region was uneven but all saw an increase in FDI inflows in 2004:

FDI inflows to *Africa* rose for the second consecutive year since 2002, to $20 billion. A large part of the increase came from investment in natural resource exploitation, driven by a strong rebound in global commodity prices and demand for diamonds, gold, oil, platinum and palladium. Improved investor perceptions and improving regulatory framework contributed to the region's performance. As a result, natural-resource rich countries such as Algeria, Angola, the Libyan Arab Jamahiriya, Mauritania, Nigeria and South Africa received more FDI flows as compared to 2003. Flows to the Libyan Arab Jamahiriya increased significantly because of the end of sanctions in 2003. The high prices of key commodities encouraged TNCs to pursue new exploration projects in African countries, leading to high levels of inflows. The prospects for 2005 are favourable. The extension of the African Growth and Opportunity Act (AGOA) of the United States to 2015 should facilitate expansion of international production in Africa, as would the improving economic situation in the region.

[5] One single transaction involving an intra-company loan by a telecommunication company reduced FDI capital in Germany by nearly $20 billion, approximately half of the total recorded outflow of foreign capital in Germany of $42.7 billion in the first half of 2004.

FDI flows to *Asia and the Pacific* exceeded $166 billion, a 55% increase over the level in 2003. Improved economic performance, a more favourable policy environment and corporate profitability, as well as a rise in M&A activities in the region were key factors behind this performance. Regional integration encourages production networks and intraregional FDI flows, particularly between North-East Asia and South-East Asia subregions. China, India, Republic of Korea, Hong Kong (China) and Singapore saw higher inflows. This, however, suggests that flows to the region remained unevenly distributed and were dominated by a few economies. All subregions witnessed increases in flows as compared to 2003. North-East Asia (mainly due to higher flows to China and the Republic of Korea) continued to dominate flows to the region, followed by the ASEAN (Association of Southeast Asian Nations) and South Asia subregions. Singapore continued to dominate flows to ASEAN while India in South Asia subregion. Flows to Central Asia and West Asia subregions rose as a result of higher oil investment. Flows to the Pacific subregion increased, but only marginally so. The prospects for the region in 2005 are promising. Further improvement in the policy environment and liberalization in the region will contribute to the brighter prospects as would be the increase in the number of bilateral and regional agreements on establishing free trade areas, which involves a growing number of countries in Asia.

FDI flows to *Latin America and the Caribbean* in 2004 increased for the first time in five years, by 37% to $69 billion. Improvements in economic situation and policy environment were main factors behind the rebound. Mexico and Brazil together accounted for half the inflows to the region in 2004. While the recovery was impressive in Mexico, FDI inflows appeared to have remained largely stagnant in Brazil where the GDP growth for the country has been below the average of the region. Flows to Chile rose and those to Argentina had recovered albeit marginally. The improving policy environment and economic situation, and efforts to streamlined investment procedures will contribute to a more promising prospect for the region.

FDI inflows to *CEE* rebounded in 2004, to reach a record high ($36 billion) as compared with $27 billion in 2003. The surge in FDI flows involved three-quarter of the countries in the region. The eight new CEE member countries of the European Union – the group mostly affected by the downturn of 2003 – experienced the most vigorous increase. Led by Romania and

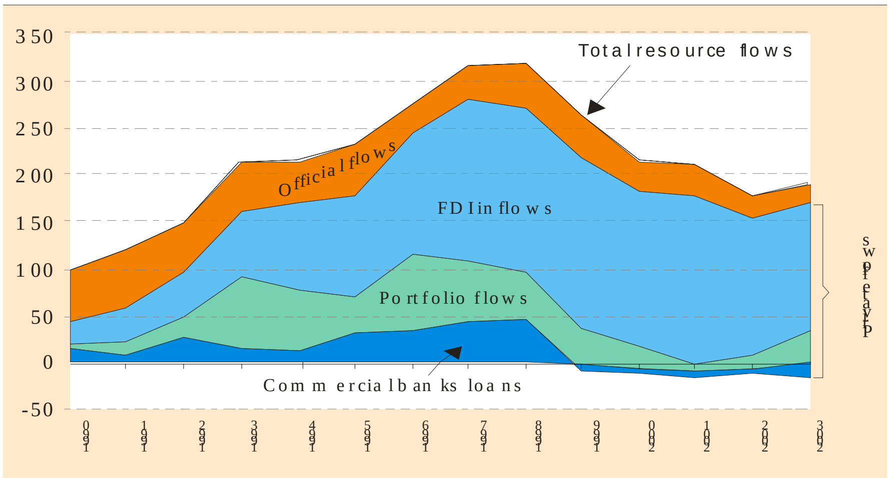
Bulgaria, flows to South-East Europe grew rapidly. FDI flows to the Russian Federation rose significantly to a level close to $10 billion. Prospects for the region in 2005 remain bright.

Box 1. The rise of FDI as a source of finance for developing countries

FDI has come to account for an increasing share of international financial flows that include (in addition to FDI) funds that firms borrow from foreign banks and raise from other sources in foreign financial markets, as well as official flows, primarily official development assistance (ODA). FDI differs in nature from private bank lending in that a good part of it is non-debt creating, and returns to it are directly linked to the performance of the projects that it finances, which are a part of the international production systems that it brings into being. Moreover, and largely because of the interest and direct involvement of the investors in the production activities financed, FDI flows differ from portfolio capital flows raised in international capital markets in that they are usually not geared towards short-term profits (but rather long-term returns) and are not prone to herd behaviour.

Box figure. Total flows to developing countries by type of flow, 1990-2003

(Billions of dollars)



FDI inflows accounted for more than 70% of total net resource flows to developing countries in 2003 (box figure). While other private flows – bank lending and portfolio investment – as well as official flows have been declining, FDI flows to developing countries have demonstrated remarkable resilience even in the face of the financial and economic crises.

Geographical and sectoral patterns

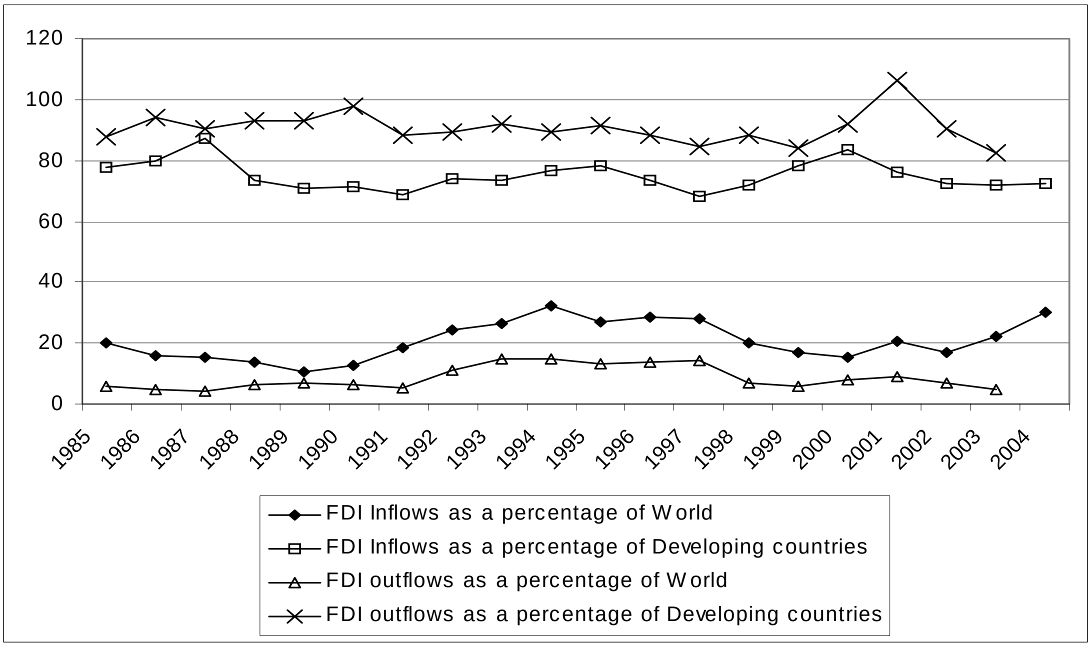
In 2004, with stagnation of FDI flows to developed countries and a significant increase in flows to developing countries, the share of developing countries in world FDI flows rose to 42%, highest since 1994. A salient feature of recent developments in FDI pertaining to developing countries has been the growing role of developing economies as investors, and their contribution to the global stock of outward FDI. The share of the global stock of outward FDI of developing economies and CEE rose from 7 per cent in 1990 to 11 per cent in 2003. The Asian economies were the fastest growing investors, with China and India emerging as notable investors.

The growing competitiveness of developing country enterprises and their desire to obtain access to markets, resources, technology and strategic assets have been the key reasons for the growth in their outward FDI. Encouragement from their governments through incentives, bank loans and a relaxation in their policies towards outward FDI has helped. The relocation of production activities to lower cost locations and the growth in intra- and inter-regional FDI flows also encouraged outward FDI flows from developing countries.

In both inward and outward FDI, what is particularly striking is the concentration of FDI flows in a handful of top home and host countries globally and also in developing countries alone (figure 2). The 10 largest *host* countries accounted for four-fifths of the total inflows in developing countries. On the *home* country side the 10 largest accounted for more than 70 per cent of total FDI outflows from developing countries.

Figure 2. Concentration of FDI flows by the ten largest developing host/home countries, 1985-2004

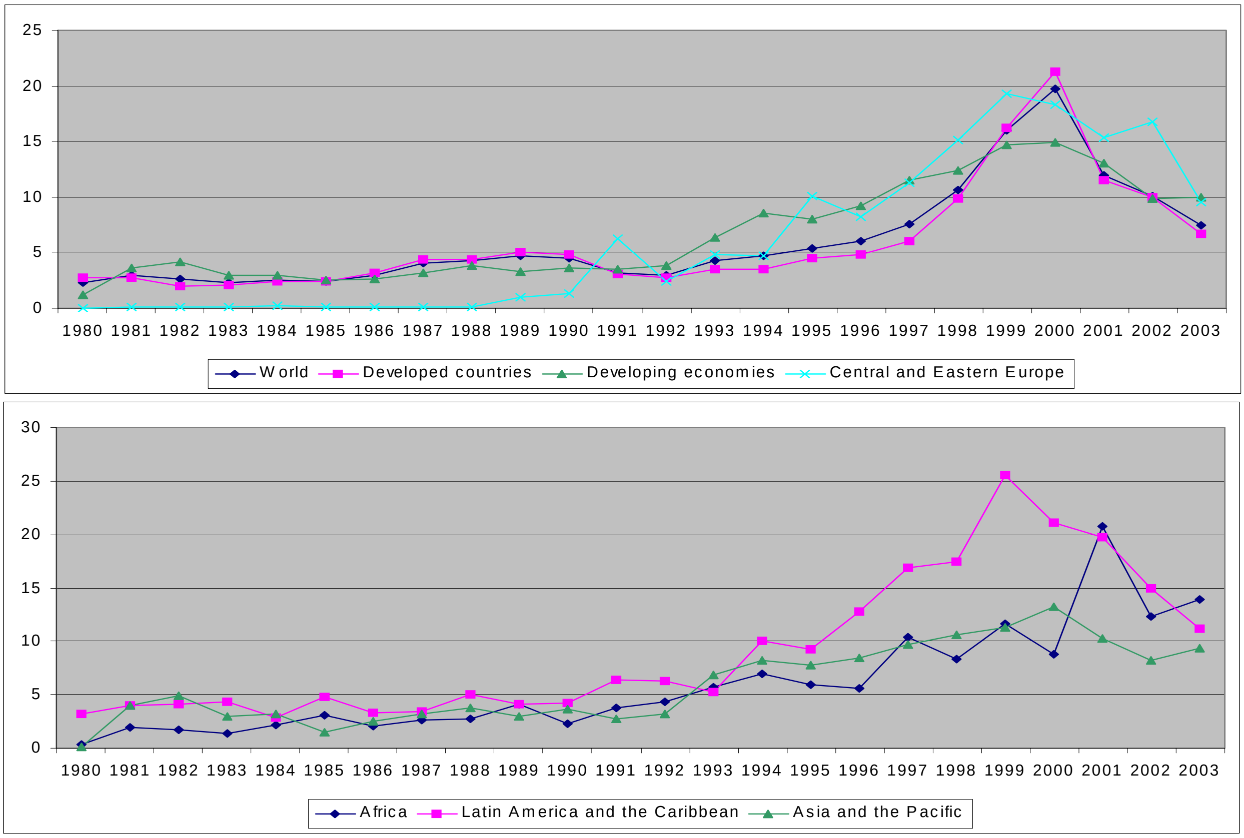
(Percentage)



The pattern of concentration of FDI inflows and outflows by absolute values of flows does not, however, provide a full picture of the significance of inward and outward FDI for different countries. If the size of host economies is taken into account by looking at FDI inflows as a percentage of gross fixed capital formation, developing countries as a group received about the same size as and even more FDI than did developed countries throughout the past two decades or so except 1999-2000. The disparities among different developing regions were considerably reduced from those suggested by the distribution of absolute values of world FDI inflows until the mid-1990s, but they are becoming wide recently (figure 3). What this means, of course, is that developing countries receive more FDI inflows than might be expected on the basis of their market size alone and the FDI performance differs considerably. This is not surprising, since FDI is also attracted by factors other than market size, especially natural and human resources as well as other locational factors (e.g. policies, incentives, infrastructure). Perhaps more importantly, this means that the significance of FDI needs to be seen against the size of each economy to appreciate its importance.

Figure 3. FDI inflows as a percentage of gross fixed capital formation, 1980-2003

(Percentage)



As far as FDI outflows are concerned, outflows as a percentage of gross fixed capital formation are higher from certain countries such as Singapore, Hong Kong (China), Chile than those from major developed countries (table 2). This suggests that, even at lower levels of development, countries are likely to have firms that are sufficiently competitive to establish themselves abroad.

Table 2. FDI outflows as a percentage of gross fixed capital formation in selected developing economies, 2001-2003[a]

(Percentage)

Economy	Value
Singapore	36.3
Hong Kong, China	28.2
Taiwan Province of China	10.5
Chile	7.4
Malaysia	5.3
India	1.0
China	0.8
Brazil	0.2
South Africa	-5.0
Memorandum:	
Sweden	27.4
France	22.0
United Kingdom	19.0
United States	6.6
Germany	4.1
Japan	3.2
Greece	1.8

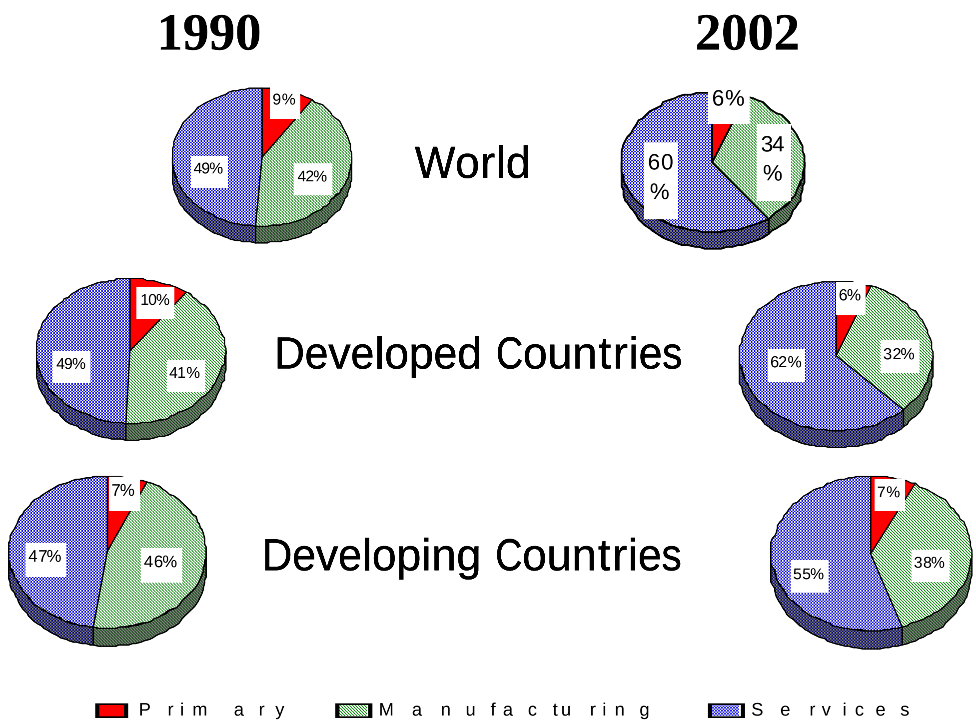
Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

a Annual average.

Another significant development in global FDI situation has been the shift towards services. In the early 1970s, services accounted for only one-quarter of the world FDI *stock*; in 1990 this share was less than one-half; and by 2002, it had risen to about 60% or an estimated $4 trillion. Over the same period, the share of the primary sector in world FDI stock declined, from 9% to 6%, and that of manufacturing fell even more, from 42% to 34%. In the case of FDI *inflows*, on average, services accounted for two-thirds of the total during 2001-2002, valued at some $500 billion. As the transnationalization of the services sector in home and host countries lags behind that of manufacturing, there is scope for a further shift towards services. Offshoring and outsourcing of services abroad by firms in developed and developing countries have been contributing to the shift. The gradual liberalisation of services industries, privatisation, the preferred M&A mode of market servicing and the increasing drive by firms to build on cost competitiveness have further strengthened the growth of FDI in services.

Figure 4. Sectoral distribution of FDI inward stock, 1990 and 2002

(Percentage)



Source: UNCTAD, *World Investment Report 2004: The Shift Towards Services.*

The composition of services FDI is also changing. Until recently, it was concentrated in trade and finance, which together still accounted for 47% of the inward stock of services FDI and 35% of flows in 2002 (compared to 65% and 59%, respectively, in 1990). However, such industries as electricity, water, telecommunications and business services (including IT-enabled corporate services) are becoming more prominent. Between 1990 and 2002, for example, the value of the FDI stock in electric power generation and distribution rose 14-fold; in telecoms, storage and transport 16-fold; and in business services 9-fold.

What explains the shift of FDI towards services? Partly it reflects the ascendancy of services in economies more generally: by 2001, this sector accounted, on average, for 72% of GDP in developed countries, 52% in developing and 57% in CEE countries. Moreover, most services are not tradable – they need to be produced when and where they are consumed. Hence the principal way to bring services to foreign markets is through FDI. In addition, countries have liberalized their services FDI regimes, which has made larger inflows possible, especially in industries previously closed to foreign entry. Of particular importance has been the privatization of State-owned utilities in Latin America and the Caribbean, and in CEE.

Firms have reacted by expanding their service production abroad. Traditionally, FDI in such services as banking, insurance and transportation had been undertaken by firms moving abroad to support or complement trade or overseas manufacturing by their manufacturing clients. This is still taking place, but the pattern has been changing: service providers more and more invest abroad on their own account, as they seek new clients and exploit their own ownership advantages. Added to that are competitive pressures. In non-tradable services, growth remains the principal location advantage for attracting FDI. In directly tradable services, the main location advantages are access to good information and communication technologies, an appropriate institutional infrastructure and the availability of productive and well-trained personnel at competitive costs.

B. The impact on development

Various measures – value-added,[6] sales, employment, exports, R&D, profits – show that, while international production is increasing in importance at the global level, its relative importance in individual host countries varies greatly. During the past decade, global output and sales of foreign affiliates have been growing faster than output generally, that is, world GDP (table 3). Output and sales of foreign affiliates have also been growing faster than world exports. Indeed, the value of estimated total foreign-affiliate sales ($17 trillion in 2003) has exceeded that of world exports ($9 trillion in 2003) since the early 1980s, making international production globally more important than trade in terms of delivering goods and services to foreign markets.

Table 3. Selected indicators of FDI and international production, 1982-2003

[6] "Value added" refers to the total value of outputs minus that of inputs purchased by firms – that is, net addition to production. The value-added measure is a better indicator of the size of production than are sales, which involve problems of measurement since sales may refer to operating revenues, total revenues or net sales, and sales in certain industries (such as wholesale trade, financial institutions) are not directly comparable to those of the manufacturing sector. The data on sales of all industries are therefore not reported by countries.

(Billions of dollars and per cent)

Item	Value at current prices (Billions of dollars)			Annual growth rate (per cent)						
	1982	1990	2 003	1986-1990	1991-1995	1996-2000	2000	2001	2002	2003
FDI inflows	59	209	560	22.9	21.5	39.7	27.7	-41.1	-17.0	-17.6
FDI outflows	28	242	612	25.6	16.6	35.1	8.7	-39.2	-17.3	2.6
FDI inward stock	796	1 950	8 245	14.7	9.3	16.9	19.1	7.4	12.7	11.8
FDI outward stock	590	1 758	8 197	18.1	10.7	17.1	18.5	5.9	13.8	13.7
Cross border M&As [a]	..	151	297	25.9 [b]	24.0	51.5	49.3	-48.1	-37.7	-19.7
Sales of foreign affiliates	2 717	5 660	17 580 [c]	16.0	10.2	9.7	16.7	-3.8	23.7 [c]	10.7 [c]
Gross product of foreign affiliates	636	1 454	3 706 [d]	17.4	6.8	8.2	15.1	-4.7	25.8 [d]	10.1 [d]
Total assets of foreign affiliates	2 076	5 883	30 362 [e]	18.2	13.9	20.0	28.4	-5.4	19.6 [e]	12.5 [e]
Export of foreign affiliates	717	1 194	3 077 [f]	13.5	7.6	9.9	11.4	-3.3	4.7 [f]	16.6 [f]
Employment of foreign affiliates (thousands)	19 232	24 197	54 170 [g]	5.6	3.9	10.8	13.3	-3.2	12.3 [g]	8.3 [g]
GDP (in current prices) [h]	11 737	22 588	36 163	10.1	5.1	1.3	2.7	-0.9	3.7	12.1
Gross fixed capital formation	2 285	4 815	7 294	13.4	4.2	2.4	3.8	-3.6	-0.6	9.9
Royalties and licences fees receipts	9	30	77 [i]	21.3	14.3	7.7	9.5	-2.5	6.7	..
Export of goods and non-factor services [h]	2 246	4 260	9 228	12.7	8.7	3.6	11.4	-3.3	4.7	16.6

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

[a] Data are only available from 1987 onward.

[b] 1987-1990 only.

[c] Based on the following regression result of sales against FDI inward stock (in millions dollars) for the period 1980-2001: Sales = 1 542.5036+1.945042*FDI inward stock.

[d] Based on the following regression result of gross product against FDI inward stock (in millions dollars) for the period 1982-2001: Gross product = 493.8792+0.389537*FDI inward stock.

[e] Based on the following regression result of assets against FDI inward stock (in millions dollars) for the period 1980-2001: Assets = -1 389.4785+3.850915*FDI inward stock.

[f] For 1995-1998, based on the regression result of exports of foreign affiliates against FDI inward stock (in millions dollars) for the period 1982-1994: Exports = 288.4750+0.454011*FDI inward stock. For 1999-2003, the share of exports of foreign affiliates in world export in 1998 (33.3 per cent) was applied to obtain the values.

[g] Based on the following regression result of employment (in thousands) against FDI inward stock (in millions dollars) for the period 1980-2001: Employment = 1,5162.6220+4.731003*FDI inward stock.

[h] Based on data from the International Monetary Fund, *World Economic Outlook*, April 2004.

[i] 2002.

Thus TNCs can, and do, contribute to the development of host countries. However, the extent to which they can contribute to the social and economic development objectives of a country depends on policies pursued by the countries concerned. The activities of TNCs do not necessarily reduce the skewed impact arising from globalization. Notwithstanding the governments of developing countries have changed attitudes towards TNCs over the past two decades. Many developing countries now see TNCs as part of the solution, rather than as part of the development problem. TNCs can enhance a country's capital inflows, strengthen its technological base, boost its export competitiveness and raise the quantity and quality of employment.

FDI brings in investible financial resources to host countries which are more stable and easier to service than commercial debt or portfolio investment. TNCs invest in long-term projects. The most comprehensive indicator to measure the degree of the role that TNCs play in host countries is FDI as a percentage of gross fixed capital formation as noted.

Technology

TNCs can bring modern technologies, some of which are not available in the absence of FDI. They can stimulate technical efficiency and upgrade technological skills of local firms. They may even set up R&D facilities. Technology, created by parent firms and elsewhere within TNC systems, is a key element in the stock of assets built up in foreign affiliates. Data on technology payments and receipts – flows of royalties and licence fees paid by technology recipients and received by technology providers – give a rough idea of trends in technology flows within and outside TNC systems. Technology payments and receipts world-wide have risen steadily since the mid-1980s, reflecting the growing importance of technology for international production. If data for Germany, Japan and the United States are indicative, between two-thirds and nine-tenths of international technology flows by this measure are intra-firm in nature. This share has increased over time, suggesting that the industrial pattern of FDI has shifted increasingly towards technology-intensive activities. As technology-based assets have become more important for TNCs' overseas operations, and R&D in foreign affiliates has risen, intra-firm flows of technology and payments of royalties and fees have increased.

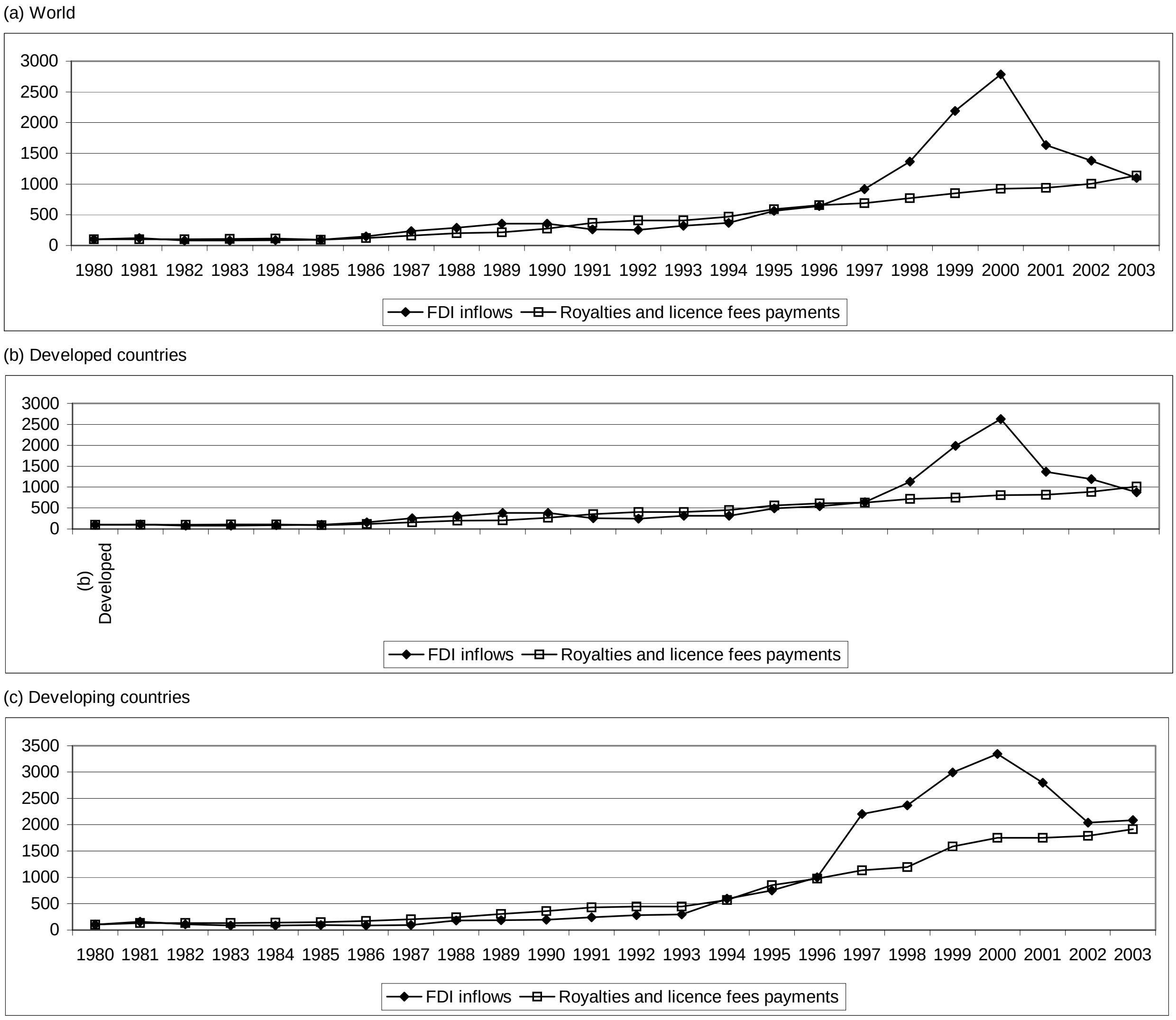
The increased share of intra-firm payments in total technology payments also suggests that, in technology-intensive industries, technological catching up by developing countries on their own becomes more difficult. It should be noted, however, inter-firm alliances for the generation of technology are on the rise, and these do not necessarily involve payment flows. In general reflecting the high share of intra-firm flows of technology in the total of such flows, world FDI flows and flows of technology measured - however imperfectly - by payments of royalties and fees have grown at comparable rates for some time (figure 5a). By region, however, the relationship between FDI flows and technology flows may not be parallel.

In the first half of the 1990s, payments of royalties and fees for technology rose more rapidly than FDI in both developed and developing countries (reversing the trends of the late 1980s). But flows of technology payments by foreign affiliates in developing countries have been rising at a faster rate than those in developed countries particularly since the latter half of the 1990s (figure 5c). This may mean that the sophistication of technologies in developing countries is rising at a faster pace than that in developed countries. In the countries of Central and Eastern Europe, the rate of growth of FDI flows has been much higher than that of technology payments ever since those countries' transition to market economies began (figure

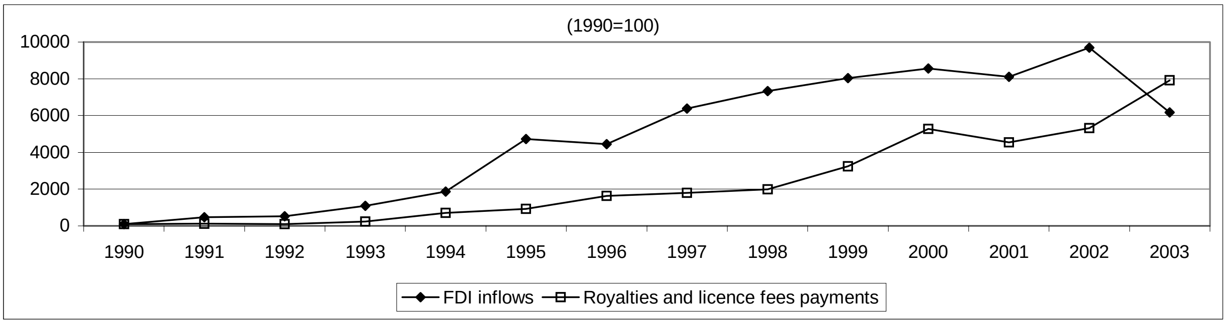
5d). This probably reflects the fact that extending the scope of international production to these countries requires, first of all, inflows of finance and, perhaps most importantly, knowledge of organizational and managerial practices ("soft technology"), rather than new or more modern product and process technologies. Interestingly, however, the trend reversed in 2003.

Figure 5. Growth of technology flows and FDI flows, by group of countries, 1980-2003

(1980=100)



(c) Central and Eastern Europe



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).
Note: Excludes economies for which rolayties and licence fees data are not available, namely: Afghanistan; Armenia; Aruba; Bahrain; Bermuda; Bhutan; Bosnia and Herzegovina; Brunei Darussalam; Cayman Islands; Central African Republic; Chad; Comoros; Congo; Congo, Democratic Republic of; Cuba; Denmark; Djibouti; Equatorial Guinea; Fiji; Gabon; Gambia; Gibraltar; Haiti; Indonesia; Iraq; Jordan; Kiribati; Korea, Democratic People's Republic of; Kuwait; Lao People's Democratic Republic; Lebanon; Liberia; Libyan Arab Jamahiriya; Maldives; Mauritania; Mongolia; Nepal; New Caledonia; Occupied Palestinian Territory; Oman; Papua New Guinea; Qatar; São Tomé and Principe; Saudi Arabia; Somalia; Sri Lanka; Switzerland; Turkmenistan; Tuvalu; Ukraine; United Arab Emirates; Uzbekistan; Viet Nam; and Yemen.

R&D is another area of international production activity of special importance to host countries. Innovatory activities, reflected partly in the number of researchers or R&D expenditures in foreign affiliates, contribute to the building of technological capacities and competitiveness of host countries. Regarding R&D expenditures parent firms control by far the greater proportion of R&D expenditure: as much as 97 per cent (1995, most recent year) and 85 per cent (2002) of total R&D expenditures by Japanese and United States TNCs, respectively. In general, developing countries have not attracted much by way of TNC activities in R&D, despite their eagerness to attract technology-intensive FDI and, in some cases, special incentives offered to such FDI.

Market access

TNCs can provide access to export markets for goods and services that are already produced in host countries by helping them switch from domestic to international markets, and for new activities that exploit a host country's comparative advantages. In some countries such as Hungary, Singapore and Malaysia more than half of exports are made by foreign affiliates (table 4). Exports by foreign affiliates – including intra-firm exports – are estimated to account for one fifth of sales of foreign affiliates in the world (table 3), a ratio that ranges widely between countries. On the one hand, international production is the principal means for the international delivery of products – especially services – that are impossible or difficult to trade at arm's length. On the other hand, international production provides a stimulus to international commerce in goods and services that are tradable. This it does by extending the opportunities for the international division of labour by bringing mobile and nonmobile factors of production together in particular locations for production within TNC systems and, in the case of some industries, by enabling firms to reap large economies of scale and scope. Trade within TNC systems and involving TNCs at arm's length makes up for a significant share of world trade (each accounting for about one third of total world trade).

Table 4. Shares of foreign affiliates in the exports of selected developing host economies, all industries and manufacturing,[a] selected years

(Percentage)

Economy	Year	All industries	Manufacturing[a]
Developing economies:			
Argentina[f]	1995	14	..
	2000	29	..
Bolivia[f]	1995	11	..
	1999	9	..
Brazil[f]	1995	18	..
	2000	21	..
Chile[f]	1995	16	..
	2000	28	..
China	1991	17[g]	16
	2001	50[g]	44[h]
Colombia[f]	1995	6	..
	2000	14	..
Costa Rica	2000	50	..
Hong Kong, China	1985	..	10
	1997	..	5
India	1985	3	3
	1991	3	3
Malaysia	1985	26	18
	1995	45	49
Mexico[f]	1995	15	..
	2000	31	..
Peru[f]	1995	25	..
	2000	24	..
Republic of Korea	1999	..	15[i]
Singapore	1994	..	35
	1999	..	38
Taiwan Province of China	1985	17	18
	1994	16	17

[a] Share of exports of foreign affiliates in the manufacturing sector in merchandise exports of host economies.

[f] Data for exports of foreign affiliates were based on 1998-2000 average and were provided by ECLAC, International Trade and Integration Division. Based on a sample of 385 foreign-owned firms, 82 in Argentina, 160 in Brazil, 20 in Chile, 21 in Colombia, 93 in Mexico and 9 in Peru.

[g] Data from MOFTEC. [h] 2000.

[i] Data from Soon (2001), based on exports of 267 exporting companies out of a sample of 305 manufacturing foreign affiliates, accounting for 47.5 per cent of the stock of FDI in the Republic of Korea. Total exports generated by foreign affiliates are thus likely to be considerably larger (based on a survey undertaken by the Korea Institute of Economy and Technology.

It should be noted that in some countries in which foreign affiliates contribute significantly to exports, they also have high propensities to import, indicating that the strong link between international production and trade may sometimes result in increasing the deficit or reducing the surplus of the countries on their trade and balance-of-payments accounts.

Creation of employment

One dimension of international production that is of particular interest to many host countries is the extent to which location-bound factors of production – especially labour – are utilized in international production. In recent years, the number of employees in foreign affiliates has increased noticeably, even though employment by TNC systems world-wide (parent firms and their foreign affiliates together) has stagnated. In particular, employment in foreign affiliates in developing countries has grown significantly. About 19 million people were employed in foreign affiliates in developing countries at end-1990s, compared with 7 million in the mid-1980s. They account for roughly one third of total employment of all foreign affiliates in the world. Furthermore, the number of jobs created indirectly by these affiliates is one to two times the number of employees directly hired by them. Nevertheless, it accounts for only a small percentage of total paid employment even in those countries taken as a group.

In some developing Asian countries TNCs are now in a position to influence the level of employment (table 5). For example, in Singapore, foreign affiliates are major employment sources, accounting for more than a half of total employment in manufacturing. Hong Kong (China), Malaysia and Taiwan Province of China experienced an increasing share of foreign employment over the past decade. Reflecting dormant FDI flows into Latin America until the early 1990s the significance of employment in foreign affiliates declined in Brazil and Mexico.

Table 5. Significance of employment in foreign affiliates in selected developing countries, various years

		Number of employees in foreign affiliates (Thousands)		Number of total employees[a] (Thousands)		Number of employees in foreign affiliates as a percentage of total number of employees	
Host economy	Year	Manufacturing	All industries	Manufacturing	All industries	Manufacturing	All industries
Brazil	1987	..	..	..	..	24.3	16.2
	1995	952.3	1 447.4	7 108.0	40 800.0	13.4	3.5
China	1987	..	210.0 [a]	32 092.0	96 543.0	..	0.2
	1997	..	5 987.9 [a]	50 830.0	146 680.0	..	4.1
Hong Kong, China	1985	86.4	..	847.6	2 182.4	10.2	..
	1994	67.5	324.6	423.0	2 533.2	16.0	12.8
Indonesia	1992	262.5 [b]	384.6 [b]	7 847.6 [c]	78 104.1 [c]	3.3	0.5
	1996	505.2 [b]	758.1 [b]	10 773.0 [c]	85 701.8 [c]	4.7	0.9
Malaysia	1985	141.0 [d]	..	473.3	..	29.8	..
	1994	529.2 [d]	..	1 211.3	..	43.7	..
Mexico	1985	424.5	532.1	994.1	..	42.7	…
	1993	906.6	1 097.9	5 078.0 [c]	32 833.0 [c]	17.9	3.3
Singapore	1980	149.4	..	287.2	..	52.0	..
	1996	197.4	..	378.7	..	52.1	..
Taiwan Province	1985	230.7	261.6	2 501.0	7 428.0	9.2	3.5
of China	1995	517.6	1 003.6	2 449.0	9 045.0	21.1	11.1
Viet Nam	1995	110.9	144.4	745.0 [e]	2 707.0	14.9	5.3

Source: UNCTAD.

[a] Data cover the urban areas only.

[b] Data exclude those of the oil and gas sector, banking, non-bank institutions, insurance and leasing.

[c] Data include both paid and unpaid employees.

[d] Estimates.

[e] Includes the mining sector.

TNCs provide employees in their foreign affiliates host countries with advanced skills and knowledge by bringing in experts and by setting up state-of-the-art training facilities. Improved and adaptable techniques can yield competitive benefits for firms as well as help sustain employment as economic and technological conditions change.

C. Policy environment

The continuing improvement in policy environment contributed to the global FDI situation and patterns. In 2003, there were 244 changes in laws and regulations affecting FDI, and 220 of which were in the direction of more liberalization (table 6). Given the fact that FDI is concentrated in a limited number of countries and, within these countries, in certain locations with attractive clusters, FDI policies in host countries call for new approaches, going beyond the first and second generations of investment promotion policies. In the first generation of investment promotion policies, many countries adopt market friendly policies. They liberalize their FDI regimes by reducing barriers to inward FDI, strengthening standards of treatment for foreign investors and giving a greater role to market forces in resource allocation. Virtually all countries – to varying degrees – have undertaken steps in this direction. Some countries can go a long way in attracting FDI with these steps, if the basic economic determinants for obtaining FDI are right. In the second generation of investment promotion policies, governments go a step further and actively seek to attract FDI by "marketing" their countries. This approach leads to the setting up of national investment promotion agencies. Again, of course, the success of pro-active efforts depends, in the end, on the quality of the basic economic factors in a host country.

Table 6. National regulatory changes, 1991-2003

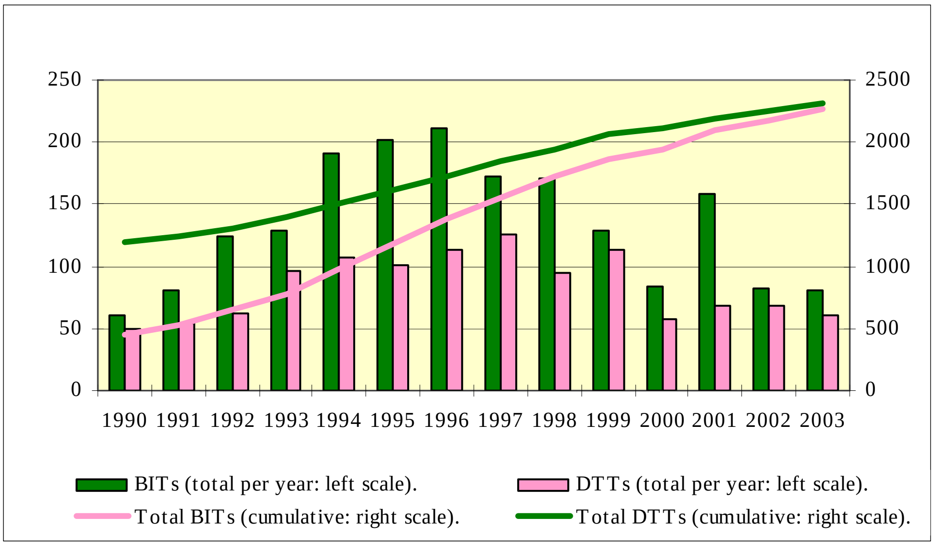
Item	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76	60	63	69	71	70	82
Number of regulatory changes	82	79	102	110	112	114	151	145	140	150	208	248	244
of which:													
More favourable to FDI [a]	80	79	101	108	106	98	135	136	131	147	194	236	220
Less favourable to FDI [b]	2	-	1	2	6	16	16	9	9	3	14	12	24

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

The third generation of investment promotion policies takes the enabling framework for FDI and a pro-active approach towards attracting FDI as a starting point. It then proceeds to target foreign investors at the level of industries and firms to meet their specific locational needs at the activity and cluster level, in light of a country's developmental priorities. Such a strategy, in turn, is greatly helped if a country can nurture specific clusters that build on the country's competitive advantages, capitalize on the natural inclination of firms to agglomerate and that eventually acquire a brand name. A critical element of such investment promotion is to improve – and market – particular locations to potential investors in specific activities. Of course, a country's general economic, political and regulatory features also matter, because they affect the efficiency of the clusters within it. But the key to success of such new investment promotion strategies is that they actually address one of the basic economic FDI determinants while understanding the changing location strategies of TNCs.

At the bilateral and regional level, in 2003, 86 bilateral investment treaties (BITs) and 60 double taxation treaties (DTTs) were concluded, bringing the totals to 2,265 and 2,316, respectively (figure 6). However, the annual number of new treaties concluded has been declining, since 2002 in the case of BITs and since 2000 in the case of DTTs. This decline could partly be attributed to the rapid recent increase in the number of bilateral and regional FTAs, which include significant provisions on investment. These provisions in most cases cover investment liberalisation, facilitation, promotion and protection. More countries are taking steps to further improve their competitiveness in attracting FDI through introducing favourable national policy measures in 2004. More bilateral FTAs and regional FTAs have been initiated and negotiated in 2004.

Figure 6. Number of BITs and DTTs concluded, cumulative and year to year, 1990-2003



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The global landscape of FDI flows is changing. Competition for FDI is growing stronger with more countries competing, and more introduced favourable national policy changes. Economies with strong growth and improved regulatory framework are attracting high levels of flows. Thus good policies can make a major difference. There are, for example, dangers that TNCs may crowd out domestic competitors and undermine new domestic ventures as they enter developing countries. Sound regulatory frameworks are vital. No less important is the existence of appropriate government institutions for FDI policy administration, coordination and problem solution.