

United Nations Conference on Trade and Development

World Investment Report 2002

**Transnational Corporations and
Export Competitiveness**

Overview



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Note

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The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

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Reference to "dollars" (\$) means United States dollars, unless otherwise indicated;

Annual rates of growth or change, unless otherwise stated, refer to annual compound rates;

Details and percentages in tables do not necessarily add to totals because of rounding.

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UNCTAD/WIR/2002 (Overview)

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World Investment Report 2002: Transnational Corporations and Export Competitiveness

Overview

TRENDS IN INTERNATIONAL PRODUCTION

The role of TNCs in the globalizing world economy is increasing,...

International production continues to grow, as transnational corporations (TNCs) expand their role in the globalizing world economy. Recent estimates suggest there are about 65,000 TNCs today, with about 850,000 foreign affiliates across the globe. Their economic impact can be measured in different ways. In 2001, foreign affiliates accounted for about 54 million employees, compared to 24 million in 1990; their sales of almost \$19 trillion were more than twice as high as world exports in 2001, compared to 1990 when both were roughly equal; and the stock of outward foreign direct investment (FDI), increased from \$1.7 trillion to \$6.6 trillion over the same period (table 1). Foreign affiliates now account for one-tenth of world GDP and one-third of world exports. Moreover, if the value of worldwide TNC activities associated with non-equity relationships (e.g. international subcontracting, licensing, contract manufacturers) is considered, TNCs would account for even larger shares in these global aggregates.

The world's largest TNCs dominate this picture. For example, in 2000, the top 100 non-financial TNCs (with Vodafone Group, General Electric and ExxonMobil Corporation in the lead) accounted for more than half of the total sales and employment of foreign affiliates (see table 2 for the top 25 of these firms). Mainly as a result of major mergers

Table 1. Selected indicators of FDI and international production, 1982-2001
(Billions of dollars and percentage)

Item	Value at current prices (Billions of dollars)			Annual growth rate (Per cent)					
	1982	1990	2001	1986-1990	1991-1995	1996-2000	1999	2000	2001
FDI inflows	59	203	735	23.6	20.0	40.1	56.3	37.1	-50.7
FDI outflows	28	233	621	24.3	15.8	36.7	52.3	32.4	-55.0
FDI inward stock	734	1 874	6 846	15.6	9.1	17.9	20.0	22.2	9.4
FDI outward stock	552	1 721	6 582	19.8	10.4	17.8	17.4	25.1	7.6
Cross-border M&As ^a	..	151	601	26.4 ^b	23.3	49.8	44.1	49.3	-47.5
Sales of foreign affiliates	2 541	5 479	18 517 ^c	16.9	10.5	14.5	34.1	15.1 ^c	9.2 ^c
Gross product of foreign affiliates	594	1 423	3 495 ^d	18.8	6.7	12.9	15.2	32.9 ^d	8.3 ^d
Total assets of foreign affiliates	1 959	5 759	24 952 ^e	19.8	13.4	19.0	21.4	24.7 ^e	9.9 ^e
Exports of foreign affiliates	670	1 169	2 600 ^f	14.9	7.4	9.7	1.9	11.7 ^f	0.3 ^f
Employment of foreign affiliates (thousands)	17 987	23 858	53 581 ^g	6.8	5.1	11.7	20.6	10.2 ^g	7.1 ^g
GDP (in current prices)	10 805	21 672	31 900	11.5	6.5	1.2	3.5	2.5	2.0
Gross fixed capital formation	2 285	4 841	6 680 ^h	13.9	5.0	1.3	4.0	3.3	..
Receipts from royalties and licence fees	9	27	73 ^h	22.1	14.3	5.3	5.4	5.5	..
Export of goods and non-factor services	2 081	4 375	7 430 ⁱ	15.8	8.7	4.2	3.4	11.7	-5.4

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, table I.1.

^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 of dollars) for the period 1982-1999: Sales=323+2.6577*FDI inward stock.

^d Based on the following regression result of gross product against FDI inward stock (in millions of dollars) for the period 1982-1999: Gross product=364+0.4573*FDI inward stock.

^e Based on the following regression result of assets against FDI inward stock (in millions of dollars) for the period 1982-1999: Assets=-1 153+3.8134*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: Export=254+0.474*FDI inward stock. For 1999-2001, the share of exports of foreign affiliates in world exports in 1998 (34 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 of dollars) for the period 1982-1999: Employment=12 138+6.0539*FDI inward stock.

^h Data are for 2000.

ⁱ WTO estimates.

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

Table 2. The world's top 25 non-financial TNCs, ranked by foreign assets, 2000
(Millions of dollars and number of employees)

Ranking in 2000 by: Foreign assets	Ranking in 1999 by: Foreign assets	Ranking in 1999 by: TNI ^a	Corporation	Home economy	Industry ^b	Assets		Sales		Employment		TNI ^a (Per cent)
						Foreign	Total	Foreign ^c	Total	Foreign	Total	
1	15	-	Vodafone	United Kingdom	Telecommunications	221 238	222 326	7 419	11 747	24 000	29 465	81
2	73	1	General Electric	United States	Electrical & electronic equip.	159 188	437 006	49 528	129 853	145 000	313 000	40
3	30	2	ExxonMobil	United States	Petroleum expl./ref./distr.	101 728	149 000	143 044	206 083	64 000	97 900	68
4	42	47	Vivendi Universal	France	Diversified	93 260	141 935	19 420	39 357	210 084	327 380	60
5	84	4	General Motors	United States	Motor vehicles	75 150	303 100	48 233	184 632	165 300	386 000	31
6	46	3	Royal Dutch/Shell	United Kingdom	Petroleum expl./ref./distr.	74 807	122 498	81 086	149 146	54 337	95 365	57
7	24	10	BP	United Kingdom	Petroleum expl./ref./distr.	57 451	75 173	105 626	148 062	88 300	107 200	77
8	80	6	Toyota Motor	Japan	Motor vehicles	55 974	154 091	62 245	125 575	..	210 709	35
9	55	30	Telefónica	Spain	Telecommunications	55 968	87 084	12 929	26 278	71 292	148 707	54
10	47	50	Fiat	Italy	Motor vehicles	52 803	95 755	35 854	53 554	112 224	223 953	57
11	57	9	IBM	United States	Electrical & electronic equip.	43 139	88 349	51 180	88 396	170 000	316 303	53
12	44	12	Volkswagen	Germany	Motor vehicles	42 725	75 922	57 787	79 609	160 274	324 402	59
13	64	-	ChevronTexaco	United States	Petroleum expl./ref./distr.	42 576	77 621	65 016	117 095	21 693	69 265	47
14	52	-	Hutchison Whampoa	Hong Kong, China	Diversified	41 881	56 610	2 840	7 311	27 165	49 570	56
15	23	19	Suez	France	Electricity, gas and water	38 521	43 460	24 145	32 211	117 280	173 200	77
16	93	7	DaimlerChrysler	Germany	Motor vehicles	..	187 087	48 717	152 446	83 464	416 501	24
17	11	31	News Corporation	United States	Media	36 108	39 279	12 777	14 151	24 500	33 800	85
18	4	11	Nestlé	Switzerland	Food & beverages	35 289	39 954	48 928	49 648	218 112	224 541	95
19	62	-	TotalFinaElf	France	Petroleum expl./ref./distr.	33 119	81 700	82 534	105 828	30 020	123 303	48
20	87	16	Repsol YPF	Spain	Petroleum expl./ref./distr.	31 944	487 763	15 891	42 563	16 455	37 387	29
21	51	20	BMW	Germany	Motor vehicles	31 184	45 910	26 147	34 639	23 759	93 624	56
22	48	22	Sony	Japan	Electrical & electronic equip.	30 214	68 129	42 768	63 664	109 080	181 800	57
23	77	-	E.On	Germany	Electricity, gas and water	..	114 951	41 843	86 882	83 338	186 788	39
24	3	21	ABB	Switzerland	Machinery and equip.	28 619	30 962	22 528	22 967	151 340	160 818	95
25	10	33	Philips Electronics	Netherlands	Electrical & electronic equip.	27 885	35 885	33 308	34 870	184 200	219 429	86

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, table IV.1.

^a The transnationality index (TNI) is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

^b Industry classification for companies follows the United States Standard Industrial Classification.

^c In a number of cases companies reported only total foreign sales without distinguishing between exports from the parent company and sales of their foreign affiliates. Some foreign sales figures might therefore also include parent company exports.

.. Data on foreign assets, foreign sales and foreign employment were not available. In case of non-availability, they are estimated using secondary sources of information or on the basis of the ratios of foreign to total assets, foreign to total sales and foreign to total employment.

Note: In some companies, foreign investors may hold a minority share of more than 10 per cent.

and acquisitions (M&As) in 2000, the foreign assets of the 100 largest TNCs increased by 20 per cent in 2000, their foreign employment by 19 per cent and their sales by 15 per cent. M&As also affected industrial composition, resulting in an increase in the number of telecom and media companies on the list. All this, of course, represents only a snapshot of the situation just before the global economic slowdown took hold, the euphoria about new technology firms and the stock market at large evaporated, and the problem of auditing irregularities in a number of TNCs emerged.

For the first time since UNCTAD started collecting data on the largest TNCs, a record five firms headquartered in developing economies – Hutchinson Whampoa (Hong Kong, China); Petronas (Malaysia); Cemex (Mexico); Petróleos de Venezuela (Venezuela); and LG Electronics (Republic of Korea) – made it to the top 100 list for 2000. These are also the companies that have mainly driven the continued transnationalization of the top 50 companies from developing countries (see table 3 for the top 25 of these firms). These top 50 were less affected by stock market rallies and the cross-border M&A wave. Consequently, their overall foreign assets, sales and employment expanded more modestly, as is evident if the top five companies are excluded from the list.

Data for the top 25 TNCs in Central and Eastern Europe (CEE) confirm that Russian TNCs are larger and more globally spread than other TNCs from this region (see table 4 for the top 15 of these firms). Lukoil, for example, with foreign assets of more than \$4 billion, is on par with some of the largest TNCs from developing countries. In 2000, most of these top 25 TNCs continued to grow, with their expansion abroad surpassing that of their operations at home. However, not all top TNCs in the region are on a growth path. Some Czech, Slovak and Polish firms are undergoing major restructuring, which often involves withdrawing from foreign activities.

The expansion of international production is driven by a combination of factors that play out differently for different industries and for different countries. Three forces are the main drivers. The first is policy liberalization: opening up national markets

Table 3. The top 25 non-financial TNCs from developing economies, ranked by foreign assets, 2000
(Millions of dollars and number of employees)

Ranking by		Corporation	Home economy	Industry ^b	Assets		Sales		Employment		TNI ^a (Per cent)
Foreign assets	TNI ^a				Foreign	Total	Foreign ^c	Total	Foreign	Total	
1	11	Hutchison Whampoa	Hong Kong, China	Diversified	41 881	56 610	2 840	7 311	27 165	49 570	50
2	8	Cemex	Mexico	Non-metallic mineral products	10 887	15 759	3 028	5 621	15 448	25 884	55
3	15	LG Electronics	Korea, Republic of	Electrical & electronic equip.	8 750	17 709	9 331	18 558	20 072	46 912	43
4	20	Petróleos de Venezuela	Venezuela	Petroleum expl./ref./distr.	8 017	57 089	49 780	53 234	5 458	46 920	36
5	27	Petronas	Malaysia	Petroleum expl./ref./distr.	7 690	36 594	11 790	19 305	3 808	23 450	30
6	43	New World Development	Hong Kong, China	Diversified	4 578	16 412	565	2 633	800	23 530	16
7	39	Samsung Corporation	Korea, Republic of	Diversified/trade	3 900	10 400	8 300	40 700	175	4 740	18
8	21	Samsung Electronics	Korea, Republic of	Electrical & electronic equip.	3 898	25 085	23 055	31 562	16 981	60 977	35
9	4	Neptune Orient Lines	Singapore	Transport and storage	3 812	4 360	4 498	4 673	6 840	8 734	79
10	29	Companhia Vale Do Rio Doce	Brazil	Mining & quarrying	3 660	10 269	758	4 904	6 285	17 634	29
11	7	Sappi	South Africa	Paper	3 239	4 768	3 601	4 718	9 399	19 276	58
12	26	COFCO	China	Food & beverages	2 867	4 543	4 767	12 517	350	26 000	31
13	1	Guangdong Investment	Hong Kong, China	Diversified	2 852	4 605	460	634	6 837	7 875	88
14	19	China National Chemicals, Imp. & Exp.	China	Chemicals	2 603	4 701	10 755	18 036	600	8 600	37
15	47	Hyundai Motor	Korea, Republic of	Motor vehicles	2 488	25 393	4 412	25 814	6 532	84 925	10
16	42	Keppel	Singapore	Diversified	2 293	22 180	338	3 657	5 910	16 389	17
17	2	First Pacific	Hong Kong, China	Electrical & electronic equip.	2 116	2 322	652	809	8 511	8 560	81
18	13	Citic Pacific	Hong Kong, China	Construction	2 076	4 022	981	2 058	7 118	11 354	49
19	34	Grupo Carso	Mexico	Diversified	2 043	8 827	4 000	9 315	19 542	89 954	26
20	24	South African Breweries	South Africa	Food & beverages	1 966	4 384	1 454	5 424	15 763	48 079	31
21	3	Orient Overseas International	Hong Kong, China	Transport and storage	1 819	2 155	2 382	2 395	3 792	4 414	81
22	46	Singtel	Singapore	Telecommunications	1 790	8 143	..	2 845	2 500	12 640	13
23	45	Posco	Korea, Republic of	Metal and metal products	1 777	15 901	2 311	10 873	2 741	26 261	13
24	30	San Miguel	Philippines	Food & beverages	1 738	3 061	300	1 861	3 091	14 864	28
25	17	Jardine Matheson	Hong Kong, China	Diversified	1 641	10 339	7 148	10 354	50 000	130 000	37

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, table IV.10.

^a The transnationality index (TNI) is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

^b Industry classification for companies follows the United States Standard Industrial Classification.

^c In a number of cases companies reported only total foreign sales without distinguishing between export from the parent company and sales of their foreign affiliates. Some foreign sales figures might therefore also include parent company exports.

.. Data on foreign assets, foreign sales and foreign employment were not available. In case of non-availability, they are estimated using secondary sources of information

or on the basis of the ratios of foreign to total assets, foreign to total sales and foreign to total employment.

Note: In some companies, foreign investors may hold a minority share of more than 10 per cent.

Table 4. The top 15 non-financial TNCs based in Central and Eastern Europe,^a ranked by foreign assets, 2000
(Millions of dollars and number of employees)

Ranking by		Corporation	Country	Industry	Assets		Sales		Employment		TNI ^b (Per cent)
Foreign assets	TNI ^b				Foreign	Total	Foreign	Total	Foreign	Total	
1	11	Lukoil Oil	Russian Federation	Petroleum and natural gas	4 189.0	12 008.0	7 778.0 ^d	14 436.0	20 000	130 000	35
2	6	Novoship	Russian Federation	Transport	963.8	1 107.0	271.5	372.0	88	7 406	54
3	1	Latvian Shipping ^c	Latvia	Transport	459.0	470.0	191.0	191.0	1 124	1 748	87
4	5	Primorsk Shipping	Russian Federation	Transport	256.4	444.1	85.3	116.5	1 308	2 777	59
5	24	Hrvatska Elektroprivreda	Croatia	Energy	296.0	2'524.0	10.0	780.0	..	15 877	4
6	7	Gorenje Group	Slovenia	Domestic appliances	236.3	420.8	465.5	615.5	590	6 691	47
7	10	Far Eastern Shipping	Russian Federation	Transport	236.0	585.0	134.0	183.0	263	8 873	39
8	13	Podravka Group	Croatia	Food & beverages/ pharmaceuticals	.. ^e	440.1	139.8	316.5	516	6 827	32
9	9	Pliva Group	Croatia	Pharmaceuticals	181.9	915.9	384.7	587.6	2 645	7 857	40
10	3	Atlantska Plovidba ^c	Croatia	Transport	138.0	154.0	46.0 ^d	46.0	..	509	63
11	8	Krka	Slovenia	Pharmaceuticals	129.2	462.4	212.0	273.0	483	3 322	40
12	20	MOL Hungarian Oil and Gas	Hungary	Petroleum and natural gas	102.7	3 281.6	758.8	3 632.2	870	18 016	10
13	14	Tiszai Vegyi Kombinát Rt.	Hungary	Chemicals	101.2	481.8	272.9	537.8	208	4 548	25
14	2	Adria Airways ^c	Slovenia	Transport	116.3	129.2	103.4	104.6	19	597	64
15	19	Petrol Group	Slovenia	Petroleum and natural gas	98.8	536.1	129.0 ^d	1 187.9	49	1 943	11

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, table IV.17.

^a Based on survey responses.

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

^c 1999 data.

^d Including export sales by the parent firm.

^e Data not revealed by the firm; estimates have been made using secondary sources of information.

.. Data on foreign assets, foreign sales and foreign employment were not available. In case of non-availability, they are estimated using secondary sources of information

or on the basis of the ratios of foreign to total assets, foreign to total sales and foreign to total employment.

Note: In some companies, foreign investors may hold a minority share of more than 10 per cent.

and allowing all kinds of FDI and non-equity arrangements. In 2001, 208 changes in FDI laws were made by 71 countries (table 5). More than 90 per cent aimed at making the investment climate more favourable to inward FDI. In addition, last year, as many as 97 countries were involved in the conclusion of 158 bilateral investment treaties, bringing the total of such treaties to 2,099 by the end of 2001. Similarly, 67 new double taxation treaties, were concluded. Moreover, the investment issue figured prominently at the Fourth WTO Ministerial Conference in Doha, Qatar, in November 2001. Part of the follow-up work involves a substantial effort to help developing countries evaluate better the implications of closer multilateral cooperation in the investment area for their development process.

The second force is rapid technological change, with its rising costs and risks, which makes it imperative for firms to tap world markets and to share these costs and risks. On the other hand, falling transport and communication costs – the “death” of distance – have made it economical to integrate distant operations and ship products and components across the globe in the search for efficiency. This is contributing, in particular, to efficiency-seeking FDI, with important implications for the export competitiveness of countries.

The third force, a result of the previous two, is increasing competition. Heightened competition compels firms to explore new ways of increasing their efficiency, including by extending their international reach to new markets at an early stage and by shifting certain production activities to reduce costs. It also results in international production taking new forms, with new ownership and contractual arrangements, and new activities being located in new sites abroad.

...although FDI flows declined sharply in 2001 as a result of the economic slowdown,...

These driving forces are long-term in nature. The investment behaviour of firms is also strongly influenced by short-term changes in business cycles, testified by recent trends in FDI. After the record high levels of 2000, global flows declined sharply in 2001 – for the first time in a decade (figure 1). This was mainly the result of the weakening of the global economy, notably in the world’s three largest economies which all fell into recession, and a consequent drop in the value of cross-border M&As. The total value of cross-border M&As completed in 2001 (\$594 billion) was only half that in 2000. The number of cross-border M&As also declined, from more than 7,800 in 2000 to some 6,000 in 2001. The number of cross-border deals worth over \$1 billion fell from 175 to 113, their total value falling from \$866 billion to \$378 billion.

Table 5. National regulatory changes, 1991-2001

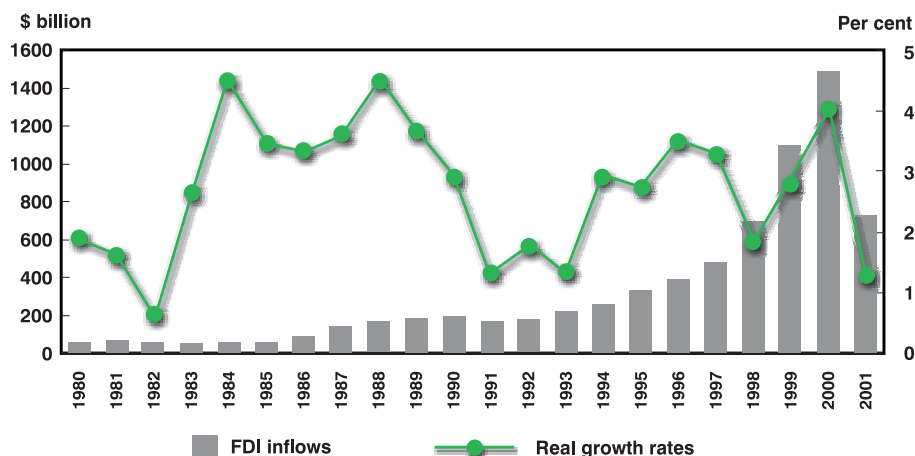
Item	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76	60	63	69	71
Number of regulatory changes	82	79	102	110	112	114	151	145	140	150	208
of which:											
-more favourable to FDI ^a	80	79	101	108	106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

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, box table I.2.1.

^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.

Figure 1. FDI inflows and real growth rates of GDP in the world, 1980-2001
(Billions of dollars and percentage)



Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, figure I.1.

As a result, the decline in FDI was mainly concentrated in developed economies, in which FDI inflows shrank by 59 per cent, compared to 14 per cent in developing economies. Inflows to Central and Eastern Europe as a whole remained stable. World inflows of FDI amounted to \$735 billion, of which \$503 billion went to developed economies, \$205 billion to developing economies and the remaining \$27 billion to the transition economies of CEE. The shares of developing countries and those of CEE in global FDI inflows reached 28 per cent and 4 per cent respectively in 2001, compared to an average of 18 per cent and 2 per cent in the preceding two years. The 49 LDCs remain marginal recipients, with only 2 per cent of all FDI to developing countries or 0.5 per cent of the global total.

The economic slowdown has intensified competitive pressures, accentuating the need to search for lower-cost locations. This may result in increased FDI in activities that benefit from relocation to, or expansion in, low-wage economies. Outflows may also rise from countries in which domestic markets were growing slower than foreign markets. There are signs that both factors have contributed to the recent increase in Japanese FDI to China and the growth of flows to CEE.

Meanwhile, flows to the developing world and to CEE remain unevenly distributed. In 2001, the five largest recipients attracted 62 per cent of the total inflows to developing countries, while the corresponding figure for CEE was 74 per cent. Among the top 10 country gainers in terms of absolute increases, eight were developing countries, led by Mexico, China and South Africa. Conversely, among the 10 countries experiencing the steepest declines in FDI inflows, eight were developed countries; Belgium and Luxembourg, the United States and Germany reported the sharpest declines.

It could be argued that 2001 saw a return of FDI to “normal” levels after the hectic M&A activity of the previous two years. In developing countries and economies in transition, FDI proved fairly resilient despite the global economic downturn and the tragic events of September 11. This resilience is more pronounced in comparison to inflows of portfolio investment and bank lending. On a net basis (inflows less outflows), FDI flows were the only positive component of private capital flows to developing countries and transition economies during 2000-2001. The total of net private capital flows was projected to be a low of \$31 billion in 2001.

Despite the dampening impact of weak demand in the largest economies, the longer-term prospects for FDI remain promising. A number of surveys of investment plans suggest that major TNCs are likely to continue their international expansion. More

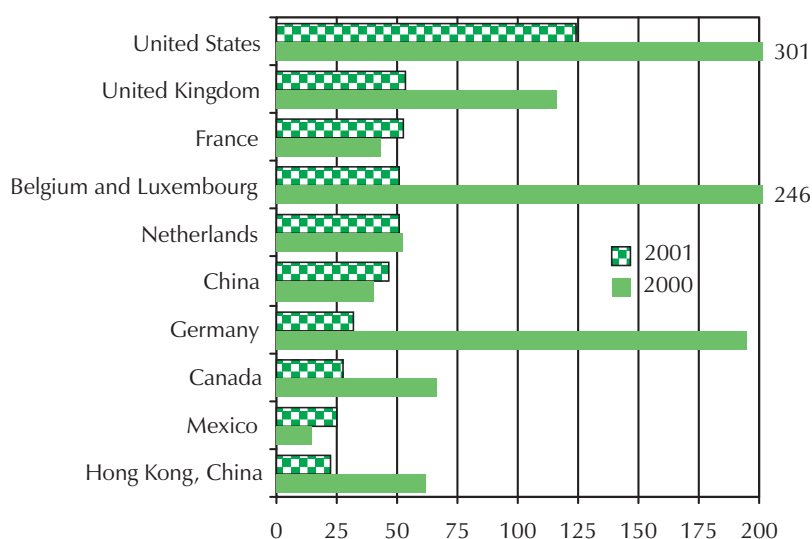
specifically, they suggest that the most preferred destinations will include large developed-country markets (such as the United States, Germany, the United Kingdom and France), as well as a number of key destinations in developing countries (especially China, Brazil, Mexico and South Africa) and in CEE (e.g. Poland, Hungary and the Czech Republic). Interestingly, many of these developing countries and economies in transition have been especially successful in attracting export-oriented FDI.

...with major regional differences,...

Recent developments in FDI vary significantly between different regions. As already mentioned, the slowdown in FDI activity in 2001 was mainly related to developed countries. Both outflows and inflows of FDI fell sharply in these countries, by more than half, to \$581 billion and \$503 billion, respectively, after reaching a peak in 2000. The United States, despite the economic slowdown and the events of September 11, retained its position as the largest FDI recipient, but inflows more than halved, down to \$124 billion (figure 2). The country regained its position as the world's largest investor, although outflows of \$114 billion reflected a decline of 30 per cent (figure 3). Major partners for inward and outward FDI were again the European Union (EU) countries; nevertheless, the importance of the North American Free Trade Agreement (NAFTA) partners as a destination for United States FDI increased, partly due to the acquisition of Banamex (Mexico) by Citigroup. Regarding inward FDI, cross-border M&As continued to be the primary mode of entry, led by the acquisition of VoiceStream Wireless Corp. by Deutsche Telekom for \$29.4 billion, the largest cross-border M&A deal worldwide in 2001.

Inflows and outflows to and from the European Union in 2001 dropped by about 60 per cent to \$323 billion and \$365 billion, respectively. This was mainly due to a decline in M&A-related FDI. Inflows to the United Kingdom (the main recipient in Western Europe) and Germany (figure 2) declined the most, while those to France, Greece and Italy increased. Declines in outward FDI were even greater, the only exceptions being Ireland, Italy and Portugal. As in previous years, outflows comprised mainly cross-border M&As. France became the largest outward investor of the region, followed by Belgium and Luxembourg (figure 3). Intraregional flows accounted for an increased share of FDI in the EU.

Figure 2. World FDI inflows, top 10 economies, 2000 and 2001^a
(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

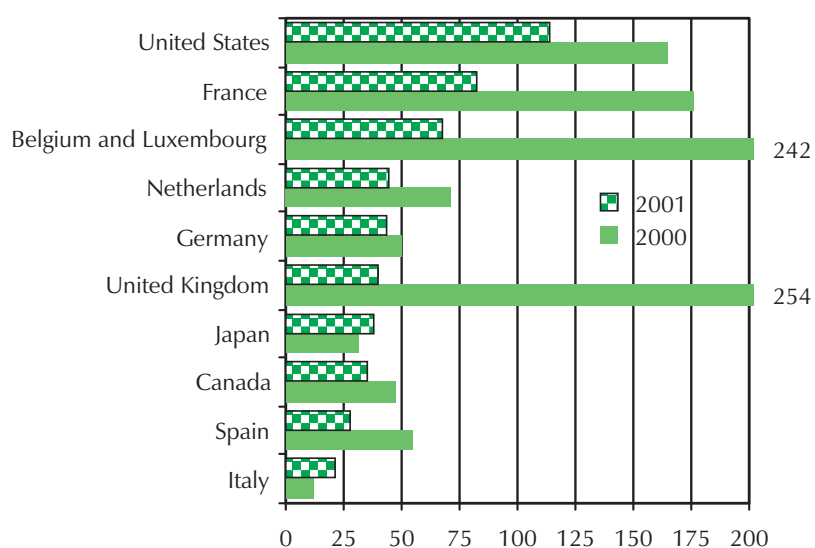
^a Ranked on the basis of the magnitude of FDI inflows in 2001.

Countries of other Western Europe experienced similar developments, with Switzerland accounting for 75 per cent of FDI to these countries. Among other developed countries, FDI outflows from Japan grew in 2001, while domestic investment as well as inward FDI declined, mainly due to the prolonged economic recession in that country. FDI flows to and from Australia and New Zealand, countries that have closer economic ties to the Asia-Pacific region, were less affected by developments in the United States than was Canada, where inflows fell by 60 per cent.

FDI inflows to developing countries also fell, from \$238 billion in 2000 to \$205 billion in 2001. However, the bulk of this decline was limited to a relatively small number of host countries. In particular, three economies – Argentina, Brazil and Hong Kong, China – saw a decline in FDI inflows amounting to as much as \$57 billion. Africa remains a marginal recipient of FDI, even though FDI inflows rose from \$9 billion in 2000 to more than \$17 billion in 2001. At first sight this increase looks impressive, but it masks the fact that for most African countries FDI flows remained at more or less the same level as in 2000. The increase by \$8 billion was largely due to a few large FDI projects, notably in South Africa and Morocco, and the way they are reflected in FDI statistics. However, although the continent received only 2 per cent of global FDI inflows, relative to its economic size, the amount of FDI to Africa did not differ much from that to other developing regions. Also, the overall pattern hides some dynamic developments at the country level, including least developed countries (LDCs) such as Uganda. Furthermore, there are indications that certain policy initiatives, notably the African Growth and Opportunity Act (AGOA), of the United States, have contributed to increased FDI in some countries that benefit from improved market access.

Recent figures also show that the sectoral composition of FDI inflows into the African continent is changing. While more than half of FDI flows went into the primary sector, particularly into oil and petroleum, FDI flows into service industries (such as banking and finance, and transport) have become almost as important over the past two years. This suggests a gradual broadening of investment opportunities over time, albeit at a slow pace.

Figure 3. World FDI outflows, top 10 economies, 2000 and 2001^a
(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

^a Ranked on the basis of the magnitude of FDI outflows in 2001.

FDI inflows to the developing countries of Asia and the Pacific fell from \$134 billion in 2000 to \$102 billion in 2001. Much of the decline was due to an over 60 per cent drop in flows to Hong Kong, China from a record level of \$62 billion in 2000 (figure 2). Hence, excluding Hong Kong, China, inflows in 2001 reached the same level as in the peak years of the 1990s. While inflows remained stagnant in North-East and South-East Asia, they increased significantly in South and Central Asia (by 32 per cent and 88 per cent, respectively). The share of the Asia-Pacific region in world inflows rose from 9 per cent in 2000 to nearly 14 per cent in 2001. Within these overall trends, economies performed unevenly in 2001. China regained its position – lost to Hong Kong, China in 2000 – as the largest FDI recipient in the region as well as in the developing world as a whole. India, Kazakhstan, Singapore and Turkey were significant recipients in their respective subregions. The Association of South-East Asian Nations (ASEAN) saw a fall in FDI levels in recent years, causing some concern among its member States: FDI inflows to this region during 2000-2001 were only \$12 billion per annum, which corresponds to only about one-third of the peak in 1996-1997. Outward FDI from developing Asia, at about \$32 billion in 2001, hit its lowest level since the mid-1990s, mainly because of a fall in outflows from the largest traditional investor, Hong Kong, China. Chinese TNCs are becoming more visible in world markets.

FDI into Latin America and the Caribbean declined for the second consecutive year, mainly because of a significant drop in FDI to Brazil, where the privatization process of the past few years has almost stopped, and Argentina, where the economic and financial crisis has discouraged any new investments. Meanwhile, Mexico became the largest regional recipient with the acquisition of the bank Banamex by Citicorp (United States) for \$12.5 billion. Outflows from Latin American economies remained modest and mainly directed at other countries in the region.

FDI in the 49 LDCs was small in absolute terms, but it continued to make a contribution to local capital formation, as shown by the high share of FDI in gross domestic capital formation in a number of those countries. As a percentage of total investment, it averaged 7 per cent for LDCs as a group during 1998-2000, compared to 13 per cent for all other developing countries. However, FDI flows to LDCs are highly concentrated, though the share of the top five recipients is lower now than it was in the late 1980s. More than 90 per cent of these flows were through greenfield investments rather than cross-border M&As. In 2001, despite the general economic slowdown, FDI in LDCs rose to \$3.8 billion, mainly as a result of increased flows to Angola. Official development assistance (ODA) remains the largest component of external financial flows to LDCs, even though it declined in absolute and relative terms between 1995 and 2000. LDCs as a whole received \$12.5 billion in bilateral and multilateral ODA in net terms in 2000, compared to \$16.8 billion in 1990. For bilateral ODA, the amounts declined from \$9.9 billion to \$7.7 billion during this period. FDI, on the other hand, has become more prominent: 28 LDCs experienced simultaneous increases in FDI and decreases in bilateral ODA during the 1990s. But only in seven LDCs (Angola, Equatorial Guinea, the Gambia, Lesotho, Myanmar, the Sudan and Togo), did FDI inflows exceed bilateral ODA in 2000, and three of them are major oil exporters. Since most LDCs rely on ODA as their major source of finance, and ODA and FDI are not substitutes for each other, this decline in ODA is worrying.

LDCs themselves have begun to promote their countries more actively to foreign investors. Investment promotion agencies have been established in 38 LDCs, 28 of which have joined the World Association of Investment Promotion Agencies. Moreover, at the end of 2001, 41 LDCs had concluded a total of 292 bilateral investment treaties and 138 double taxation treaties. Finally, a growing number of LDCs are now signatories to relevant multilateral agreements. For example, as of June 2002, 20 LDCs had acceded to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards; 37 LDCs had ratified or signed the Convention on the Settlement of Investment Disputes between States and Nationals of other States; 34 LDCs were members (another six in

the process of becoming members) of the Multilateral Investment Guarantee Agency; and 30 LDCs were members of the World Trade Organization.

FDI inflows to (\$27 billion) and outflows from (\$4 billion) CEE remained at levels comparable to those of 2000. FDI inflows increased in 14 of the region's 19 countries, and the region's share of world FDI inflows rose from 2 per cent in 2000 to 3.7 per cent in 2001. Five countries (Poland, the Czech Republic, the Russian Federation, Hungary and Slovakia) accounted for more than three-quarters of the region's inflows in 2001. FDI outflows from CEE declined somewhat in 2001, due to a slowdown in flows from the Russian Federation, which accounts for three-quarters of the outward FDI from the region.

...as well as national differences, as revealed in two UNCTAD indices developed for benchmarking inward FDI performance and potential.

While the role of TNC activity is increasing in most parts of the world, there are notable differences by country. Benchmarking the performance and potential of individual economies in attracting FDI, as measured by UNCTAD's Inward FDI Performance Index and Inward FDI Potential Index, respectively, can provide useful data to policy-makers and analysts on the relative performance of countries.

According to the Inward FDI Performance Index, which compares the ratio of a country's share in global FDI flows to its share in global GDP, an index value of one implies that a country's share of global FDI is equal to that country's share of world GDP. Countries with an index value higher than one attract more FDI than may be expected on the basis of the relative size of their GDP. On the basis of this measure, during the period 1998-2000, the developed world as a whole was more or less balanced in terms of the FDI it received, although the EU reported the highest score (1.7) and Japan the lowest (0.1). In terms of changes during the past decade, Africa experienced a fall in its score (from 0.8 during 1988-1990 to 0.5 during 1998-2000), while Latin America's improved significantly (from 0.9 to 1.4). East and South-East Asia had scores above one (1.7 during 1988-1990 and 1.2 during 1998-2000), while West and South Asia, by contrast, reported low scores over the past decade (0.1-0.2). CEE had a score close to one.

The country rankings for FDI performance yield interesting findings. The top 20 countries included 5 small developed countries, 12 developing economies and 3 from CEE. The 20 countries with the lowest scores were mainly developing countries, including several LDCs, but they also included some developed countries, such as Japan and Greece. The greatest gains in the Performance Index over the past decade were those for Angola, Panama, Nicaragua and Armenia, whereas the largest declines were recorded for Oman, Greece, Botswana and Sierra Leone.

UNCTAD's Inward FDI Potential Index ranks countries according to their potential for attracting FDI. This Index is based on structural factors that tend to change only slowly. As a result, the index values are fairly stable over time. The top 20 economies in 1998-2000 by this measure were developed countries or high-income developing economies, while the bottom 20 ranks were all held by developing countries.

The ranking of countries according to both the Performance and Potential Indices yields the following matrix (table 6):

- countries with high FDI performance (i.e. above the mid-point of the ranking by performance of all countries) and high potential (i.e. above the mid-point of the ranking by potential of all countries): the "front-runners";

Table 6. Country classification by FDI performance and FDI potential, 1998-2000

	High FDI performance	Low FDI performance
High FDI potential	<p>Front-runners</p> <p>Argentina, Bahamas, Bahrain, Belgium and Luxembourg, Bulgaria, Canada, Chile, Costa Rica, Croatia, Czech Republic, Denmark, Dominican Republic, El Salvador, Estonia, Finland, France, Germany, Guyana, Hong Kong (China), Hungary, Ireland, Israel, Latvia, Lithuania, Malaysia, Malta, Namibia, Netherlands, New Zealand, Norway, Panama, Peru, Poland, Portugal, Singapore, Slovakia, Spain, Sweden, Switzerland, Thailand, Trinidad and Tobago and the United Kingdom.</p>	<p>Below potential</p> <p>Australia, Austria, Belarus, Botswana, Brunei Darussalam, Cyprus, Egypt, Greece, Iceland, Islamic Republic of Iran, Italy, Japan, Jordan, Kuwait, Lebanon, Mexico, Oman, Qatar, the Republic of Korea, the Russian Federation, Saudi Arabia, Slovenia, Suriname, Syrian Arab Republic, Taiwan Province of China, United Arab Emirates, the United States and Uruguay.</p>
Low FDI potential	<p>Above potential</p> <p>Angola, Armenia, Azerbaijan, Bolivia, Brazil, China, Côte d'Ivoire, Ecuador, the Gambia, Georgia, Honduras, Jamaica, Kazakhstan, Kyrgyzstan, Malawi, Mozambique, Nicaragua, Papua New Guinea, the Republic of Moldova, Romania, the Sudan, TFYR Macedonia, Togo, Tunisia, Uganda, Venezuela, Viet Nam and Zambia.</p>	<p>Under-performers</p> <p>Albania, Algeria, Bangladesh, Benin, Burkina Faso, Cameroon, Colombia, Dem. Rep. of the Congo, Congo, Ethiopia, Gabon, Ghana, Guatemala, Guinea, Haiti, India, Indonesia, Kenya, Libyan Arab Jamahiriya, Madagascar, Mali, Mongolia, Morocco, Myanmar, Nepal, Niger, Nigeria, Pakistan, Paraguay, the Philippines, Rwanda, Senegal, Sierra Leone, South Africa, Sri Lanka, Tajikistan, Turkey, Ukraine, the United Republic of Tanzania, Uzbekistan, Yemen and Zimbabwe.</p>

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, table II.3.

- countries with high FDI performance (i.e. above the mid-point of the ranking by performance of all countries) and low potential (i.e. below the mid-point of the ranking by potential of all countries): the “above-potential economies”;
- countries with low FDI performance (i.e. below the mid-point of the ranking by performance of all countries) and high potential (i.e. above the mid-point of the ranking by potential of all countries): the “below-potential economies”; and
- countries with low FDI performance (i.e. below the mid-point of the ranking by performance of all countries) and low potential (i.e. below the mid-point of the ranking by potential of all countries): the “under-performers.”

In 1998-2000, there were 42 front-runners, i.e. countries that combined strong potential with strong performance. This group included industrialized countries such as France, Germany, Sweden, Switzerland and the United Kingdom; the Asian “tigers”, including newer ones, such as Hong Kong, China, Malaysia, Singapore and Thailand; and a number of Latin American countries, such as Argentina and Chile. It also included strong entrants to the FDI scene such as Costa Rica, Hungary, Ireland and Poland.

The above-potential economies comprised mainly those without strong structural capabilities that have done well in attracting FDI; most of them are relatively poor and lack a strong industrial base. Brazil and China are notable exceptions, which were nevertheless, also part of this group. The below-potential economies included many rich and relatively industrialized economies that have a weak FDI performance because of policy preferences and a tradition of low reliance on FDI (Italy, Japan, Republic of Korea and Taiwan Province of China, especially in the earlier period), unfavourable political and social factors or weak competitiveness (not captured by the variables used here). The United States fell within this category, along with some developing countries

that are relatively capital-abundant (e.g. Saudi Arabia) and in which FDI flows may not adequately reflect the extent of TNC participation because of non-equity forms or a reliance on local financing. The 42 under-performers were generally poor countries that, for economic or other reasons, did not attract their expected share of global FDI.

What policy implications emerge from this analysis? For front-runners wishing to remain important recipients of FDI, the issue is one of retaining their competitive edge in terms of FDI attraction. The under-performers may need to improve various aspects of their investment environment to upgrade their position in the Potential Index. Countries that move from under-performers to above-potential economies have to strive to build their competitive potential quickly to retain their edge in attracting investors. Similarly, for countries that retain high potential but slide in FDI attraction, there may be a need to address investor perceptions and undertake more targeted efforts to promote existing locational advantages.

TNCs AND EXPORT COMPETITIVENESS

Improving export competitiveness helps countries develop...

An important consideration for policy-makers when promoting development is to improve “export competitiveness”. While export competitiveness starts with increasing international market shares, it goes far beyond that. It involves diversifying the export basket, sustaining higher rates of export growth over time, upgrading the technological and skill content of export activity, and expanding the base of domestic firms able to compete internationally so that competitiveness becomes sustainable and is accompanied by rising incomes. Competitive exports allow countries to earn more foreign exchange, and so to import the products, services and technologies they need to raise productivity and living standards. Greater competitiveness also allows countries to diversify away from dependence on a few primary commodity exports and move up the skills and technology ladder, which is essential for increasing local value added and sustaining rising wages. It permits a greater realization of economies of scale and scope by offering larger and more diverse markets. Exporting feeds back into the capacities that underlie competitiveness: it exposes enterprises to higher standards, provides them with opportunities for easier access to information and subjects them to greater competitive pressures, thereby encouraging domestic enterprises to make more vigorous efforts to acquire new skills and capabilities. Ideally, attaining increased market shares should be accompanied by all these other benefits in order to maximize the developmental impact.

However, these developmental impacts from improved export competitiveness cannot be taken for granted. For example, if all economies aim at exporting the same products at the same time, most of them may well become worse off. Similarly, in the absence of adequate national policies to strengthen national capabilities and increase local value added, an expansion in market shares may not produce the expected benefits.

TNCs can help raise competitiveness in developing countries and economies in transition, but tapping their potential is not easy. Attracting export-oriented TNC activities is itself an intensely competitive business – and even successful countries may find it difficult to sustain competitiveness as their wages rise and market conditions change. Coherent and consistent policy support is essential to ensure that attracting export-oriented TNC activities is embedded in a broader national development strategy. Export competitiveness is important and challenging, but it needs to be seen as a means to an end – namely development.

...and the changing international production systems of TNCs can play a key role, ...

Through equity and non-equity links, TNCs account for substantial shares of exports in a number of developing countries, and their role spans all sectors. In the primary sector, besides minerals and petroleum, TNCs can contribute to the development of resource-based exports in such areas as food processing and horticulture. In manufacturing, TNCs tend to be the leaders in export-oriented production and marketing, especially for the most dynamic products, for which linking up to marketing and distribution networks is crucial. Their international production systems can take various forms, ranging from production-driven, FDI-based systems involving intra-firm trade among affiliates to looser, buyer-driven, non-equity-based networks of independent suppliers (as in international subcontracting and contract manufacturing). The increased tradability of services offers new opportunities for exports, the Indian software industry being the best-known example so far. Opportunities also extend to such services as regional headquarters, procurement centres, shared-services centres and R&D activities.

With the spread of global value chains in many low- and medium-technology activities, TNCs are now involved in the whole spectrum of manufactured exports. In some low-technology segments, other players are also active, and TNCs often assume the role of coordinating local producers in addition to setting up their own affiliates. In many technologically complex activities, TNCs are particularly important because a large proportion of trade is internal to their international production systems. Trade in parts and components, especially those of the dynamic industries, has assumed more importance, indicating an increasing trend towards trade specialization associated with international production systems. The most dynamic products in world trade are found mainly in non-resource-based manufactures, particularly electronics, automotive and apparel (table 7). TNCs have played an important role in the export expansion of these products, albeit in different ways. They can play a similar role in other products and industries, using similar strategies.

The growth of international production systems reflects the response of TNCs to dramatic changes in the global economic environment: technological change, policy liberalization and increased competition. Falling barriers to international transactions allow TNCs to locate different parts of their production processes, including various service functions, across the globe, to take advantage of fine differences in costs, resources, logistics and markets. They exhibit an unending search for enhanced competitive advantage through the optimal geographic configuration of their activities. What is distinct about the rise of international production systems as opposed to earlier TNC operations is, first, the intensity of integration both on a regional and a global scale and, second, the emphasis on the efficiency of the system as a whole. Global markets therefore increasingly involve competition between entire production systems, orchestrated by TNCs, rather than between individual factories or firms.

Three core elements of international production systems are critical in this context: governance, global value chains and geographic configuration. Governance concerns the structure of control that determines the geographic and functional distribution of business activities and ensures their coordination. Governance in international production systems occurs in various forms. These range from ownership (or equity) linkages that provide direct managerial supervision, to various non-equity linkages in which formally independent intermediaries – suppliers, producers and sales outlets – are linked through a variety of relationships such as franchising, licensing, subcontracting, marketing contracts, common technical standards or stable, trust-based business relationships. Equity-based governance systems internalize control and allow stronger protection of firm-specific advantages. Where these advantages lie in brand names and marketing, more externalized forms of control may suffice.

Table 7. Dynamic products in world exports, ranked by change in market share, 1985-2000
(Millions of dollars and percentage)

Rank	SITC code	Product	Market share			Value		Annual growth rate
			1985	2000	Increment	1985	2000	
1	7764	Electronic microcircuits	0.82	3.38	2.56	13 976	186 887	18.9
2	7599	Parts and accessories for data processing machines	1.02	2.33	1.30	17 446	128 882	14.3
3	7524	Digital central storage units, separately consigned	0.02	1.01	0.99	295	55 942	41.9
4	7643	Television, radio & related transmitters and receivers	0.11	0.91	0.81	1 811	50 614	24.9
5	5417	Medicaments	0.53	1.24	0.71	8 985	68 452	14.5
6	7649	Parts and accessories for telecom and recording apparatus	0.67	1.28	0.61	11 346	70 633	13.0
7	7641	Telephone and telegraphic apparatus	0.28	0.83	0.55	4 704	45 962	16.4
8	7523	Complete digital central processing units	0.30	0.74	0.44	5 160	40 845	14.8
9	7721	Electrical apparatus for making/breaking electrical circuits	0.64	1.05	0.41	10 919	58 297	11.8
10	7788	Other electrical machinery and equipment ^a	0.48	0.86	0.39	8 132	47 829	12.5
11	8942	Children's toys, indoor games	0.40	0.79	0.39	6 804	43 509	13.2
12	8939	Miscellaneous articles of chemicals	0.40	0.77	0.37	6 815	42 483	13.0
13	7924	Aircraft, mechanically propelled (other than helicopters)	0.44	0.78	0.34	7 496	43 222	12.4
14	7525	Peripheral units for data processing equipment	0.66	0.98	0.32	11 248	54 390	11.1
15	7712	Other electric power machinery and parts	0.17	0.49	0.32	2 829	26 929	16.2
16	7731	Insulated electric wire, cable, bars, strip and the like	0.29	0.60	0.30	5 012	33 062	13.4
17	5148	Other nitrogen-function compounds	0.15	0.45	0.30	2 578	25 009	16.4
18	8462	Under garments, knitted or crocheted, of cotton	0.16	0.44	0.28	2 714	24 145	15.7
19	7768	Piezo-electric crystals, parts of transistors and cathode valves	0.31	0.58	0.27	5 285	32 259	12.8
20	7522	Complete digital data processing machines	0.20	0.47	0.27	3 400	26 035	14.5
21	7810	Passenger motor cars	4.90	5.15	0.25	83 547	285 222	8.5
22	5839	Other polymerization and copolymerization products	0.16	0.40	0.24	2 736	22 087	14.9
23	8219	Other furniture and parts	0.32	0.55	0.22	5 495	30 281	12.1
24	7763	Diodes, transistors and similar semiconductor devices	0.22	0.42	0.20	3 735	23 025	12.9
25	7149	Parts of non-electrical engines and motors	0.28	0.46	0.19	4 712	25 648	12.0
26	8211	Chairs and other seats	0.26	0.43	0.18	4 366	24 006	12.0
27	8983	Gramophone records and other sound or similar recordings	0.33	0.50	0.17	5 609	27 880	11.3
28	8720	Medical instruments and appliances ^a	0.24	0.41	0.17	4 122	22 722	12.1
29	8451	Jerseys, pullovers, twin-sets, cardigans, jumpers etc.	0.39	0.54	0.15	6 594	29 987	10.6
30	8439	Other outer garments, women's, girls', infants', of textile fabrics	0.30	0.45	0.15	5 161	25 015	11.1
31	7284	Machinery and parts for specialized industries	0.68	0.82	0.14	11 618	45 617	9.6
32	7132	Internal combustion piston engines for road vehicles	0.45	0.58	0.14	7 599	32 368	10.1
33	5989	Chemical products and preparations ^a	0.45	0.58	0.13	7 603	31 865	10.0
34	7611	Television receivers, colour	0.27	0.40	0.13	4 589	21 955	11.0
35	5156	Heterocyclic compounds; nucleic acids	0.32	0.44	0.12	5 445	24 599	10.6
36	7849	Other parts and accessories of motor vehicles ^a	2.23	2.33	0.10	37 954	129 051	8.5
37	6672	Diamonds (except sorted industrial diamonds), unworked, cut	0.83	0.92	0.09	14 166	50 741	8.9
38	7139	Parts of internal combustion piston engines ^a	0.34	0.40	0.06	5 814	22 249	9.4
39	7492	Taps, cocks, valves etc. for pipes, boiler shells, tanks, vats	0.34	0.40	0.06	5 854	22 168	9.3
40	7929	Aircraft parts ^a (except tyres, engines, electrical parts)	0.49	0.53	0.04	8 334	29 475	8.8
		Total of above products	21.84	36.71	14.87	372 006	2 031 347	12.0

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, box table VI.1.1.

^a Not elsewhere specified.

Note: Those products that accounted for at least 0.33 per cent of total world trade in 2000, ranked according to their increase in market share between 1985 and 2000.

The second element of an international production system is the organization and distribution of production activities and other functions, in what is commonly known as the global value chain. It extends from technology development, through production, to distribution and marketing. Value chains are becoming fragmented, as business functions are differentiated into ever more specialized activities. In many industries, TNCs have recently tended to focus more on the knowledge-intensive, less tangible, functions of the value chain such as product definition, R&D, managerial services, and marketing and brand management. In consequence, contract manufacturers have grown rapidly.

The third element of international production systems, which holds particular interest for developing countries, is their geographic configuration. The past 15 years have seen great changes in the determinants of the optimal location of TNC activities, and hence in the geographic distribution of technology, production and marketing activities within international production systems. Production has been internationally dispersed for decades, but the trend towards integration on ever larger geographic scales is relatively new. Supply chains have extended to new areas of the globe and integrated formerly distinct regional production activities. However, while distance might matter less for many transactions (due to improved information and communication technology), proximity to main markets remains important for certain products.

Whereas the growth of international production systems is well recognized, less well known is the growing tendency for firms, even large TNCs, to specialize more narrowly and to contract out more and more functions to independent firms, spreading them internationally to take advantage of differences in costs and logistics. Some are even opting out of production altogether, leaving contract manufacturers to handle it while they focus on innovation and marketing. The main suppliers and contract manufacturers are themselves often large TNCs, with global “footprints” matching those of their principals, and with their own subcontractors and suppliers. However, TNCs also increasingly use national suppliers and contractors in host economies. Specialization does not stop there: leading TNCs are also entering into joint innovation arrangements with other firms – competitors, suppliers or buyers – and with institutions like research laboratories and universities. Thus, the emerging global production system is increasingly open in terms of ownership, but with tighter coordination by lead players in each international production system.

...providing opportunities as well as challenges for developing countries and economies in transition, ...

Changing corporate strategies and production systems open new possibilities for developing countries and economies in transition to enter technology-intensive and export-oriented activities they could not otherwise undertake, and to become a part of international production systems. At the same time, the increasing demands put on key suppliers raise the barriers to market entry for the smaller and newer suppliers from developing countries and economies in transition which do not possess the capabilities and competitive advantages that modern production systems require.

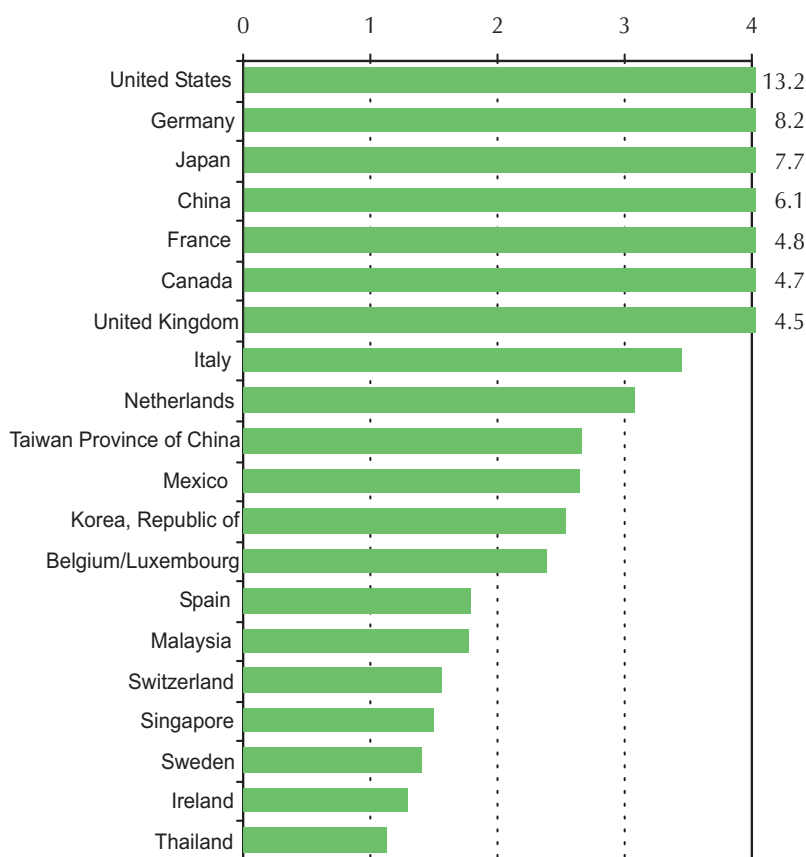
Improved export competitiveness can have significant consequences. In terms of market shares, only 20 economies together account for over three-quarters of the value of world trade (figure 4). Developed countries, especially Germany, Japan and the United States, are major traders. However, it is mainly developing economies, such as China, the Republic of Korea, Mexico, Malaysia, Thailand, Taiwan Province of China, Singapore, the Philippines, and economies in transition, such as the Hungary, that accounted for the largest gains in market share during 1985-2000 (figure 5). In fact, with their recent market-share gains, seven of these economies now belong to the 20 largest exporters in the world. In other words, dramatic changes are taking place in the composition of world trade, and a number of developing countries and economies in transition are among the principal beneficiaries.

The growth of exports from many of these winner countries is directly linked to the expansion of international production systems, especially in the electronics and automotive industries. For example, foreign affiliates now account for about half or more of exports of manufactures in a few of these countries (table 8). However, such systems tend to be concentrated by country, region and activity. It is possible that the export dynamism seen in the “winners” will spread to other developing countries and economies in transition as international production gathers pace and increases in scope, but to date the bulk of such TNC-related export activity – especially in the most dynamic segments of world trade – is concentrated in a handful of countries, mainly in East and South-East Asia and in regions contiguous to North America and the European Union. At the same time, though, TNCs are also significant players in many countries that are not major global exporters.

Each of the six countries selected for further analysis in *WIR02* – China, Costa Rica, Hungary, Ireland, Mexico and the Republic of Korea – experienced not only a sharp increase in market shares, but also a shift in their export repertoire: from non-dynamic to dynamic products and from low-technology to medium- and high-technology activities. Asian winner countries gained market shares in all principal markets (Japanese,

Figure 4. World export market shares, 2000

The 20 economies with the largest export market shares, 2000
(Percentage)



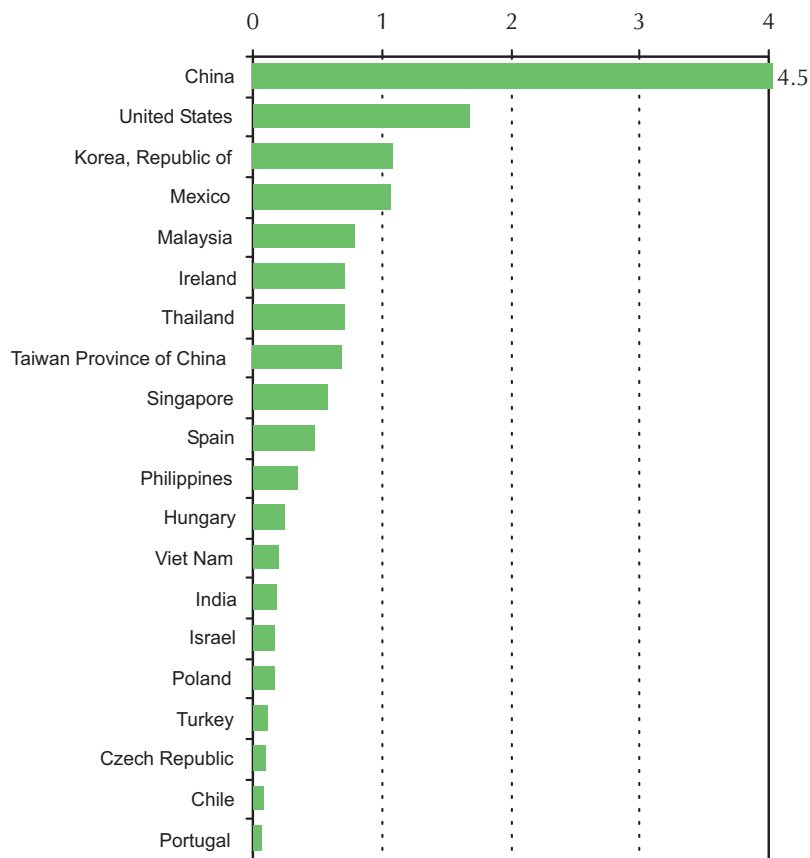
Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, figure VI.1.

European and North American), while those from other regions advanced mainly in a regional context. Western and Eastern European countries gained mainly in European markets, and countries in Latin America and the Caribbean have mainly in North American markets.

In all of them, TNCs have played an important role in expanding exports, either through equity or non-equity relationships. But large as the share of TNC activities is in the exports of these countries, it varies considerably. Of the leading exporters, the Republic of Korea is an example of a winner with a relatively small presence by way of inward FDI, although non-equity links have played a role in enhancing the competitiveness of large domestic companies, which are at the heart of the Korean economy. The other winners, especially in non-resource-based manufactures – the most dynamic in world trade – have relied on TNCs to boost their export performance. China, Costa Rica, Hungary, Ireland and Mexico became export winners mainly by relying on FDI to generate their most dynamic exports. Beyond that, each country had its own specific advantages that enabled it to become linked to international production systems. China's advantage is the size of its economy, which allows economies of scale and helps expand exports. For Hungary, Ireland and Mexico it is their preferential access to a major market. In Costa Rica and Ireland, national policy in the form of a proactive approach to attracting high-technology FDI and linking up to international supplier networks has been an important factor.

Figure 5. Changes in world export market shares, 1985-2000

The 20 winner economies, based on export market share gains, 1985-2000
(Percentage points)



Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, figure VI.1.

...but the development gains from export expansion cannot be taken for granted.

Improving export competitiveness is important and challenging, but it is not an end in itself. It is a means to an end: the promotion of development. This raises the question of the benefits resulting from TNC-associated trade, beginning with improving the trade balance and continuing with upgrading export operations and sustaining them over time. Even though export-oriented FDI helps to increase exports, foreign affiliates also import. In some cases, net foreign exchange earnings may be small, and high export values may coexist with low levels of value added. In each case, the issue is how host developing countries can most benefit from the assets that TNCs command. Much depends on the strategies pursued by TNCs, on the one hand, and the corresponding host-country capabilities and policies, on the other.

Over-dependence on TNCs for export competitiveness has its own drawbacks. TNCs may focus solely on the static comparative advantages of a host country. While this might resolve some of the short-term, efficiency-related problems of TNCs, it means that a number of the longer-term benefits that can be associated with export-oriented foreign affiliates may fail to materialize in the host country. In particular, dynamic comparative advantages may not be developed and affiliates may not embed themselves in the local economy by building linkages to the domestic entrepreneurial community, by further developing labour skills, or by introducing more complex technologies.

Table 8. Shares of foreign affiliates in the exports of selected host economies, all industries and manufacturing,^a selected years
(Percentage)

Economy	Year	All industries	Manufacturing ^a
<i>Developed countries:</i>			
Austria	1993	23	14
	1999	26	15
Canada ^b	1994	46	41
	1995	44	39
Finland	1995	8	10
	1999	26	31
France ^b	1996	22	27
	1998	21	26
Ireland ^b	1991	..	74
	1999	..	90
Japan	1988	4	3
	1998	4	4
Netherlands ^b	1996	44	22
Portugal ^b	1996	23	21
	1999	17	21
Sweden ^{b, c}	1990	21	21
	1999	39	36
United States	1985	19	6
	1999	15	14
<i>Developing economies:</i>			
Argentina ^d	1995	14	..
	2000	29	..
Bolivia ^d	1995	11	..
	1999	9	..
Brazil ^d	1995	18	..
	2000	21	..
Chile ^d	1995	16	..
	2000	28	..
China	1991	17	16
	2001	50	44 ^e
Colombia ^d	1995	6	..
	2000	14	..
Costa Rica	2000	50	..
Hong Kong, China	1985	..	10
	1997	..	5

/...

Upgrading exports involves both an improvement in the efficiency of production and a restructuring of static to dynamic comparative advantage. The starting point is that specialization in different segments of international production systems may imply different benefits and competitive prospects. There is therefore reason for concern that specialization in labour-intensive segments, even of high-technology exports, may, in some instances, be undesirable; it may provide few benefits in training or technology and meagre spillovers to the local economy. Besides, the competitive edge of low-cost labour may disappear as wages rise. On the other hand, labour-intensive exports are economically beneficial as long as local value added is positive at world prices, even if it does not rise at the same pace as exports. In fact, where surplus labour is unlikely to be used in more remunerative or economically desirable activities, it is in the interest of the countries concerned to use it in export-oriented production. Any theory of comparative advantage would suggest that these countries should specialize in labour-intensive processes at the beginning of their export drive; the question is whether they can subsequently upgrade and sustain their exports.

(Table 8, concluded)

Economy	Year	All industries	Manufacturing ^a
India	1985	3	3
	1991	3	3
Malaysia	1985	26	18
	1995	45	49
Mexico ^d	1995	15	..
	2000	31	..
Peru ^d	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
<i>Central and Eastern Europe:</i>			
Czech Republic	1993	..	15
	1998	..	47
Estonia ^b	1995	..	26
	2000	60	35 ^f
Hungary	1995	58	52 ^g
	1999	80	86 ^f
Poland ^b	1998	48	35 ^g
	2000	56	52 ^f
Romania	2000	21	..
Slovenia	1994	..	21
	1999	26	33 ^f

Source: UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, table VI.3.

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

^b Data for exports of foreign affiliates refer to exports of majority-owned foreign affiliates only.

^c Manufacturing includes mining and quarrying.

^d 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.

^e 2000.

^f 1998.

^g 1993.

Note: For full footnotes to this table, see *World Investment Report 2002: Transnational Corporations and Competitiveness*, table VI.3.

TNCs can contribute to the upgrading of a country's competitiveness either by investing in higher-value-added activities in industries in which they have not invested before, or by shifting within an industry, from low-productivity, low-technology, labour-intensive activities to high-productivity, high-technology, knowledge-based ones. This underlines the importance of ensuring the sustainability of export-oriented foreign affiliates. If these foreign affiliates are to become embedded in host economies, they need to upgrade as well as progressively establish backward linkages with domestic enterprises. Where such linkage creation takes place, the exports involved are not only likely to be more sustainable and broadly beneficial for the host countries, but also to involve higher domestic value added and contribute to strengthening the competitiveness of the domestic enterprise sector – the bedrock of economic development. The success of the national industrialization strategies of a number of (mainly Asian) countries that have combined efforts to attract export-oriented TNC activities with the development of domestic capabilities, serves as a model to others.

In sum, it would appear that the benefits of TNC export activity can be further exploited. Technologies are changing. Processes and functions are increasingly divisible, and the boundaries of what is internal and external to firms are shifting. The diminishing cost of transport is stretching location maps. New activities are likely to join the globalization surge, including many from developing countries and economies in transition. The challenge for countries that would like to improve their export competitiveness in association with TNCs is, first, to link up with the international production systems of these firms and, next, to benefit more from them. This is where policies – and the need for national policy space – come in.

PROMOTING EXPORT-ORIENTED FDI

Policies to promote export-oriented FDI are evolving...

A priority among countries – whether rich or poor – is to upgrade and sustain exports so that they contribute more to development. Just as firms are forced to make their production systems more competitive, countries have to figure out how to move, in any industry, into higher-value-added activities. There are many ways in which TNCs can help to enhance host countries' export competitiveness. The challenge is to tap TNC potential for this purpose. In order to attract export-oriented FDI and to ensure that such investment translates into development gains, countries need to find the most effective ways to make their locations more conducive to the kind of export activities they aim to foster. Even traditionally significant recipients of export-oriented FDI need to upgrade to sustain rising wages and maintain their competitiveness as an export base.

In line with the dynamic changes in corporate strategies affecting key export industries, the rising competition among countries and sub-national entities for export-oriented FDI, the changing regulatory environment, and the changing development objectives of countries themselves, policy formulation and implementation are evolving. While recognizing that macroeconomic stability as well as structural factors, such as technological capacity and human resources, are key in making a location competitive, the focus here is on policies related to export-oriented FDI: how to attract, upgrade and benefit from such FDI. It is beyond the scope of the *WIR02* to look into what policies are needed for upgrading human resources and technology per se. Rather, this volume focuses on other important lessons that can be drawn from the experience of developing countries and economies in transition that have successfully taken advantage of inward FDI to enhance their export competitiveness. Care must be taken, however, in applying these lessons: the effectiveness of any given policy depends on the specific economic, historical, geographical, cultural and political context.

Access to key markets is a necessary, but not sufficient, condition for attracting export-oriented activities. Although multilateral trade liberalization has been an important facilitating factor behind the emergence of international production systems and the establishment of export-oriented activities abroad by TNCs, access to developed-country markets, especially for products of export interest to developing countries, needs to be further improved. In particular, tariff peaks, tariff escalation and non-tariff barriers in agriculture, textiles and clothing need to be addressed. Meanwhile, a rise in protectionism could effectively jeopardize the prospects for poor countries to exploit their comparative advantages fully. The growing use of trade measures, such as anti-dumping and safeguards, and of targeted subsidies in developed countries all give cause for concern in this context.

Despite the erosion of preferential margins, many regional and preferential arrangements still remain important for the location of export production (e.g. in the context of the European Union and its association agreements, NAFTA, the United States Caribbean Basin Initiative and AGOA) as do various offshore production schemes. While host-

country policy-makers need to be aware of opportunities arising from such arrangements, they also need to understand their limits. For example, offshore production schemes generally discourage the use of local components and may thereby restrict the upgrading of local operations. Trade preferences in and by themselves provide neither a sufficient nor a sustainable basis for developing competitive export industries (with or without FDI). The same applies to countries that have attracted export-oriented FDI thanks to unused quotas for export to countries that restricted access for textiles and clothing products under the Multifibre Arrangement. As the quotas are to be phased out by 2005, there is a risk of the relocation of existing investment to countries that offer more competitive conditions. Trade preferences need to be seen as a temporary window of opportunity that provides time to allow countries to strengthen their locational advantages.

On the part of host-country Governments, there are a number of measures that can be considered to improve the long-term attractiveness of a country as a base for export-oriented production. While the focus here is on policy measures that are directly related to FDI, it should be re-emphasized that these have to be viewed as part of broader efforts to promote development.

A key policy area is to improve access to imported inputs through trade facilitation measures. Such efforts are important, as the competitiveness of export-oriented activities (especially in non-resource-based industries) often depends, to a large extent, on imported inputs. Various countries have tried to induce more exports from foreign affiliates through export-performance requirements. However, in order not to deter inward FDI, these have normally been tied to some kind of advantage received by the investor. In an increasingly competitive environment, and in the light of WTO rules, mandatory export performance requirements are becoming more difficult to use.

In order to lower production costs and risks, many countries offer incentives aimed at inducing new or more export-oriented FDI. The use of incentives also has evolved over time. Developed countries frequently employ financial incentives (such as outright grants), whereas fiscal measures are more common in developing countries (which cannot afford a direct drain on the government budget). Incentives have been an important element in the development strategies of many countries, especially those successful in attracting export-oriented FDI. Some of these countries have adopted an increasingly targeted approach to attracting FDI.

The challenge for developing countries wishing to use incentives in their efforts to promote export-oriented FDI is to weigh the benefits and costs involved. Where effectively implemented, incentives have typically complemented a range of other measures aimed at enhancing aspects such as the level of skills, technology and infrastructure. To compensate for major deficiencies by offering incentives may not always be a wise strategy, as it increases the risk of public funds being spent on projects that do not offer the externalities needed to warrant the incentives in the first place. Without efforts to improve the business environment, make it more conducive to attracting investment, upgrading production and embedding FDI into the local economy, there is a greater risk that investors will leave as soon as the incentives expire. Thus, subsidies should not be used as an isolated measure, but rather as part of a broader policy package.

The setting up of export processing zones (EPZs), with a view to providing efficient infrastructure and removing red tape within the confines of a limited area, is also a widely used tool in the context of promoting export-oriented FDI. In fact, most of the winners identified in figure 4 have established EPZs (or other schemes that share some of their characteristics), and a number of them account for a large share of non-resource-based manufactured exports. However, the performance of EPZs depends very much on other policies, notably policies that aim at enhancing human resources and creating the infrastructure necessary to attract and upgrade export-oriented FDI. Successful

zones can be found in countries such as China, Costa Rica, the Dominican Republic, the Philippines and Singapore. On the other hand, there are many EPZs that have failed to attract substantial investments and where outlays have far exceeded social benefits.

As in the case of other policy areas, the nature and use of EPZs are also evolving. As already noted, the requirement to export has been relaxed in many countries in recent years, thus allowing for significant domestic sales. More domestic companies are now established in the zones and efforts are being made by Governments to encourage more linkages between foreign affiliates and domestic firms, as well as to encourage the training of local employees and the development of technical and technological infrastructure. The industrial composition of production within EPZs and other zones is also changing. While it used to be dominated by low-technology, labour-intensive, incentive-driven manufacturing activities, a number are now moving into new areas such as electronics assembly, electronic design, testing and R&D, not to mention regional headquarters and global logistics centres. In developing countries, such trends may be accelerated by the WTO disciplines in the area of export subsidies.

...in the light of WTO rules on export subsidies, ...

When considering using incentives, not least in the context of EPZs, developing countries not only need to identify the most effective ones, but also to ensure that they conform with the international regulatory framework, notably WTO rules. In this context, attention is especially warranted to the role of export subsidies. Apart from the WTO members listed in Annex VII of the Agreement on Subsidies and Countervailing Measures (namely, LDCs and members listed in Annex VII until their per capita GNP reaches \$1,000), other developing country members will have to eliminate export subsidies as of 1 January 2003, with the exception of those that will be granted an extension of the transition period. And even these need to consider what to do once it expires. The possibility of offering other specific incentives that do not meet the definition of prohibited subsidies remains, but any "specific" subsidy that causes adverse effects to another WTO member's interests is actionable and potentially subject to remedial action. Furthermore, subsidized imports into another WTO member may be subject to countervailing measures by the latter, if they cause, or threaten to cause, material injury to a domestic industry providing the like product in the importing member. The provision of "specific" subsidies therefore becomes risky.

EPZs are likely to continue to play an important role in the overall strategy of countries to promote export-oriented FDI. They can continue to exempt exports by companies in these zones from indirect taxes (such as sales taxes), border taxes (e.g. consular fees) and import charges. Duty drawback and duty exemption systems are thus permissible. While duty drawback schemes may not include capital goods used to produce exported goods, many smaller WTO members may have little or no domestic production of such capital goods, and thus could consider simply lowering or eliminating import duties on such goods. Furthermore, arguably, the most structural advantages in the form of well-functioning infrastructure and streamlined administrative procedures remain unaffected. Partly in the light of this, a number of countries, including some developed ones, are beginning to turn their EPZs into industrial parks or science parks that can act as catalysts for cluster development.

There is a risk that intense competition for export-oriented FDI will translate into a race to the bottom (in social and environmental standards) and a race to the top (in incentives). Such concerns have been voiced especially in the context of EPZs. Successful EPZs should not be judged solely on their capacity to attract FDI or increase exports and foreign exchange earnings. They should also be assessed by the extent to which they help meet broader economic and social objectives. Countries that pursue more integrated policy approaches to attracting export-oriented FDI – for example by involving tripartite representation on EPZ committees, guaranteeing workers' rights (including

freedom of association and collective bargaining), and upgrading skills and working conditions – have tended to attract higher-quality FDI. Singapore and Ireland are two examples of countries that have pursued more integrated policy approaches in this area. In both these countries, efforts were made to promote training, facilitate dialogue between labour and management, and provide first-class infrastructure for investors. Good labour relations and the upgrading of skills enhance productivity and competitiveness.

With regard to the risk of an incentives race to the top, while the Agreement on Subsidies and Countervailing Measures prohibits the use of export subsidies, other incentives, especially locational ones, are still widely used in both developed and developing countries to promote export-oriented FDI. As competition for export-oriented FDI increases, the risk of ever-increasing incentives by competing locations calls for further international cooperation in this area. The differences in resources available for public support to private investment also suggest that developing countries are at a disadvantage in such incentive-based competition. A reduction in the use of locational incentives by developed and developing countries should help Governments allocate more resources for the development of skills, infrastructure and other areas relevant to the attraction of export-oriented activities. At the same time, a case could be made for making certain development-oriented subsidies to foreign affiliates non-actionable under WTO rules, for example, if they serve to encourage the provision of technology, technical assistance and training to local suppliers and their personnel. However, to avoid free riding, firms receiving incentives should be required formally to commit sufficient resources on a long-term basis.

...while investment promotion becomes more targeted, ...

The choice of policy instruments with regard to export-oriented FDI needs to be in tune with a country's overall development strategy. There is growing recognition that various policy tools are most effective if they are applied in a targeted and coherent manner. Because TNCs typically consider a number of potential investment locations for export-oriented FDI, the need for a focused approach to investment promotion is particularly relevant. A targeted approach is likely to be less costly in relation to the results achieved, than one in which a country attempts to attract export-oriented investment in a more ad hoc fashion. But, above all, the main reason to target is to increase the chances of attracting investment that furthers the specific development objectives of a country. This requires, among other things, that Governments determine what type of FDI is likely to have the greatest potential for linkages with indigenous investment.

An important starting point for successful targeting is a good understanding of the relative competitiveness of a host country (or an area within it) for specific activities. While an assessment of a location's strengths and weaknesses can be undertaken at various levels of sophistication and detail, useful insights can be obtained from a relatively inexpensive rule-of-thumb approach involving an analysis of existing trade and industry patterns, consultations with existing investors (domestic and foreign), an analysis of which competing locations are exporting and what they have attracted in terms of export-oriented FDI, and an identification of other factors that might attract export-oriented FDI, including membership of free trade areas, preferential trade schemes, clusters of economic activity, and industrial parks. Such an assessment can form the basis for a narrower segmentation of the market, for example, based on economic, geographic, demographic and other criteria.

Another important element of targeting is a sound analysis of corporate strategies affecting the choice of location. In response to increased geographical and functional specialization in many industries, countries may find it useful to identify production niches through which they can link up with international production systems. The more focused the approach, the easier it is to streamline the activities of investment promotion

agencies (IPAs) to meet the needs of investors. Important clues as to where to look for potential investors relate to foreign affiliates that are already established in the country. They are “living proof” of the existence of investment opportunities, and their presence may be indicative of where to search for additional investment. Their competitors, too, may potentially be prime targets, especially if the existing foreign affiliates are linked to leading TNCs. Companies that are part of the value chains of domestic as well as foreign affiliates in the host country (e.g. as buyers or suppliers) are also potential targets. Nurturing close contacts with existing firms may generate useful insights into their investment strategies and how these “related” firms make their investment decisions.

Targeting should not be a one-off initiative but a continuous learning process in which relationship-building plays a key role. Governments need to recognize the importance of dynamism in niche market identification, and be aware of the need to revise their strategies over time, as competitive conditions and corporate strategies evolve. Advantages based upon preferential market access, for example, are valuable but must fit into a clear plan for creating sustained advantage over time. IPAs can contribute to such plans, but their conceptualization and implementation also involves other agencies of government and public-private partnerships.

There are, however, risks involved in developing a more targeted and focused strategy. Resources may be focused on attracting investments that do not materialize, or considerable efforts and resources may be devoted to seeking the wrong types of firms, or firms that would have invested in any event. Improving the overall policy environment for investment – domestic and foreign alike – should not be sacrificed to a selective focus on attracting a few firms. A realistic understanding of the strengths and weaknesses of a location as a base for export-oriented production provides a stronger base for targeting. There is an obvious risk of wishful thinking in seeking to win “high-status” TNCs if a country does not have the basic conditions to attract this type of investor (such as an educated and highly skilled workforce and excellent, low-cost infrastructure). Competition for high-profile investment projects can be intense and, for every winner there are often several losers that, in the end, may have expended considerable resources in a failed attempt to attract a project. Thus, for most developing countries, the investors to target will probably not be the top 100 TNCs, but smaller firms within the appropriate industry or activity.

While it is clear that adopting an investor targeting strategy can be effective in attracting FDI, it also presents considerable challenges for Governments. Effective targeting requires business-oriented IPAs with well-developed links to the private sector as well as to other branches of government. Investor targeting should be well integrated into the overall development strategy of a country, and IPAs need to work closely with other parts of government to identify and, indeed, create comparative advantages that are sustainable rather than ephemeral.

...and integrated into a comprehensive approach to meeting the competitiveness and development challenge.

To repeat, expanding exports is a means to an end: promoting development. To maximize the benefits of government intervention, the promotion of export-oriented FDI should be an integral part of the overall development strategy of a country. The bottom line is that the degree of success of a host country in attracting and upgrading export-oriented FDI as well as in reaping development benefits from such investment relies critically on its ability to develop domestic capabilities. Indeed, some of the countries most successful in boosting export competitiveness and leveraging export-oriented FDI practised a two-pronged approach based on developing domestic capacities while targeting foreign resources and assets. Important elements of such an approach can include:

- ensuring that what is targeted through investment promotion is in line with the country's broader development and industrial strategies;
- providing a package of incentives in a focused way to encourage TNCs to invest in strategic activities (taking into account WTO rules on export subsidies);
- involving foreign affiliates in the development and upgrading of human resources;
- developing high quality infrastructure, such as EPZs and science parks; and
- providing targeted support for domestic enterprises and supplier and cluster development.

The last bullet addresses a particularly important issue. To benefit fully from export-oriented FDI, facilitate an upgrading of export-oriented activities and make them sustainable, host countries need to encourage linkages between foreign affiliates and local suppliers. Export-oriented foreign affiliates – especially if operating in enclaves – often import all or most of their input requirements of components and raw materials, assemble the product in the host country and then export the semi-finished or finished output. It is partly against this background that linkage promotion has become an increasingly important policy area. Linkages with foreign affiliates are a key channel for the diffusion of skills, knowledge and technology to domestic firms. As discussed in depth in *WIR01*, key policy instruments include information provision and matchmaking; encouraging foreign affiliates to participate in programmes aimed at upgrading domestic suppliers' technological capabilities; promoting the establishment of supplier associations or clubs; the joint provision of training; and various schemes to enhance domestic suppliers' access to finance. Meanwhile, as in other policy areas, linkage promotion strategies also have to adapt to the changing nature of corporate strategies. For example, some countries (e.g. Ireland) are abandoning the idea of promoting linkages only between local firms and foreign affiliates and, instead, promote the participation of domestic firms in supply chains of TNCs based anywhere in the world.

Linkages between domestic suppliers and foreign affiliate buyers can also take place more frequently if buyers and suppliers operate in the same spatial and industrial area. Indeed, the increasingly interdependent nature of policies on investment, trade, technology and enterprise development calls for a more integrated approach to fostering export-oriented FDI and economic development. As the development of infrastructure, business services and specialized skills often involves significant levels of investment, many countries have encouraged the formation of localized industrial clusters. Such efforts seek to create conditions that will promote dynamic interaction, learning, technology upgrading and competition among all relevant actors. A number of countries that have seen improvements in their export competitiveness over the past two decades have hosted agglomerations of mainly foreign-owned producers. Prominent examples include Ireland, Malaysia (Penang), Mexico, Singapore and a few CEE countries. However, not all export-oriented projects are good candidates to become nodes of dynamic industrial clusters. The chances of production concentrating in a limited number of locations increase when there are economies of scale at the plant level, relatively low costs per unit of output, low barriers to trade, and the presence of externalities and spillovers.

While the formation of industrial clusters can be spontaneous, resulting from the agglomeration of firms engaged in similar or related activities, increasingly, strategic government intervention can facilitate their creation. Three kinds of effort have been identified as essential for the development of clusters involving inward FDI. The first is *investment and business promotion* in a targeted manner. As policy-makers have to understand the competitive needs of different industries to avoid making misdirected investments in the wrong sort of clusters, cluster diagnostics is fundamental. There is also a special need in FDI-based cluster development for close cooperation between IPAs and related government institutions.

The second is *institution-building*, which is a complex process. Agglomeration tendencies can be encouraged by the establishment of EPZs, industrial parks and other specialized facilities, often specializing in one or more industries. Institutions engaged

in metrology, standards, testing and quality assurance provide the infrastructure of modern industrial activity. Their importance to competitiveness is growing as a result of increasingly stringent quality, precision, tolerance and other standards in international markets. Other relevant institutions are those responsible for initiating research, providing access to financial resources, and creating business networks and professional associations.

The third element focuses on the *training and upgrading of human resources*. For knowledge-based activities, in particular, training and upgrading of relevant human resources are key (WIR99). Such efforts may involve the establishment of specialized training centres, possibly with the involvement of foreign affiliates. Another approach is to attract internationally mobile skills to complement the local skills base. In general, the more knowledge-intensive the activity, the more important it becomes for clusters to attract skills.

In conclusion, the continuous need for countries to move up the value-added ladder and improve the attractiveness of their locational advantages is a challenging task for policy-makers in developing countries. It calls for more sophisticated and comprehensive policy approaches that take into account changes in corporate strategies and international rule-making. Furthermore, at the top of the agenda should be the development of domestic capabilities, as this helps not only to attract quality FDI but is also necessary to facilitate an upgrading of existing activities. Given the potential of improved export competitiveness for promoting development, the need for developing countries to preserve sufficient policy space to pursue their development objectives also has to be recognized. Finally, the extent to which developing countries profit from new opportunities created by the emergence of international production systems depends largely on their own actions. Developed countries can also help in a number of ways: they can provide assistance for the development of institutional capacity, disseminate information about export-oriented investment opportunities, and dismantle barriers to exports from developing countries.

Geneva, July 2002

Rubens Ricupero
Secretary-General of UNCTAD

World Investment Report 2002: *Transnational Corporations and Export Competitiveness*

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9. Are you a regular recipient of Transnational Corporations (formerly The CTC Reporter), the Division's tri-annual refereed journal?

Yes

No

If not, please check here if you would like to receive a sample copy sent to the name and address you have given above. Other title you would like to receive instead (see list of publications):

10. How or where did you obtain this publication:

I bought it

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11. Would you like to receive information on UNCTAD's work in the area of Investment Technology and Enterprise Development through e-mail? If yes, please provide us with your e-mail address:
