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

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The world in 2001 witnessed the looming threat of growth slowdown becoming a reality. This process was aggravated by the fact that the euphoria about the new economy and the stockmarket had evaporated and a number of auditing irregularities had emerged in a number of transnational corporations (TNCs). This was the backdrop for a decline in global foreign direct investment (FDI) inflows for the first time in a decade. Yet, argues UNCTAD's *World Investment Report 2002 (WIR 2002)*, transnational corporations continued to be the driving force in the internationalization of the production process as they expanded their role in globalizing the world economy.

In 2001, foreign affiliates accounted for about 54 million employees compared to 24 million in 1990; their sales of almost $19 million were more than twice as high as world exports in 2001, whereas in 1990 both were roughly equal; and the stock of outward FDI, increased from $1.7 trillion to $6.6 trillion over the same period. Further, if the value of worldwide TNC activities associated with non-equity relationships (e.g., international sub-contracting, licensing, contract manufactures) is considered, TNCs would account for even larger shares in these global aggregates. This dominating presence, argues the *Report*, was a consequence of the expansion of international production driven by a combination of three factors: policy liberalization, rapid technological change and increasing competition. These factors played out differently in different industries and in different countries.

According to *WIR 2002*, policy liberalization facilitated a process that was underway for a number of other reasons. Technological change, which is associated with rising sunk costs and risks, had made it imperative for firms to tap world markets and to spread costs and risks. On the other hand, falling transport and communication costs had made it economical to integrate distant operations and to ship products and components across the globe in search of efficiency. This contributed to an increase in efficiency-seeking. FDI. Increased competition resulted in firms exploring new ways of increasing their efficiency, extending their international reach into new markets and shifting production activities to reduce costs, for instance, and also in creating new forms of international production, with new ownership and contractual arrangements and new activities being located in new sites abroad. If this was true, what explains the fact that global FDI flows declined sharply in 2001 for the first time in a decade? According to the *Report*, although the factors driving FDI are long-term in nature, they were constrained by short-term changes associated with the business cycle. The decline in FDI was mainly the result of the weakening of the global economy, reflected in the deceleration in growth in the world's three largest economies and a consequent drop in the value of cross-border mergers and acquisitions (M&As). The total value of cross-border M&As completed in 2001 ($594 billion) was only half that in 2000.

Though the United States retained its position as the largest FDI recipient, inflows more than halved and were down to $124 billion. And though the country regained its position as the largest investor, investments declined by 30 per cent. The major partners for inward and outward FDI were again the EU countries and North American Free Trade Agreement (NAFTA) partners. Inflows and outflows to the EU dropped by about 60 per cent and were mainly due to a decline in M&A-related FDI. Inflows to the United Kingdom and Germany declined, and the declines in outward FDI were even greater in these countries. Within Europe Ireland, Italy and Portugal were the only exceptions, with positive outward FDI flows. Thus, the decline in FDI flows was concentrated in the developed economies, where FDI inflows shrank by 59 per cent as compared with 14 per cent in the developing economies. World inflows of FDI amounted to $735 billion, of which $503 billion went to the developed world, $205 to the developing world and the remaining to the transition economies of Central and Eastern Europe (CEE).

It is worth noting that even as developed countries experienced a decline in inflows, the share of developing economies in global FDI inflows stood at 28 per cent compared to an average of 18 per cent in the preceding two years. In developing countries FDI proved fairly resilient despite the global economic downturn and the tragic events of 11 September. The resilience was more pronounced in comparison to inflows of portfolio investment and bank lending. On a net basis, FDI flows were the only positive component of private capital flows to developing countries during 2000–01.

Reporting these facts, *WIR 2002* argues that TNCs as sources of FDI and exports are important means to further the process of development. Further, the *Report* brings back the much-maligned 'state' by giving it a role not as an agency protecting domestic against foreign investors but as an important instrument for attracting FDI and increasing its developmental impact. To that end the *Report* uses the rise in developing country share of FDI inflows to emphasize that though FDI flows are still predominantly between developed economies, the developing countries are growing in importance as destinations and, in a few cases, as sources of FDI. The *Report* predominantly concentrates on China to establish the two points made above.

However, as in the past, flows to the developing world remained unevenly distributed. The forty-nine least developed countries (LDCs) remained marginal recipients, with only 2 per cent of all FDI to developing countries or 0.5 per cent of the global total. In 2001, the five largest recipients attracted 62 per cent of the total inflows to developing countries. Among the top ten country gainers, eight were from the developing world. FDI to developing countries fell from $238 billion in 2000 to $205 billion in 2001, with the bulk of this decline being limited to a relatively small number of host countries—Argentina, Brazil, and Hong Kong China.

In terms of regions, Africa remained a marginal recipient of FDI, with a substantial concentration of the flows going to South Africa and Morocco. Further, the FDI flows to Africa were narrowly concentrated in the primary sector. The share of the Asia-Pacific region in world inflows increased from 9 per cent in 2000 to nearly 14 per cent in 2001. China regained its position as the largest recipient in the Asia-Pacific region as well as in the developing world as a whole, replacing Hong Kong China. India, Kazakhstan, Singapore and Turkey were significant recipients in their respective sub-regions. With the effects of the late 1990s' financial crisis still to wear off, the Association of South-East Asian Nations (ASEAN) saw a fall in FDI levels in

recent years to about one-third of the peak in 1996–97. Further, since that region included some of the most important developing country sources of FDI, outward FDI from developing Asia fell to its lowest level since the mid-1990s.

Finally, FDI in Latin America and the Caribbean declined for the second consecutive year. This was mainly due to a significant fall in FDI inflows to Brazil, where the privatization process has almost stopped, and to Argentina, where the financial and economic crisis has discouraged any new investment.

UNCTAD Inward FDI Performance and Potential Index

WIR 2002 attempts to capture the degree to which different countries were successful in 'attracting' FDI. The Inward FDI Performance Index compares the ratio of a country's share in global FDI flows to its share in global GDP. An index of 1 implies that a country's share of global FDI is equal to that country's share of global GDP. Countries with an index value greater than 1 attract larger FDI than is expected on the basis of the relative size of their GDP. During the period 1998–2000, the developed world as a whole was more or less balanced in terms of the FDI it received. Africa had a score of 0.5 while Latin America had a score of 1.4. East and South-East Asia had an index value of 1.2, while West and South Asia had an index value of 0.2.

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 slowly and are therefore fairly stable. The top twenty economies in 1998–2000 by this measure were high-income developed countries.

The two indices are then combined in the *Report* to yield a matrix that classifies countries as

• 'Front-runners'—countries with high FDI performance and high potential (i.e. above the mid-point of the ranking by potential of all countries). This group includes the industrialized countries of Europe, the Asian 'Tigers', and Argentina and Chile from Latin America.

• 'Above-potential economies'—comprised those economies that were successful in attracting FDI even without strong structural capabilities. China and Brazil are notable exceptions that belong to this group according to the combination of the indices.

• 'Below-potential economies', which include many rich and industrialized economies that have weak FDI performance due to policy preferences and a tradition of low reliance on FDI. Italy, Japan, the Republic of Korea, Taiwan Province of China and the US fall within this category.

• 'Under-performers'—were generally poor countries that did not attract their expected share of FDI.

Export Competitiveness, TNCs and Development

Has liberalization aimed at attracting FDI helped improve the export competitiveness of developing countries? Export competitiveness certainly starts with increasing market shares. But it should go beyond that. It involves diversifying the export basket, sustaining higher rates of

export growth over time, upgrading the technological and skill content of economic activity, and expanding the base of domestic firms able to compete internationally so that competitiveness becomes sustainable and is accompanied by rising incomes. Successful increases of exports should lead to increased foreign exchange earnings, and thereby the means to import products, services and technologies needed to raise productivity and living standards.

Needless to say, a few countries dominate the global market even in the current 'transnationalized' context. In terms of market shares only twenty economies account together for over three-quarters of the value of world trade. Though developed countries are the major traders, developing economies such as China, Mexico, the Republic of Korea, Malaysia, Thailand, Taiwan Province of China, the Philippines, Singapore and Hungary accounted for the largest gains in market shares from 1985–2000. Seven of these economies are now among the twenty largest exporters.

The growth of exports from many of these winner countries is indeed linked to the expansion of international production systems. In the six countries taken for analysis in the *WIR 2002*—China, Costa Rica, Hungary, Ireland, Mexico and the Republic of Korea—TNCs have played a major role in expanding exports, either through equity or non-equity relationships. But large as the share of TNC activities in these countries is, it varies considerably. The Republic of Korea is a winner with a relatively small presence of inward FDI. China, Costa Rica, Hungary, Ireland and Mexico relied on inward FDI to become export winners. But beyond this, each country had its own specific advantages that enabled it to become a part of the international production system. China's advantage is its economic size and for Hungary, Ireland and Mexico it is their preferential access to a major market. In Costa Rica and Ireland, a national policy of attracting high-technology FDI and linking up to international supplier networks has been an important factor.

But development gains cannot be taken for granted from export expansion. Export expansion and competitiveness should be seen as a means to an end— namely, development. For example, 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 development effects. Further, an export expansion driven by active TNC participation might be short-lived if the TNCs are not firmly embedded in the host country. 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. TNCs may focus only on the static comparative advantage of the host economy. Dynamic comparative advantages might not be developed and affiliates may not be embedded in the local economy by building linkages to the domestic entrepreneurial community, or by further developing labour skills or introducing local technologies.

Role of the State

The *Report* brings forth the need for an active role for the state in the economy in two ways. First, it does so by arguing for a national policy that makes the particular economy an extremely attractive destination for TNC FDI and thereby overcomes the competition that it faces in the global economy from other economies. Second, the key to translating successful export

competitiveness, driven by TNCs in particular, into sustainable development lies in the national policies of a particular government.

The importance of the role of the state might seem contradictory in a policy environment where globalization and liberalization are the new economic *mantra*. But even as institutions that are the chief proponents of this *mantra* call for a 'lesser state', it should be realized that they in no way means 'no state'. This is best exemplified by the smart use of the state in the success stories of the winner countries described in the *WIR 2002*, particularly China, Costa Rica and Ireland. A conscious national policy in these countries helped to attract specific kinds of TNC and their FDI as well as to make them develop linkages with their respective economies. It took the form of export processing zones, export subsidies, tax-free imports for exports, etc. The role of the state in the economies of those countries that argue vehemently against it is also, in a way, proof enough!

Further, most developing countries are characterized by substantial concentration of capital, wealth, land and other material assets, as well as education, skills and other non-material assets. The former often determines the latter, as also the livelihood benefits that can be derived from increased participation of TNCs in the economy. The state, as it deems appropriate to particular circumstances, should ensure the spread of education and skill across the population, so that the benefits of increased investment are not the privilege of a few.

In short, an increase of exports that results in concentrated distribution of benefits, no local value added, no linkages with the rest of the economy, no addition to skill, negative effects on the environment and social standards, is no development whatsoever. Even an increase in export competitiveness through increased participation of TNCs resulting in increased exports need not translate into development. For development to occur, first, exports should develop strong linkages with the rest of the economy and have increasing value-added products in the export basket; and second, the benefits should be more evenly spread.

The *WIR 2002* clearly mentions the failure of the first as a lack of development. But the spread of benefits finds no mention in the *Report* even though an economy with increased exports that establishes backward linkages but fails to spread benefits is not on a path of development.

China's experience with FDI and TNC's

The Chinese experience with FDI flows and the rush of TNCs into it has made it a 'classic' example for UNCTAD to quote to other developing nations. But do we have a good enough understanding of FDI in China?

Vintage development theory as well as the UNCTAD *Report* suggests a role for FDI in augmenting the capital resources of developing countries. Yet in China, FDI did not have this role. The Chinese savings rate has been very high in recent years, around 40 per cent of the gross domestic product. Its domestic investment rate is 35–40 per cent of GDP. Even though FDI has reached around $40 billion of late, it accounts for only 4 per cent of GDP and 10 per cent of gross investment.

Further, FDI in China was not the result of 'shock therapy', as in the 'transition economies', or imposed under Fund/Bank programmes. The Chinese authorities determined and set the policy, the contents, the timing and the phasing. The Chinese state created transitional institutions aimed at improving economic efficiency by generating the right incentives, encouraging competition and making the reform process more acceptable. The role of the state vis-à-vis FDI was a very active one and tallies with the argument put forth by *WIR 2002*.

The particularity of FDI in China, particularly in the export sector, lies in the fact that overseas Chinese played a major role. The creation of special economic zones in south China suited the overseas Chinese. They could identify items for production, partners for joint ventures, invest huge amounts and lift products for exports through their own networks. It was estimated that in the early years, FDI from overseas Chinese constituted 80 per cent of total FDI, which has declined to 50 per cent in recent years. It is also known that around 50 per cent of this investment was money coming dubiously from the mainland and going back to get concessions as FDI.

But one should also note that the role of FDI in Chinese exports was no fairytale. Initially, it was the success of state-owned-enterprises (SOEs) that attracted other investors. Chinese exporters in the private sector had the skills to produce traditional handicrafts, garments, shoes and toys, and did not need foreign technology. What they needed was capital. The obvious question is, the country was flush with capital, as suggested earlier, why were they capital-constrained? This was because until 1998, government-owned banks in China were prohibited from lending to private firms and had to confine their lending to SOEs. They had to depend entirely on internal sources for survival and expansion. Hence when the FDI window opened, they rushed headlong into it. In other words, FDI was a substitute for what in other countries is covered by bank loans.

The freedom for FDI operations in China is more a myth than a reality. In contrast to the freedom given in coastal areas, the Chinese are schizoid when it comes to FDI operations elsewhere. Foreign firms are subject to severe regulations and have to achieve industrial policy goals and conform to performance requirements, like local procurement from specified agencies. Here the role of the state is to ensure backward linkages for the rest of the economy, as suggested in *WIR 2002*.

But, in spite of such an active state, there is growing evidence of weaknesses. As has been noted widely, the disparity between regions is increasing rapidly. While the coastal regions have grown rich, other regions who do not have a share in the growth face a major problem of unemployment. Part of the reason is the way FDI is now operating in the export processing zones. They are not integrated into the rest of the economy and remain as processing platforms performing labour-intensive operations on imported goods for re-export. This is in contrast to the previously mentioned Chinese experience in other regions. The Chinese state appears softer and less able to control the activities of FDI in these zones.

In statistical terms, the UNCTAD *Report* seems right in advancing China as the example to emulate vis-à-vis FDI and TNCs. But a qualitative study of the Chinese case shows up certain particularities of China in terms of FDI flows, and also the duality of the state with respect to export processing zones and other regions. The *Report* also overlooks the increasing

unemployment and growth performance of non-coastal Chinese regions, as well as the increasing number of migrant workers seeking employment in booming cities along the coast.

In other words, the half-truth of China is a dangerous example to be cited to other developing nations vis-à-vis FDI flows and TNCs. Further, the Chinese state as an example for other developing countries to emulate is not only a bad one but a confusing one.