

Zimny, Zbigniew

**Article**

## Long-term trends in international production

EIB Papers

**Provided in Cooperation with:**

European Investment Bank (EIB), Luxembourg

*Suggested Citation:* Zimny, Zbigniew (2004) : Long-term trends in international production, EIB Papers, ISSN 0257-7755, European Investment Bank (EIB), Luxembourg, Vol. 9, Iss. 1, pp. 26-51

This Version is available at:

<https://hdl.handle.net/10419/44832>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

## ABSTRACT

*This paper describes long-term trends in international production, i.e. the production of goods and services that is under the governance of transnational corporations – either through foreign direct investment (FDI) or non-equity arrangements. It recounts the rapid growth in international production, the increasing importance of non-equity arrangements, and the shift towards services. The paper then examines the geography of FDI, emphasising that EU countries have emerged as a major source and destination of FDI – a process shaped considerably by EU integration. New EU members from Central and Eastern Europe received substantial FDI inflows in the transition from plan to market. Recognising FDI opportunities that emerged for these countries from regional integration, the paper takes a cautionary stance as to whether these countries can expect increased FDI inflows following EU accession.*

Zbigniew Zimny ([Zbigniew.Zimny@unctad.org](mailto:Zbigniew.Zimny@unctad.org)) is Head of the Investment Issues Analysis Branch in the Division on Investment, Technology and Enterprise Development (DITE) of the United Nations Conference on Trade and Development (UNCTAD). He is indebted for comments and suggestions to Padma Mallampally. The responsibility for the contents of the paper is the author's own, and the views expressed in the paper cannot be attributed to UNCTAD.

# Long-term trends in international production

## 1. Introduction

Since the mid-1980s, international production has grown very rapidly, playing a larger and more important role in the world economy and changing the ways in which economic integration takes place among countries. It has become a key driving force of globalisation, growing faster than other economic aggregates such as national production and international trade. The nature of international production has also changed, responding to rapid technological change, intensified competition and economic liberalisation. These factors, combined with falling transportation and communication costs, are allowing transnational corporations (TNCs) to integrate production processes and other corporate functions across countries in historically unprecedented ways. The United Nations Conference on Trade and Development (UNCTAD) *World Investment Reports* have termed this process “deep integration” – integration at the production level – with specialised activities located by TNCs in different countries linked by tight, long-lasting bonds, in distinction from “shallow integration” of markets alone, brought about by arm’s-length trade that earlier dominated international economic relations (UNCTAD 1999).

This paper proceeds in Section 2 with an overview of long-term trends and key features of the internationalisation of production. This section will argue that the internationalisation of production results not only from foreign direct investment (FDI), but also increasingly from non-equity relationships between firms from different countries. Section 3 zooms in on the changing sectoral composition of FDI, and Section 4 portrays the changing geography of FDI. Following up on this, Section 5 examines how EU integration has affected the position of EU member states in international production and what to expect from the enlargement of the EU to countries of Central and Eastern Europe (CEE). Section 6 offers concluding observations, including an observation on key global policy issues.

## 2. International production: definition, main trends, and key features

### 2.1 What is international production?

International production refers to the production of goods and services that is under the governance of firms – called transnational corporations (TNCs) – headquartered in other countries. TNCs govern, that is, manage or exercise control over production in countries (host countries) other than their own country (home country) either through the ownership of a minimum share in the equity capital stock of the enterprises (foreign affiliates) in which the production takes place, or through contractual (non-equity) arrangements that confer control upon them (UNCTAD 1999). As a result, international production systems emerge in which not only goods and services but also factors of production move among units governed by TNCs, located in different countries. These systems increasingly cover a variety of activities, ranging from extraction of natural resources to manufacturing and service functions such as accounting, advertising,



**Zbigniew Zimny**

marketing, research and development (R&D) and training, dispersed over host country locations and integrated across locations (host and home) to produce final or intermediate goods or services.

From the perspective of factor use, and of the world economy, all of the production that takes place in these systems (in parent firms or home-country units as well as in foreign affiliates or host-country units) constitutes international production. Viewed from the perspective of home and host countries, however, it is, respectively, the production in foreign locations by a country's own firms and the production by foreign firms in a country's own locations that constitutes international production.

It is this latter concept of production, i.e. production by foreign affiliates, that is most commonly used to depict international production. For lack of better measures, flows and stocks of foreign direct investment (FDI) are used as proxies for the activities of TNCs and international production. FDI flows represent annual changes in these activities, while stocks give an idea about the accumulated value of the capital owned by TNCs that forms the base for international production. Though imperfect, FDI data – especially flow data – are published by most countries of the world, thus allowing broad inter-country comparisons. This is not the case with other data, e.g., sales, output or employment, not mentioning production controlled through non-equity arrangements. These data are only available for selected countries and will also be used here to illustrate broad trends.

## 2.2 The emergence and growth of international production

Until not long ago the main form of countries' integration with the world economy was trade. International production as an important form of international economic involvement is a fairly recent phenomenon. A prominent scholar in international production and TNCs' activities noted in a book published in the early 1980s that production "undertaken by enterprises which deliberately coordinate their operations (purchasing, production, finance, R&D, marketing) on a global basis to make the most efficient use of their resources (material, financial, technical and managerial) is still more the exception than the rule. Even on the eve of the Second World War, the value of such production was only one-third that of international trade. In the mid-1950s and 1960 the growth of such production outpaced that of trade, and in spite of trade liberalisation and rising oil prices, by 1976 it had exceeded that of trade." (Dunning 1981, p.388).

*The internationalisation of production has grown faster than global economic aggregates.*

During the past two decades all indicators of international production associated with TNC-governance through ownership have increased much faster than global economic aggregates (Table 1) and, as a result, international production is of considerable importance to the world economy, much greater than ever before. Global sales of foreign affiliates were about two and a half times higher than global exports in 2002, compared to almost parity about two decades ago. Global gross product attributed to foreign affiliates was about one-tenth of global GDP, compared to 6 percent in 1982. The ratio of the FDI stock to global GDP has risen from 6 percent to over one-fifth over this period. The ratio of FDI flows to world gross domestic capital formation was 10 percent in 2002, compared to 2 percent in 1982 and 5 percent in 1990. It is significantly higher for manufacturing – around one-fifth – and typically much higher in developing countries than in developed countries.

**Table 1. Selected indicators of international production, 1982–2002**

	Value at current prices (in billions of US dollars)				Annual growth rate (in percent)		
	1982	1990	2000	2002	1986 -1990	1991 -2000	2001 -2002
FDI inflows	59	209	1,393	651	23.1	30.3	-21.0
FDI outflows	28	242	1,201	647	25.7	25.8	-9.0
FDI inward stock	802	1,954	6,147	7,122	14.7	13.1	7.8
FDI outward stock	595	1,763	5,992	6,866	18.0	13.7	8.7
Cross border M&As	...	151	1,144	370	25.9	37.1	-37.7
Sales of foreign affiliates	2,737	5,675	15,087	17,685	16.0	10.5	7.4
Gross product of foreign affiliates	640	1,458	2,807	3,437	17.3	7.3	6.7
Total assets of foreign affiliates	2,091	5,899	23,460	26,543	18.8	16.6	8.3
Export of foreign affiliates	722	1,197	2,594	2,613	13.5	8.6	4.2
Employment of foreign affiliates ('000)	19,375	24,262	51,013	53,093	5.5	8.4	5.7
GDP (in current prices)	10,805	21,672	31,319	32,227	10.8	3.4	3.4
Gross fixed capital formation	2,286	4,819	6,598	6,422	13.4	2.5	1.3
Royalties and licences fees receipts	9	30	75	72	21.3	10.2	...
Export of goods and non-factor services	2,053	4,300	7,780	7,838	15.6	4.4	4.2

Note: Data on foreign affiliates are estimates.

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

The number of firms that have become transnational has risen exponentially over the past three decades. In the case of 15 developed countries for which data are available, the number of TNCs increased from some 7,000 at the end of the 1960s to around 40,000 in the second half of the 1990s. The number of parent firms worldwide is now in the range of 60,000. They form a diverse universe that spans all countries and industries, and include a large and growing number of small and medium-sized enterprises. More and more TNCs hail from countries that have only recently begun to undertake international production – witness the growth of TNCs from some developing countries and economies in transition. The roughly 60,000 parent firms mentioned above have an estimated 700,000 foreign affiliates (UNCTAD 2003a).

*Transnational corporations include a large and growing number of small and medium-sized enterprises.*

### 2.3 Mergers and acquisitions increasingly drive international production

Cross-border mergers and acquisitions (M&As) are now key drivers of international production. During the second half of the 1990s, when international production was booming, most of its growth was via cross-border M&As rather than greenfield investment. It is not possible to determine precisely the share of cross-border M&As in FDI flows.<sup>1</sup> Making an extreme assumption that all cross-border M&As are financed by FDI

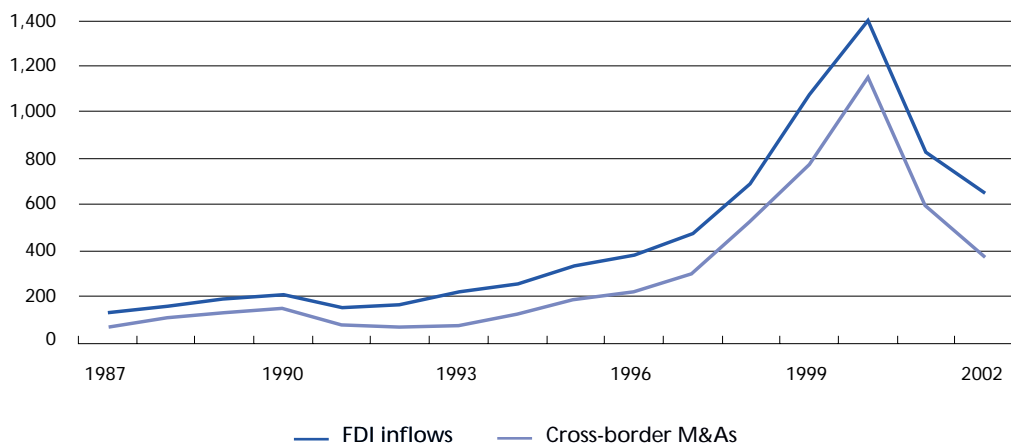
<sup>1</sup> The reason is that although both data series, i.e. cross-border M&As and FDI flows, measure similar phenomena, they do so in different ways. To illustrate, when a company from one country acquires a company from another country, the M&A database records the whole value of the transaction (on an announcement or a completion basis) in a particular year even if actual payments are phased over several years or the actual value of the transaction differs from the announced one. FDI data will record only the part of the transaction financed by acquiring company's own funds. Furthermore, only actual payments in a particular year would be registered. In addition, FDI data would not register the transaction at all if it were financed by a loan raised in the capital market of the host country (for more on this, see UNCTAD 2000, pp. 104-106).

*EU firms play an increasing role in cross-border mergers and acquisitions.*

(certainly incorrect for developed countries, but less so for developing countries and economies in transition), the ratio of cross-border M&As to world FDI inflows increased from 52 percent in 1987 to 83 percent in 1999. For developed countries, the ratio is much higher, having risen from 62 percent to 100 percent between these years. For developing and transition countries, the ratio is lower, but has been rising with considerable variations among regions and countries. The bulk of cross-border M&As takes place among developed countries, with EU firms playing an increasingly important role: the share of EU firms in cross-border M&A sales has increased from an average of 34 percent during 1987-90 to 51 percent during 1995-2002, while the share in purchases increased from 50 percent to 63 percent (UNCTAD 2003a). The growing importance of EU firms in cross-border M&As was triggered by the Single Market programme (see below) and the global restructuring of industries, which led EU firms to acquisitions of US companies, especially in the second half of the 1990s.

Given the strong correlation between FDI flows and M&As, the rhythm and fluctuations of the latter determine annual patterns of FDI flows. When M&As fall, as they drastically did during the economic slowdown of 2001-02, FDI flows follow (see Figure 1).

**Figure 1. FDI inflows and cross-border M&As in billions of US dollars, 1987-2002**



Source: UNCTAD (2003a).

## 2.4 The growth of non-equity relationships

Traditionally, cross-border agreements – or non-equity relationships between firms in different countries – played an important role in the global expansion of firms. In services industries, in particular, non-equity relationships between firms have been more important than equity-based relationships. International restaurant networks, especially fast-food chains, car rentals and retail trading networks have been frequently based on franchising agreements. And then, management contracts are used in the hotel industry (together with equity forms), and partnerships rather than equity links in services such as accounting, business consultancy, engineering and legal services (Mallampally and Zimny 2000). Globalisation has led to an explosive growth of international agreements among firms, with their range growing ever wider. Now they are part and parcel of international

production, complementing traditional FDI, and in particular M&As, as a form of restructuring resources and capabilities of firms in response to globalisation. The number of such agreements (excluding technology agreements and including joint ventures) concluded annually increased from 1,760 in 1990 to 4,600 in 1995 (UNCTAD 1997).

Inter-firm agreements today serve a variety of corporate objectives. Two motivations stand out as particularly important. One is better access to technology, allowing firms to accelerate innovation and share the cost and risk of innovatory activities. Another is streamlining resources and capabilities of firms through focusing on core competencies and shedding less important assets. The first motivation has boosted technology agreements (including strategic alliances) while the second has given rise to outsourcing of non-core activities to other firms.

Over the period 1980-96, a total of 8,254 inter-firm technology agreements were recorded, with their number growing from an annual average of less than 300 in the early 1980s to over 600 in the mid-1990s (UNCTAD 1998). Industries that are highly knowledge-intensive have the largest number of agreements. During 1980-96, information technology was the top industry in this respect, accounting for 37 percent of all agreements. Pharmaceuticals, notably bio-pharmaceuticals, were another important industry, with a 28 percent share in 1996 (up from 14 percent in the early 1980s). In less knowledge-intensive industries – food and automotive industries – the number of agreements peaked in the mid-1980s, but has declined in both industries since then, although inter-firm technology agreements picked up again in the food industry in the first half of the 1990s. Triad members (comprising firms from the EU, Japan and the United States) are dominant partners in these agreements. By the mid-1990s, 86 percent of these agreements had at least one US partner, 42 percent one EU partner, and 31 percent one Japanese partner. The participation of developing country firms increased from 3 percent in 1989 to 13 percent in 1995.

The rise in technology agreements reflects drastic changes in the technological environment of firms since the mid-1980s, which evolved from being reasonably predictable and stable to much more dynamic, variable and unpredictable. To name a few: patterns of demand change more rapidly than before, faster innovation reduces product life cycles, product development times become shorter and flexible, manufacturing techniques put additional pressures on firms. All these increase costs and heighten uncertainty, while at the same time technology increases in importance as the key competitive asset of firms. Initially firms turned to M&As for assembling the critical mass of technological resources to stay competitive. But M&As have frequently proved to be insufficiently flexible, hence firms have resorted to agreements: often firms do not want to acquire, or gain access to, all the assets of other firms, but only those that enhance their competitiveness (Dunning 1995).

Two caveats need to be made here. One is that inter-firm agreements do not seem to replace FDI, or, for that matter M&As. Indications are that both go hand in hand, being complements rather than substitutes (UNCTAD 1998). The second caveat is that technology, although very important, is not the only asset sought in inter-firm agreements, and consequently, technology agreements are not the only agreements on the rise. Gaining access to new markets or distribution channels and capturing economies of scale can be no less important for many firms, giving rise to a myriad of inter-firm agreements.

*Non-equity relationships, notably technology agreements, have become an increasingly important feature of international production.*

*Transnational corporations are focussing on their core competencies, and they outsource more of their non-core activities.*

A striking recent trend in the governance of international production systems in manufacturing and increasingly in services is the focus on “core competencies”, that is, activities in which “TNCs can deploy proprietary advantages, wield market power and, consequently, enjoy higher returns” (UNCTAD 2002, p. 122). This leads to greater outsourcing of a greater range of activities, giving rise to further growth of non-equity forms of international production beyond alliances or partnerships. The outsourcing trend creates even more complex structures of international production. In particular, leading TNCs have begun to withdraw from manufacturing altogether, leading to the emergence of contract manufacturers that specialise exclusively in manufacturing for other firms, in particular TNCs. Contract manufacturing differs from earlier non-equity forms such as original equipment manufacturing in that brand-holding TNCs do not simply draw on subcontractors for extra production capacity, but outsource the entire manufacturing function for individual product lines or, in some cases, like Cisco Systems, the entire product range.

Contract manufacturing is difficult to capture statistically. Some figures for the electronics industry give a broad idea of the magnitudes involved. Between 1998 and 2002, the global market for this type of activity in this industry is estimated to have increased by 140 percent, from USD 58 billion to USD 139 billion. Indications are that the share of contract manufacturing in electronics will rise from 8 percent in 1999 to 18 percent in 2004. In 2002, the largest four contract manufacturers each had revenues of over USD 10 billion, two of them being US firms, one Canadian and one Singaporean, Flextronics, (UNCTAD 2002). They had facilities all over the world – in developed, developing and transition economies.

Shedding assets or activities leads, more often than not, to equity and non-equity forms of international production instead of arm’s-length trade, as market imperfections that encourage internalisation still exist. Therefore, “the strategic need to maintain influence over the design, quality and supply of inputs, the processing of downstream activities and the pace and direction of innovation is even greater” (Dunning 1995, p. 139). So, even though international production systems are increasingly based on non-equity arrangements, TNCs typically exert significant authority through controlling key functions, such as brand management and product definition, as well through the setting and enforcing of technical, quality and delivery standards throughout the network of formally independent producers.

To summarise this section: the internationalisation of production has grown rapidly since the beginning of the 1980s; while foreign direct investment – notably in the form of mergers and acquisitions – seems to be the more prominent aspect of this process, non-equity relationships between firms around the globe are also of considerable importance, complementing FDI as a means of increasing the corporate efficiency of producing goods and services. But has this process been even across sectors and geographical areas? The next two sections will argue that it has not.

### **3. The sectoral composition of FDI: the shift towards services**

The rapid growth of FDI in the recent past has been driven largely by FDI in services. As a result, the sectoral composition of global FDI has shifted towards services. During the



1950s, FDI was concentrated in the primary sector and manufacturing. The latter FDI was of a market-seeking type, motivated by access to national markets, often sheltered from international competition by trade barriers. Today, it is mainly in services and manufacturing. The long-term shift towards services has been consistent over time: services represented less than a quarter of the stock of FDI of major home and host countries at the beginning of the 1970s; by 1985, the share of services had increased to 40 percent, and a further increase to almost 50 percent materialised by 1990 (Mallampally and Zimny 2000); the shift has continued since then and, as a result, the share of the services sector in world FDI stock now amounts to some 60 percent (UNCTAD 2003b).

In absolute terms, the FDI stock has grown in all sectors and almost all industries. Even in agriculture, hunting, forestry and fishing – traditionally not important FDI industries – the stock of inward FDI more than doubled between 1990 and 2001, while that in manufacturing tripled. The stock of inward FDI in services, however, quintupled, and the share of manufacturing thus fell to 35 percent in 2001 (from 40 percent in 1990). The share of the primary sector also declined, from 10 percent to 6 percent.

The growing significance of services FDI has taken place mainly due to FDI in non-tradable services which, not being transportable or storable, must be produced where they are consumed. FDI is often the only means of delivering them to foreign markets. In addition, in some services (such as insurance services or retail banking), which technically could be traded, host-country regulations often require local establishment for their delivery. Initially, two services industries dominated services FDI – financial and trading services. This reflected the early international expansion of trading companies (e.g., Japanese *sogo shoshas* and Western European traders) and transnational banks, which followed their customers abroad. In addition, manufacturing and primary sector TNCs used to establish foreign affiliates in these services in support of trade and other operations abroad. Although investments in these services continue, they are not as dynamic as those in other non-tradable services such as electricity (which registered a 13-fold increase in inward FDI stock between 1990 and 2001) and telecommunications and transport (a nearly 15-fold increase), as well as in business services (a nine-fold increase). As a result, finance and trading decreased from 65 percent of all inward services FDI stock in 1990 to 45 percent in 2001, while that of the “new” FDI service industries rose from 17 percent to 44 percent.<sup>2</sup>

A boost to investment in services, including in the “new” service industries, occurred when both developing and developed countries started revising their policies towards the services sector in the second half of the 1980s, with former central-plan economies following suit in the 1990s with the onset of transition. Governments set in motion a process of liberalisation with respect to domestic as well as international production and provision of services. Domestic and foreign competition has been increasingly viewed as a tool for increasing the efficiency of service industries, which in turn are recognised as being critical for economic performance generally. Deregulation and privatisation of service industries (in particular infrastructure services such as telecommunications, power generation, transportation and the provision of water) followed, combined with an opening up to FDI. On the international front, the creation of the Single Market in the EU

*FDI in services received a boost from the liberalisation of network industries.*

<sup>2</sup> Other dynamic services include health and education where stock increased by 12 and five times, respectively, over the same period; but the absolute size of the stock in these activities is still very small.

provided a powerful inducement for both EU and non-EU TNCs to invest in service industries of EU countries. The completion of the Uruguay Round and the adoption of the General Agreement on Trade in Services (GATS) have provided an additional channel for further liberalisation of developing and transition countries' policies related to FDI in services.

Notwithstanding the rapid growth in services FDI, the scope for further expansion of FDI in non-tradable services remains considerable. Prospects for services FDI have been further enlarged by advances in information and telecommunication technologies, which have greatly enhanced the abilities for processing and transporting information between geographic locations and, consequently, for the cross-border tradability of information-intensive services or parts thereof. As a result, we are witnessing a fragmentation of the production of some services by TNCs in all sectors and the relocation of production to developing and transition economies, resembling the process that took place in labour-intensive manufacturing some 20-30 years ago. According to a recent survey of the world's largest companies by AT Kearney, a global business consultancy firm, over the next three years, nearly 80 percent of cross-border business-services outsourcing, leading to export-oriented FDI and non-equity arrangements, will take place in services such as IT support, back office functions, R&D, call centres, distribution and logistics and treasury operations (AT Kearney 2003). This changes the nature of FDI in services. It will allow TNCs to pursue internationally integrated production strategies, leading to efficiency-seeking FDI, which so far has been a characteristic of the international production of goods such as cars, clothing, toys, semiconductors and other electronic products. Now, TNCs in various industries locate more and more services activities along the value chain of services in their affiliates abroad and integrate them with activities elsewhere within their production systems (Zimny and Mallampally 2002).

*Cross-border outsourcing of business services further enhances the efficiency of international production systems.*

#### **4. Changing geography of FDI**

When considering the geography of FDI, it makes sense to proceed in two stages. First, it is necessary to examine which are the main home countries (i.e. sources of FDI) and which are the main host countries (i.e. destinations of FDI). Second, one can ask to what extent home and host countries overlap and why. In answering why there is an overlap between host and home countries, one needs to look at the forces that give rise to regional clustering of FDI and those that foster inter-regional FDI. The structure of this section reflects this approach.

##### **4.1 Home countries: EU countries take the lead**

During the two decades after the Second World War, outward FDI was dominated by the United States and a few former colonial powers of Western Europe. In 1960, four countries accounted for over four-fifths of the world outward stock of FDI. The United States was the largest home country, holding around half of the world stock, followed by the United Kingdom (18 percent), the Netherlands (10 percent) and France (6 percent) (UN CTC 1988). Almost all FDI originated from developed countries.

During the decades that followed, the geographical composition of outward FDI became more diverse, especially among developed countries. The dominance of the four countries

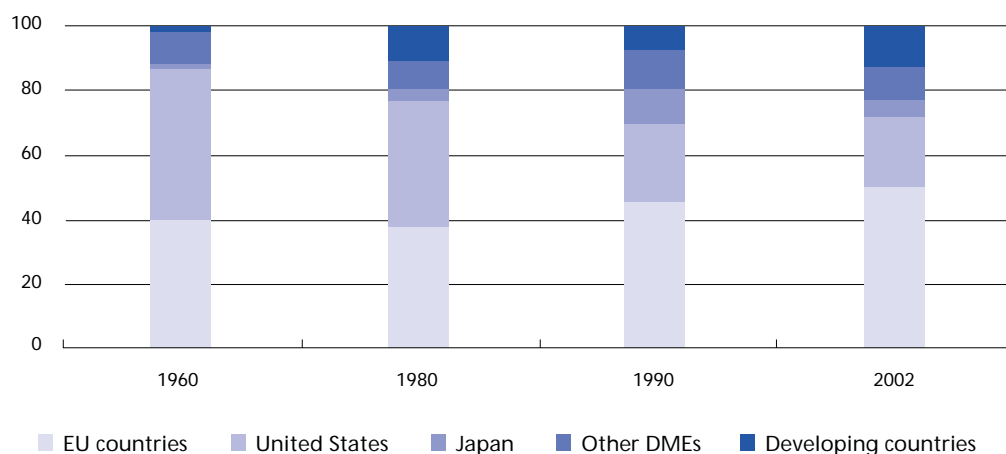
mentioned subsided to some two-thirds during the early 1980s; it has fallen further since then, reaching some 50 percent at the beginning of the new millennium. Their relative drop happened, however, almost entirely due to the declining share of the United States, to one-fifth of the global FDI stock in 2002. By contrast, in 2002, the share of the three remaining countries was close to that in 1960 (30 percent vs. 34 percent), fluctuating during the 1980s and 1990s around one-quarter. The United States remains the largest home country in the world, but the distance to the countries following it largely diminished. New major global players and a group of smaller investor-countries, which stepped up their foreign investments over the past few decades, account for the declining US share in outward FDI. But which countries have emerged as the new kids on the block?

*Outward FDI has become geographically more diverse, and EU countries have taken the lead.*

**Japan's role in outward FDI has seen dramatic ups and downs.** As regards individual countries, the largest upsurge in foreign production originated from Japanese TNCs, which increased their investment sharply, particularly in the United States in the 1980s and in Europe in the 1990s. Between 1980 and 1994, Japanese outward stock increased 14 times, and Japan's share in the world stock rose from 3½ to 12 percent. In the early 1990s, Japan outpaced the United Kingdom and had the second largest outward stock. But with the prolonged stagnation of its economy during the 1990s, Japan lost this position and its share declined to some 5 percent by 2002. Japan, however, remains a significant home country in terms of the absolute size of FDI stock (ranking seventh in the world).

**TNCs from developing countries have entered the scene.** Another significant change was the emergence of TNCs based in the developing world. In the 1970s and 1980s, their investment was about 3 percent of the world total (UN CTC 1988). It was mainly trade supporting FDI and investment in services catering to the needs of emigrants from these countries. This share rose to around 11 percent in the early 1990s and, with some fluctuations, stayed at this level for the next decade. Almost all the increase originated in a few newly industrialising Asian economies, including the Republic of Korea, Taiwan Province of China, Singapore and Hong Kong (China), as part of a regional flying-geese pattern: when these economies started losing comparative advantage in

**Figure 2. Composition of global outward FDI stock (in % of total)**



Notes: DME = developed market economies.  
Source: UNCTAD (2003a).

unskilled labour-intensive manufacturing, their firms moved out to seek more competitive locations in the region, more recently in China in which Hong Kong (China) is by far the largest investor. Automotive and electronics TNCs from these countries also undertook a number of investment projects in developed countries. As a result of the emergence of developing countries' TNCs (and recently those from transition economies, although still on an insignificant scale), the dominance of the world stock of FDI by developed countries decreased to below 90 percent (Figure 2).

**EU countries have taken the lead.** EU countries considerably strengthened their position in world outward investment, increasing their share from 38 percent in 1980 to 45 percent in 1990 and 50 percent in 2001-02. While in 1980 EU countries' stock was similar to that of the United States, in 2002 it was 2.3 times larger. The three mature investing countries mentioned earlier (i.e. the United Kingdom, the Netherlands, and France) and Germany dominate the EU stock, accounting for three-quarters of the Union's 50 percent. But it is worth noting that these countries account for only 3 percentage points of the 12-percentage-point increase in the EU countries' share in the world FDI stock since the beginning of the 1980s – and here foreign investment of French firms stands out. Germany joined the group of the largest EU home countries before the 1980s. Since then, it has retained its position, with its share hovering around 7-8 percent of the world FDI stock. The biggest gain came from the “newcomers” to the EU, the group of small countries and Spain that joined the EU in various years between 1973 and 1995 (Denmark, Ireland, Portugal, Spain, Austria, Finland and Sweden) – almost 7 percentage points, and the balance from Belgium and Luxembourg (whose FDI data are reported together) and Italy. All in all, out of 15 EU member states, 10 increased their shares in global FDI stock between 1980 and 2001, two (the United Kingdom and Germany) maintained their shares and only one, Greece, decreased its share. France and Spain registered the largest gains (3½ and 3 percentage points, respectively) followed by Italy (1.6) and Sweden (1.3).<sup>3</sup>

#### 4.2 Host countries: more balanced distribution

*The field of inward FDI is more crowded than that of outward FDI.*

The inward FDI stock has always been much less concentrated than the outward stock. In the 1960s, almost all FDI originated in developed countries; 70 percent of this went to developed countries and the balance to developing countries (Dunning 1993). Obviously, outward FDI requires a pool of companies with ownership-specific advantages, which only a small group of developed countries have, but many more countries have some locational advantages (such as natural resources, a competitive labour force, and/or large and dynamic markets) – a condition to attract FDI. Therefore, the field of inward FDI is much more crowded than that of outward FDI.

<sup>3</sup> We have left aside the special case of Luxembourg and, consequently, Belgium because of the joint reporting of FDI data). Luxembourg is a special case because it is a host to a large number of foreign holding companies established there for tax reasons. These companies are used to channel funds between affiliates and parent companies of TNCs located in different countries in order, for example, to acquire foreign companies. As a result, according to FDI data, Luxembourg emerged in 2002 as the world's largest outward investor and the largest FDI recipient, accounting for about 19 percent (USD124 billion) of world inflows and 24 percent (USD154 billion) of outflows. Only a small part of these flows represents genuine FDI, however. In 2002, according to the Banque centrale du Luxembourg, such transshipped investment of funds for further transfer as FDI elsewhere was estimated at about 80 percent of the country's FDI inflows and outflows (UNCTAD 2003a, p. 69).

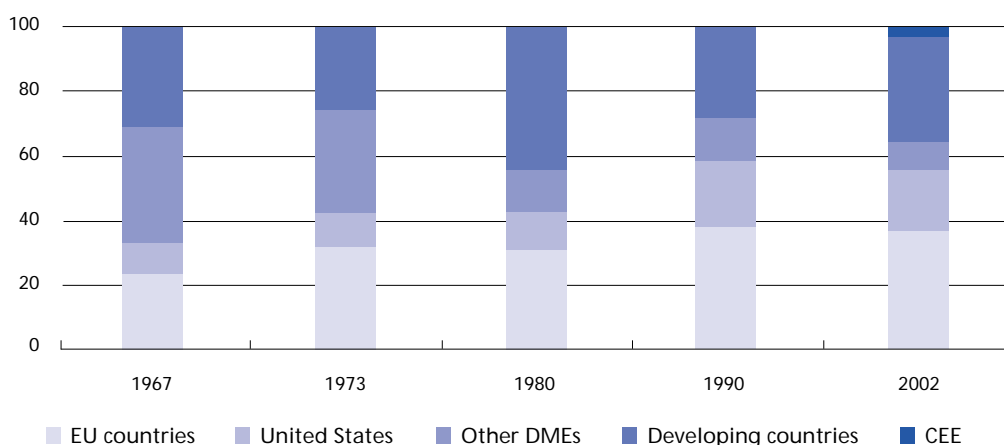
Over time, competition for FDI among countries has intensified, as more countries have opened up to FDI and actively sought to attract it. In the 1990s, competition was more intense than during the 1980s. It is worth noting that increased competition was associated with accelerating FDI growth: from 1980 to 1990, the global inward FDI stock increased 2.8 times, and between 1990 and 2000 3.2 times. In the 1990s, China and transition economies entered the picture, India started to seek FDI more actively than before, Brazil overcame the economic crisis and a number of regional integration schemes came to life, creating large regional markets (e.g., NAFTA or Mercosur) – always an attraction to foreign investors. In this situation it has become more difficult for individual host countries to increase or even maintain their FDI market share. Indeed, the country composition of inward FDI underwent significant changes compared to earlier decades. Given the turbulent FDI market, many of these changes were short-lived and gave way to new ones. But which countries were particularly successful in attracting FDI?

**The United States has become the largest host country.** In the 1960s and 1970s, the United States was a large host country (with a share in the total inward stock of around 9-10 percent), but not the largest one; the largest one was Canada. In 1979, the United States replaced Canada in this role (UN CTC 1988) and, during the 1980s, became by far the largest host to FDI, accounting for one-fifth of the world total by the end of the 1980s (the United Kingdom came next with 10 percent). Since then, the United States has maintained its share and its distance from other large host countries (Figure 3).

**China has emerged as a leading host country.** One of the most significant changes in the distribution of inward FDI over the past two decades has been the rise of China to the position of the fourth largest recipient of FDI in the world, from the 17th place in 1980 and 1990. This rise has occurred during the 1990s, when China increased its share of world inward FDI stock from 1.2 percent in 1990 to 6.3 percent in 2002 – a 5 percentage-point increase not matched by any other country of the world. In fact, China accounts for a considerable part of the rise in developing countries' share in inward investment. The greater part of FDI in China originated from developing economies of Asia, particularly Hong Kong (China), and continues to do so.

*China's share in the global stock of inward FDI rose substantially over the last decade, with most of the investment originating from Asian developing economies.*

**Figure 3. Composition of global inward FDI stock (in % of total)**



Notes: DME = developed market economies.  
Source: UNCTAD (2003a).

**CEE has emerged as a new host region.** During the 1990s, Central and Eastern Europe emerged as a new destination for FDI, increasing its share in the inward FDI stock from practically zero in 1990 to 2.6 percent in 2002. The eight countries that joined the EU in May 2004 accounted for most of this increase (nearly two percentage points).<sup>4</sup> That said, the CEE combined stock of FDI (USD190 billion in 2002) is still small; it is not much larger than Ireland's (USD160 billion) and smaller than Brazil's (USD235 billion).

**EU countries hold up well amidst tough competition.** EU countries posted gains as regards inward FDI, although they were not as big as in the case of outward FDI. Between 1980 and 2001, EU countries increased their share in the global stock from 31 percent to almost 37 percent. All these gains took place during the less competitive decade of the 1980s, however. Since 1990, EU countries have been able to maintain their share amidst increasing competition for FDI and accelerating FDI growth. Between 1980 and 2001, nine out of 14 EU members (Belgium and Luxembourg counted as one) registered increases in their shares, two (Austria and Portugal) showed no change, and the shares in the global inward FDI stock of three countries (Greece, Ireland and the United Kingdom) decreased. Interestingly, the Netherlands, which lost some clout (through losing share) as an outward investor, became a more important host country, increasing consistently its share in global inward FDI stocks from 2.7 percent in 1980 to 3½ percent in 1990 and 4.3 percent in 2001. As a result, the Netherlands has become the third largest host country in the EU (sharing this position with France), after the United Kingdom (8.4 percent share) and Germany (6.3 percent). Although the United States remains by far the largest single host country in the world, EU countries represent the largest host region, with a stock twice as big as that of the United States in 2002.

*Foreign investors have shifted away from resource-rich to leading industrial countries.*

As regards other long-term changes in the country composition of inward FDI, foreign investors shifted away from resource-rich countries like Canada and Australia to the leading industrial countries, notably the United States and Europe. The main exception in this regard is Japan, whose share in total FDI stock has remained below 1 percent over the past two decades. Within the group of developing countries, there has been a long-term relative shift away from Africa and Latin America to South, East and South-East Asia.

To summarise developments in the direction of inward FDI, there has been a long-term trend towards a more even geographical distribution. In spite of this trend, inward FDI remains highly concentrated within groups of countries. The five largest host developed countries account for 70 percent of developed countries' inward stock, while the top five host developing countries account for 60 percent and the top ten for over 70 percent of this group's inward stock. The concentration ratio for inward flows is similar. For example, the ten largest host developing countries accounted consistently for 70 to 80 percent of total FDI inflows to developing countries between 1990 and 2001 (UNCTAD 2002).

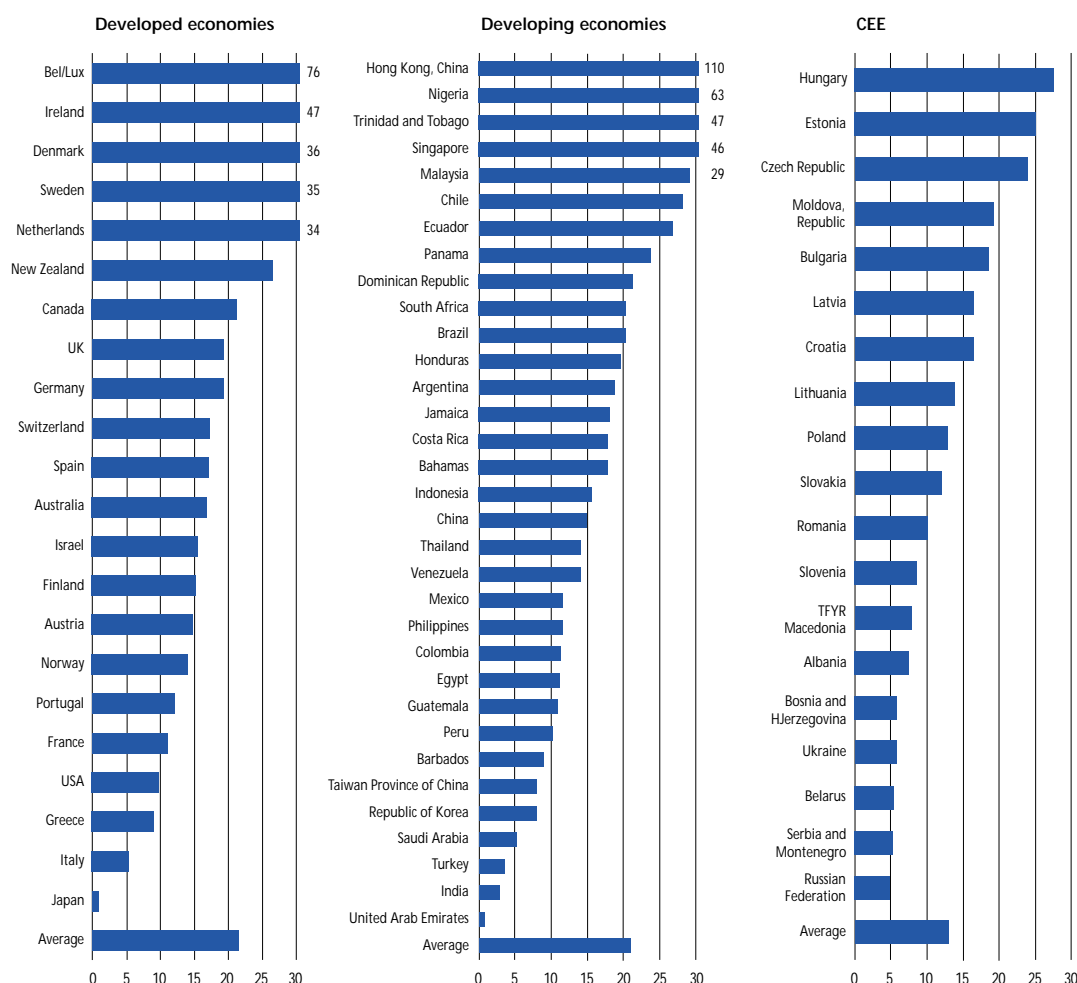
These ratios often serve to illustrate that the overwhelming majority of countries, especially developing ones, are marginalised in international production and, therefore, do not benefit fully from globalisation. While this claim is largely correct, the FDI concentration ratios do not provide a correct picture, as they do not take into account differences in the relative sizes of the economies. After all, what really matters for host

<sup>4</sup> These are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

countries is the relative role of FDI in their economic activities in terms of its contribution to investment, employment, value added, etc. The UNCTAD transnationality index of host countries tries to measure this role. It represents the average of four shares: (i) FDI inflows as a share of gross fixed capital formation; (ii) FDI inward stock as a share of GDP; (iii) value added of foreign affiliates in percent of GDP; and (iv) employment in foreign affiliates in percent of total employment. The ranking of countries by this index differs considerably from that based on countries' shares in inward FDI (Figure 4), indicating that a group of smaller countries, which will never make it to the group of top FDI recipients, are much more involved in international production through FDI than the largest host countries. To illustrate, only two out of the five largest host-developing economies – namely Hong Kong (China) and Singapore – are also in the top five by the transnationality index. Similarly, this index ranks only five of the ten largest FDI recipients (Malaysia, Singapore and South Africa, in addition to the two above) among the top ten developing countries on the transnationality list. Furthermore, several developing countries – such as Nigeria, Ecuador, Honduras, and Costa Rica – are, relatively speaking, much more involved in international production than China, the largest developing country recipient of FDI.

*While the majority of developing countries attract only a small part of global FDI, for many of them the activities of transnational corporations are economically rather important.*

**Figure 4. Transnationality index of host economies, 2002**



Notes: For details concerning the design and computation of the Transnationality Index see UNCTAD (2003a, p.6).  
Source: UNCTAD estimates.

Differences between the two lists are even bigger in the case of developed countries. Only one country, the Netherlands, is on both lists, while the top positions on the transnationality list are held by small EU countries: Belgium and Luxembourg, Ireland, Denmark and Sweden, followed by New Zealand and Canada, none of which belongs to the group of the largest host developed countries. The United States, the largest host country in the world, is 19th among developed countries (and 49th among all countries) listed in Figure 4 (not all countries in the world are included, but only those for which the four indicators are available).

### 4.3 Regional clustering versus inter-regional FDI

The previous two subsections suggest a prominent role of EU economies as both home and host countries for FDI. Evidently, a considerable portion of EU countries' FDI flows and stocks are intra-regional, i.e. they reflect the investment activities of TNCs from one EU country in another. This subsection will highlight the growing importance of intra-EU foreign direct investment and, more generally, sketch how FDI clusters geographically.

*Geography, political and cultural factors, and globalisation have contributed to the importance of EU countries as sources and destinations of FDI.*

In general, the geographical pattern of international production is shaped by conflicting factors. Two of these factors stand out. One is the preference of firms to invest in neighbouring countries (to which they used to export goods before undertaking FDI) or in countries with which they have close political, economic, cultural and/or language ties.<sup>5</sup> Regional integration reinforces the importance of this factor by creating larger and potentially more dynamic regional markets. The second factor, increasing in importance with globalisation, is the need of TNCs operating in global industries to be present in all important markets where their competitors have invested and to access competitive capabilities and resources around the globe so as to counter the risk that their competitors will use such capabilities and resources to gain a competitive edge.

To elaborate on the effects of regional integration, an important one is that it facilitates intra-regional investment by removing or reducing restrictions on the movement of capital, goods, services and people and by further protecting investors against member states. At the same time, if regional integration creates a large and dynamic regional market sheltered by trade barriers from the rest of the world, no globally ambitious TNC from outside the region can miss the opportunity to invest there. In sum, regional integration has the potential to foster both intra-regional and inter-regional FDI.

What does this all imply for EU countries' outward and inward FDI? It is fair to claim that EU countries owe their position as the largest source of FDI and a favourite destination for FDI to both factors mentioned above. To start with the empirical evidence on EU countries' outward FDI and the relative importance of intra-regional and inter-regional forces, data show that the share of Western Europe in individual EU countries' outward FDI stock was already high in the mid-1970s – with the exception of the United Kingdom. More specifically, shares ranged from 53 percent in Germany to 72 percent in Belgium/Luxembourg (United Nations 1993). During the following years – until about the mid-1980s – the United States became a much more dynamic destination than EU countries for outward

<sup>5</sup> Investment in natural resources is an obvious exception: investors often have to accept long distances to countries which have these resources.



investment from the United Kingdom, Germany, France, the Netherlands and Denmark. As a result, the US share in outward FDI of these countries increased at the expense of other EU countries. The trend reversed after the mid-1980s, when the United States' share stagnated or decreased (except in the United Kingdom's outward FDI) while that of EU countries increased. Spain and Portugal stepped up their investment in the region considerably during the period around or after their accession to the EU in 1986. The data for most EU countries as a group, available from the UNCTAD FDI/TNC data base since 1990, show that since the beginning of the 1990s, the stimulus of intra-EU investment has continued: the share of this investment in the EU outward stock increased from 43 percent to 50 percent in 2001. The only other region whose share in EU FDI increased during this period, from almost zero to three percent, was CEE. The share of the United States remained at a high level of 28 percent while that of developing countries decreased from 12 to 8 percent.

As to EU countries' inward FDI stock, the story is broadly similar, with some variations in details. By the mid-1970s, EU TNCs were dominant investors in other EU countries, with their shares in the inward FDI stock of EU countries ranging from 51 percent in the Netherlands to 76 percent in Italy. Exceptions were the United Kingdom and Ireland, where United States TNCs held the largest FDI stock. During the 1980s, intra-EU FDI stimulated investments in the Netherlands, United Kingdom and Germany. At the same time, the intra-EU share in the inward FDI stock of France stagnated and that in inward FDI of Italy dropped – though from a very high level of 81 percent in 1980 (United Nations 1993). At that time, Japan was another dynamic source of FDI into the EU, increasing its share of FDI in all five countries mentioned above. By contrast, the share of the United States increased only in France, but decreased in the remaining four countries. Between 1990 and 2001, the share of intra-EU FDI in total EU inward FDI increased from 37 percent to 60 percent, while the shares of all other major non-EU countries decreased (that of the United States from 28 percent to 24 percent).

Overall, the prominent role of EU member states as a source and destination of FDI suggests strong forces leading to regional FDI clusters. As will be argued in the next section, EU integration is undoubtedly one of the main centripetal forces in this process. But before turning to the role of EU integration, one should note that the geographical pattern of FDI has dimensions other than those apparent from the increasing importance of intra-EU investment. An important one is the clustering of host countries around the EU and the United States (and to a far lesser extent around Japan). One way to illustrate this is to look at the number and geographical location of those host countries that have strong FDI links with the three centres of world FDI activity, namely the United States, the EU, and Japan. Here, a host country is considered to have a strong FDI link with one of these centres if their foreign direct investors account for at least 30 percent of the host country's total FDI inward stock or its FDI inflows within a three-year average.

Using this definition of strong FDI links, it can be shown (UNCTAD 2003a) that the number of countries clustering around Japan is relatively small and has fallen since the mid 1980s. By contrast, clustering around the United States and the EU is much more extensive and confirms, with a few exceptions, the role of geographical proximity and/or special ties. More specifically, 12 out of 19 host countries that had strong FDI links with the United States in 2001 are on the American continent and two (Saudi Arabia and Israel) have close

*Host countries cluster around regional centres of gravity, notably the EU and the United States.*

political ties with the United States. Furthermore, 17 out of 40 countries with strong FDI links to the EU are from Europe (of which 14 from CEE), eight are from Africa and six from West Asia (essentially, natural-resource-seeking FDI). Both the United States and the EU are major partners for Argentina, Chile, Russia and Switzerland. But in general, close inter-regional ties with one of the centres of gravity are much less frequent than regional ones, and they are often motivated by the need to access natural resources, especially petroleum.

## 5. EU integration has boosted FDI

As noted above, regional integration can have a considerable impact on FDI, including on its growth, types, geographical, sectoral and industry composition. The EU represents the oldest, largest, most advanced and most successful regional integration scheme in the world. Its establishment, functioning, deepening and extension to new member countries have exerted over the years a significant impact on FDI and, thus, on the position of the EU and its individual members in international production. What follows is a brief overview of key impacts related to the integration process, shedding more light on some of the factors explaining the growing role of the EU in worldwide outward and inward FDI.<sup>6</sup> Furthermore, this section will offer some views on the impact of integration on the new EU member states from Central and Eastern Europe.

### 5.1 The establishment of the European Economic Community (EEC)

Preparations for the creation of the EEC in 1958 and the gradual implementation of the provisions of the Treaty of Rome concerning customs union and the common market coincided with large FDI in manufacturing of the EEC countries by US transnational corporations. The US FDI stock in the EEC increased three times between 1957 and 1964, much faster than its total outward stock. Between 1955 and 1972, the share of the EEC (six members) in the outward stock of the United States increased from 6 to 17 percent (UNCTAD 1998). There is consensus in the literature that this inflow was to a considerable extent triggered by dynamic effects of integration, especially by the creation and fast growth of a large regional market (Blomström and Kokko 1997, Yannopoulos 1990, and UN CTC 1993) and to a smaller degree by static effects related to trade diversion.<sup>7</sup> The creation of EFTA also attracted US FDI into manufacturing, although on a smaller scale. The main beneficiary was the United Kingdom, which explains why its accession to the EU in 1973 had a smaller impact on its inward FDI: the majority of important US transnational corporations were already in the United Kingdom at the time of accession.

The adjustment of EEC firms to integration took the form of trade (the share of intra-EEC exports in total EEC exports increased from 32 percent in 1958 to 50 percent in 1970) and domestic M&As in manufacturing (almost 90 percent of the M&As in the Community

*In its early years, European integration triggered US FDI inflows rather than intra-European FDI.*

6 Channels and mechanisms demonstrating the impact of regional integration on TNC activity and FDI are well examined in the extensive literature on the subject and there is no need to describe them here. Dunning (1993) provides an exhaustive review of this literature on pp. 479-502. See also Blomström and Kokko (1997); Dunning (1997); and Preston (1997).

7 Estimates show that during that period US exporters lost some USD 311 million as a result of trade diversion and that US FDI increased by more USD 3 billion, far more than required to compensate for trade losses.

during 1961-69 were domestic and not cross-border<sup>8</sup>), and there is no evidence that the creation of the EEC increased intra-EEC FDI. The services sector was affected neither by FDI nor by integration in general. Most services are not tradable and require establishment of production abroad and/or movement of persons. The Treaty of Rome formally provided for both the right of establishment and freedom of movement of persons (in addition to capital movement). But it did not consider internal country regulations on professions, provision of services or state-owned monopolies in telecommunications, electricity or air transportation, which proved to be formidable barriers to trade and FDI in services.

## 5.2 Deepening integration: the Single Market programme

The next boost to FDI in the EU came from the Single Market programme. The programme was launched in 1985 and implemented during the second half of the 1980s and early 1990s. It aimed at removing remaining non-tariff barriers to the movement of goods, services, capital and people, thereby unifying competitive conditions for enterprises in the EU. Most importantly, it addressed barriers to trade and investment across service industries, initiating deregulation and liberalisation of these industries.

EU and third-country firms, both in manufacturing and services, started to adapt to the new rules of the game in the mid-1980s, not waiting for the completion of the programme, and intensified this process during its implementation. Adaptation took various forms, but had a number of common threads. For one thing, when reorganising their activities, enterprises – including the EU ones – developed a regional perspective, moving away from strategies geared towards serving separate national markets.<sup>9</sup> For another, FDI played a key role in enterprise restructuring, essentially through cross-border M&As, which became far prominent than ever before; as a result, the Single Market programme led to a pattern of FDI very different from that generated by the creation of the EEC.

But what were the main differences? To begin with, the principal actors this time were TNCs from the EU and not from outside. Intra-EU FDI grew much faster than extra-EU FDI (and faster than trade) and, as a result, its share in total FDI inflows to EU countries increased from 30 percent in the mid-1980s to 60 percent in the early 1990s.

*The Single Market programme changed the pattern of FDI in Europe, boosting intra-EU FDI in particular.*

Second, as regards third-country TNCs, the most active this time were Japanese firms. Annual flows of Japanese FDI into the EU increased from USD 2 billion in 1985 to USD 14 billion in 1990, levelling off in 1993 at USD 8 billion (Kumar 1994). At the end of 1993, cumulated Japanese investment in Western Europe (mainly the EU) stood at USD 84 billion, of which some 80 percent was invested during 1987-93 in response to the Single Market programme. The main motivation of Japan's TNCs was to protect their market share gained through exports, in the face of growing EU protectionism directed against Japanese cars and electronic products. Similar motivations led to investments by a few Asian newly industrialised countries.

<sup>8</sup> Commission of the EEC (1970), *La Politique Industrielle de la Communauté*, Part One, Brussels, p. 48.

<sup>9</sup> A few US TNCs had pursued such strategies in Europe before. The prominent example is the network of Ford's factories located in various EEC countries, specialising in specific components that are then assembled in an assembly plant.

Third, a good part of FDI growth at the time, in particular among EU members, took place in the services industries such as banking, insurance, trading, transportation, telecommunication, tourism, and business services. As a result, the share of services in EU FDI flows increased from 55 percent in 1984-86 to 64 percent in 1990-92. Third-country investors in the EU also increased their investment in services and, as a result, the share of services in their investment during the same period increased from 55 percent to 62 percent (Dunning 1997).

Finally, although US foreign direct investment in the EU was not as dynamic as that of EU and Japanese TNCs, it increased relative to the United States' total FDI: the share of the EU in US outward FDI increased from 35 percent in 1985 to 41 percent in 1990 and stayed at this level for some time. The reason for its slower growth was that at the time of the Single Market programme, US firms were already well established in the EU market. In fact, they were in a stronger position than Japanese and many EU TNCs. US firms serviced the EU market 85 percent through local production and/or sales of foreign affiliates and only 15 percent through exports. In the case of Japanese firms this ratio was exactly the opposite: 15/85. Thus, US firms had less reason to fear trade protectionism. Rather than massively increasing their investment, US manufacturing TNCs focused on the restructuring and consolidation of their existing affiliates into regional networks. But US services TNCs increased their FDI considerably, mainly through cross-border M&As.

In conclusion, the Single Market programme was crucial for strengthening the position of EU countries in international production worldwide. Judging from FDI flows, which measure annual FDI outlays, consistent increases in EU countries' share in world inflows took place between 1986 and 1990 (from 26 percent to 48 percent of world total). After that, in the first half of 1990s, when the effects of the programme weakened or perhaps even subsided, and the recession of the early 1990s set in, the EU countries' share in inflows declined.

### 5.3 Broadening integration: some evidence from previous EU enlargements

Since its creation in 1958, the EU has gone through four rounds of enlargement, broadening integration to new countries: in 1973 (Denmark, Ireland and the United Kingdom); in 1981 (Greece); in 1986 (Portugal and Spain); and in 1995 (Austria, Finland and Sweden). The fifth round, extending integration to 10 additional countries (of which eight are from CEE), is taking place in 2004. Did enlargement affect FDI in countries that joined the EU?

*In many countries, the prospect of EU membership and membership itself stimulated FDI inflows.*

In many cases – perhaps in most – the answer is yes, judging from the behaviour of FDI inflows into accession countries before and after joining the EU. Even though accession took place at various times, for most countries their EU entry was associated with a clear increase of FDI inflows – both in absolute terms and relative to total inflows to EU countries and, more generally, developed market economies (DMEs) (Table 2). But obviously, the experience was not uniform across countries.

The experience of Spain and Portugal – for which data were assembled for 15 years (starting six years before accession and ending eight years after accession) – shows that the surge in FDI can start as early as three years before accession and last until a few years after.

**Table 2. FDI inflows into countries joining the EU**

Country/item	Annual average FDI inflows (millions of USD and percentages)					
	Year of accession	6-4 yrs before	3-1 yrs before	Accession year to 2 yrs after	3-5 yrs after	6-8 yrs after
<b>Denmark, value</b>	<b>1973</b>		131	240	-8	102
% of flows to EU countries		...	2.5	2.5	-0.1	0.7
% of flows to DMEs		...	1.4	1.5	-0.05	0.3
% of GDP		...	0.7	0.7	-0.02	0.1
<b>Ireland, value</b>	<b>1973</b>		29	87	228	275
% of flows to EU countries		...	...	0.6	0.9	2.4
% of flows to DMEs		...	0.3	0.6	1.3	0.7
% of GDP		...	0.6	1.1	2	1.4
<b>UK, value</b>	<b>1973</b>		1,490	3,470	3,743	7,490
% of flows to EU countries		...	...	28.5	35.7	39.2
% of flows to DMEs		...	15.7	22.2	21.9	20.3
% of GDP		...	1.1	1.7	1.4	1.5
<b>Greece, value</b>	<b>1981</b>	239	571	465	468	781
% of flows to EU countries		...	2.7	3.7	3.6	3.8
% of flows to DMEs		1.6	1.9	1.3	0.9	0.6
% of GDP		0.9	1.3	1	1.1	1.2
<b>Portugal, value</b>	<b>1986</b>	158	205	542	2,265	1,559
% of flows to EU countries			0.9	1.6	1.4	2.8
% of flows to DMEs		0.4	0.5	0.5	1.5	1.1
% of GDP		0.6	0.9	1.3	3.3	1.7
<b>Spain, value</b>	<b>1986</b>	1,661	1,787	5,014	11,635	10,262
% of flows to EU countries		...	9.9	13.9	13	14.3
% of flows to DMEs		4.4	4.6	4.7	7.7	7.2
% of GDP		0.8	1.1	1.7	2.4	2
<b>Austria, value</b>	<b>1995</b>	532	1,557	2,995	5,449	...
% of flows to EU countries		0.6	3.1	2.5	1.2	...
% of flows to DMEs		0.4	1.7	1.3	0.7	...
% of GDP		0.3	0.8	1.3	2.7	...
<b>Finland, value</b>	<b>1995</b>	343	950	1,430	4,879	...
% of flows to EU countries		0.4	1.9	1.2	1	...
% of flows to DMEs		0.2	1	0.6	0.6	...
% of GDP		0.3	1	1.1	3.9	...
<b>Sweden, value</b>	<b>1995</b>	3,378	3,385	10,284	34,643	...
% of flows to EU countries		4	6.8	8.7	7.4	...
% of flows to DMEs		2.3	3.6	4.4	4.3	...
% of GDP		1.5	1.6	4.2	14.6	...

Note: DMEs = developed market economies

Source: Author's calculations based on data from UNCTAD/FDI database.

In absolute terms, Spain and Portugal experienced the largest increases in FDI inflows. But they translated into smaller gains relative to total inflows to EU countries. This is because the accession of these countries coincided with the announcement of the Single Market programme, which, as noted above, accelerated intra-EU FDI flows. Ireland registered large increases in both its absolute and relative terms.<sup>10</sup>

For the 1995 entrants, increased FDI flows into Austria and Finland started before accession while those into Sweden coincided with the year of accession. As a caveat it is worth mentioning here that the booming global M&As in the second half of the 1990s very likely contributed to higher FDI flows into these countries.<sup>11</sup>

*In the case of the United Kingdom, however, EU accession is likely to have boosted UK investment in continental Europe rather than FDI flows to the United Kingdom.*

The experience of the United Kingdom is ambiguous. Many foreign investors entered the UK market in the 1950s and 1960s, partly in response to the establishment of EFTA. But still, FDI inflows in the United Kingdom increased considerably during the first three years of EU membership, as did the United Kingdom's share in FDI flows to developed countries and the ratio of FDI to GDP. Subsequently, in the period 3-5 years after accession, inflows were only slightly higher than during the preceding period. In the period 6-8 years after accession, the level of inflows doubled, but this was most likely due to factors other than EU accession. Overall, the prevailing view in the literature is that accession of the United Kingdom had a much greater impact on British investment in the EU than on FDI in the United Kingdom (see Yannopoulos 1990, for instance).<sup>12</sup>

Both Denmark and Greece registered decreases in their FDI after accession. The case of Denmark is not well researched. In the case of Greece, accession coincided with political and macroeconomic instability and social tensions, which kept foreign investors away from the country. In addition, removal of trade barriers resulted in some divestment in manufacturing, as it exposed earlier import-substituting FDI to foreign competition. Furthermore, rapid wage increases in the early 1980s did not help either in making Greece an attractive FDI destination (Georgakopoulos *et al.* 1994).

In sum, previous enlargements seem to have positively influenced the flow of FDI to most countries joining the EU. What does this suggest for acceding countries from CEE and, in particular, can they expect to experience a boost to inward FDI in the years following EU entry?

#### 5.4 FDI inflows to new EU member states in Central and Eastern Europe

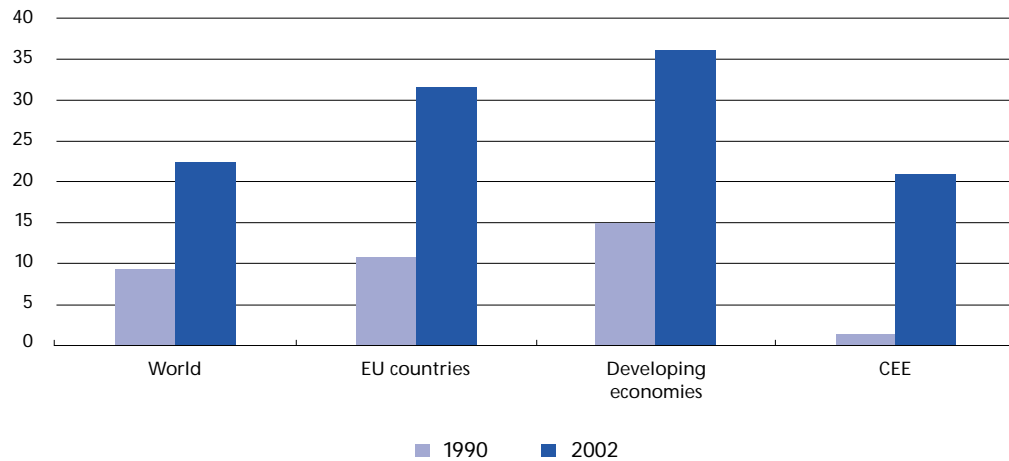
It is tempting to argue that EU entry will have an even stronger impact on FDI flows to the new entrants than it had for earlier entrants, which were all fairly advanced market economies at the time of EU entry. Arguments in support of this view point out that EU membership gives CEE access to the huge EU market, or consolidates such access. It might accelerate economic growth, making the domestic markets of CEE countries more

10 On the impact of Irish accession on FDI see Barry (2003).

11 On the impact of Swedish accession on FDI see Andersson and Fredriksson (1993) and NUTEK (1998).

12 It should be noted that the United Kingdom benefited substantially from increased FDI inflows related to the "Europe 1992" programme. For example, out of USD 70 billion of Japanese investment in the EU during 1987-93, USD 28 billion, or 40 percent, was invested in that country (Kumar 1994).

Figure 5. Inward FDI stocks (share of GDP, %)



Source: UNCTAD (2003a).

attractive to foreign investors. It helps complete FDI liberalisation, raise protection standards for foreign investors, and assure investors on the irreversibility of reforms in new members, thus reducing transaction costs and the risk of investing in these countries. Furthermore, EU funds, if properly used for purposes such as improving infrastructure or restructuring inefficient state-owned enterprises, can enhance the long-term economic attractiveness of CEE countries.

However, there are at least two reasons why the hope for an acceleration of FDI inflows to CEE is overly optimistic. One is that expected EU membership of CEE countries has already had an impact on their FDI inflows, although it is impossible to estimate how big this impact was. Since the early 1990s, these countries have been linked to the EU through association agreements. Under these agreements they gradually gained free access to the EU market for manufactured goods, thus encouraging the inflow of export-oriented FDI to CEE. Their inward FDI stocks rose from a negligible 1 percent of GDP in 1990 to 21 percent in 2002, close to the world average (Figure 5). Most of this increase took place after 1995. What is more, by 2000, exports of TNCs had gained a substantial share in CEE countries' exports, e.g. 80 percent in Hungary, 60 percent in Estonia, 56 percent in Poland, 47 percent in the Czech Republic, and 26 percent in Slovenia (UNCTAD 2002). There is thus evidence that a good part of the FDI that one usually expects to take place with regional integration has already taken place. Such FDI will certainly continue after accession, but whether and how fast it will grow remains to be seen. The abolition of special incentives for foreign investors, required as part of harmonising CEE countries' FDI regimes with EU regulations, may make FDI growth more difficult. New EU members may try to compensate for this by lowering corporate taxes, but still competition for this type of investment is increasing from countries in the region with lower wages – some of them candidates for future accession.

*CEE countries have experienced a rapid build in the stock of FDI since the beginning of transition, implying that a further increase after EU accession is everything but obvious.*

The second reason for expecting no acceleration but possibly a decline in FDI inflows to CEE countries once they are EU members is that pre-accession flows have been unusually high due to the restructuring and liberalisation of CEE economies during the transition

from plan to market. Liberalisation included the opening up of these countries to FDI and the privatisation of state-owned enterprises. This led to a substantial and in some cases heavily fluctuating FDI inflow. When one looks at FDI inflows into CEE countries in 2002, two years before accession (the right time to expect increases in inflows associated with accession, judging from the experience of previous rounds of EU enlargements), one can see that in three countries (Estonia, Hungary and Poland) inflows decreased over the previous year, while inflows increased in five countries. But in at least two of the latter countries (the Czech Republic and Slovakia), the acceleration was due to privatisation. Hungary will be an interesting case to look at for the accession impact. It completed its privatisation programme during the 1990s, with annual FDI inflows peaking at USD 4½ billion in 1995. In 2002, two years before the accession, it registered its lowest FDI inflows since the beginning of the transition (USD 854 million). Whether accession will help the country regain its previous position in FDI remains an open question. Overall, a considerable build up in FDI stocks (relative to GDP) has occurred in acceding countries and their privatisation programmes are coming to an end. Against this background, a boost to FDI inflows to CEE as a result of EU membership is everything but a foregone conclusion.

## 6. Conclusions

This paper has focused on long-term trends in the internationalisation of production. It transpires that international production has grown fast in recent decades – both in absolute terms and relative to global value added and international trade. While foreign direct investment is the better-known aspect of international production, there has been an explosive growth in non-equity relationships between firms of different countries. Likewise, although manufacturing remains at the heart of international production, the internationalisation of services has been on rapid growth trajectory. As far as Europe is concerned, the process of economic integration has undoubtedly boosted the position of EU countries as a source and a destination of globally active enterprises. Since the fall of communism, international production has also spread quickly to countries of Central and Eastern Europe, notably to those that have become new EU members. Experience with previous EU enlargements suggests that FDI flows to new members may increase after accession. Whether that will be true in the case of CEE countries is not certain. On the contrary, given that the transition from plan to market, notably the privatisation of state-owned enterprises, and the prospect of EU membership have already led to a substantial build up in inward FDI stocks, a decline in FDI flows to some of these countries (absolute and relative to GDP) should not come as a surprise.

*The EU has an important role to play in formulating international investment policies in ways that are beneficial to developing countries.*

The bulk of the international production affects advanced economies. However, this should not distract from the fact that the activities of transnational corporations are fairly important for developing countries too. In fact, the weight of such corporations relative to the size of the economy is often much bigger in developing countries than in advanced economies. Still, one of the greatest challenges of globalisation, and its unfulfilled promise, is a more equitable distribution of benefits from international production, especially in favour of the poorer developing countries. Continued marginalisation of many of these countries in the global economy is one of the reasons why globalisation is questioned in many quarters. This raises many policy issues related to international production. One is policy competition to attract FDI, which often puts developing countries at a disadvantage



*vis à vis* advanced countries and also distorts allocation of resources among and within advanced countries. Another is the issue of policy space needed in particular in developing countries to pursue their development objectives and to increase benefits from FDI. Addressing these question would go beyond the scope of this paper, but it is clear that the EU has a large role to play in formulating international investment policies in ways that are not harmful, but rather beneficial to developing countries.

## References

- Andersson, T. and Fredriksson, T. (1993). *Sveriges val, EG och direktinvesteringar*, Allmänna Förlaget, Stockholm, Sweden.
- AT Kearney (2003). "FDI Confidence Index", Global Business Policy Council: Executive Summary, Vol. 6.
- Barry, F. (2003). "EU accession and prospective FDI flows to CEE countries: A view from Ireland", in Heinz, H. and Lipsey, R. (eds), *Foreign direct investment in the real and financial sector of industrial countries*. Springer-Verlag, Germany.
- Blomström, M. and Kokko, A. (1997). "Regional integration and foreign direct investment". NBER Working Paper No. 6019.
- Dunning, J.H. (1981). *International production and the multinational enterprise*, G. Allen and Unwin, London, UK.
- Dunning, J.H. (1993). *Multinational enterprises and the global economy*, Addison-Wesley Publishing Company, Wokingham, UK.
- Dunning, J. H. (1995). "The role of foreign direct investment in a globalizing economy". *Banca Nazionale del Lavoro Quarterly Review*, (193), pp. 125-144.
- Dunning, J.H. (1997). "The European internal market programme and inbound foreign direct investment". *Journal of common Market Studies*, (35: 1), pp. 1-30.
- Georgakopoulos, T., Paraskevopoulos, C. and Smithin, J. (1994). *Economic integration between unequal partners*, Edward Elgar, Brookfield, UK.
- Kumar, N. (1994). "Regional trading blocks, industrial reorganization and foreign direct investment - the case of the Single European Market", *World Competition*, (18:2), pp. 35-55.
- Mallampally, P. and Zimny, Z. (2000). "Foreign direct investment in services. Trends and patterns", in Aharoni, Y. and Nachum, L. (eds.), *Globalization of services. Some implications for theory and practice*. Routledge, London and New York.
- Närings- och teknikutvecklingsverket (NUTEK), (1998). *EU och den inre marknaden: Effekter på den svenska ekonomin*, Gotab, Stockholm, Sweden.
- Preston, Ch. (1997). *Enlargement and integration in the European Union*, Routledge, London.
- United Nations (1993). *World Investment Directory 1992*. Developed Countries, United Nations, New York.
- UNCTAD (1997). *World Investment Report 1997*, United Nations, New York and Geneva.
- UNCTAD (1998). *World Investment Report 1998. Trends and determinants*, United Nations, New York and Geneva.
- UNCTAD (1999). *World Investment Report 1999. Foreign direct investment and the challenge of development*, United Nations, New York and Geneva.
- UNCTAD (2000). *World Investment Report 2000. Cross-border mergers and acquisitions and development*, United Nations, New York and Geneva.

- UNCTAD (2002). *World Investment Report 2002. Transnational corporations and export competitiveness*, United Nations, New York and Geneva.
- UNCTAD (2003a). *World Investment Report 2003. FDI policies for development: National and international perspectives*, United Nations, New York and Geneva.
- UNCTAD (2003b). "New FDI pattern emerging, says UNCTAD, reshaped by service economy, new industries". Press Release, UNCTAD/PRESS/PR/2003/105, 28 October 2003, Geneva.
- UN CTC (1988). *Transnational corporations in world development. Trends and prospects*, United Nations, New York.
- UN CTC (1993). *Regional economic integration and transnational corporations in the 1990s: Europe 1992, North America and developing countries*, United Nations, New York.
- Yannopoulos, G. N. (1990). "Foreign direct investment and European integration: the evidence from the formative years of the European Community", *Journal of Common Market Studies*, (28:3).
- Zimny, Z. and Mallampally P. (2002). "Internationalization of services: are the modes changing?", in M. Miozzo and I. Miles (eds.), *Internationalization, technology and services*. Edward Elgar, Cheltenham, UK.