

FDI, GLOBALISATION AND ECONOMIC DEVELOPMENT: TOWARDS  
REFORMING NATIONAL AND INTERNATIONAL RULES OF  
THE GAME

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by

Ajit Singh  
University of Cambridge  
Faculty of Economics and Politics  
Cambridge, CB3 9DE  
Email: [as14@econ.cam.ac.uk](mailto:as14@econ.cam.ac.uk)

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## **Abstract**<sup>1</sup>

The key analytical and policy question examined in this paper is whether multinational companies and their overseas investment need to be regulated at the national or the international level, in order to address market failures, and to enhance their potential contribution to world welfare. The paper examines two kinds of regulatory regimes: first the current regime and second, a new regime proposed by the European community and Japan at the WTO (ECJ) to institute fresh global rules of the game which will effectively allow multinationals unfettered freedom to invest where they like, whenever they like, how much and in what products.

Very briefly, the central conclusion of the paper is that ECJ, despite its important concession of confining itself to only one source of external finance namely FDI, is a flawed proposal both from the perspective of developing and developed countries. Its shortcomings are particularly serious with respect to developing countries as it essentially ignores the developmental dimension altogether. It is emphasized that although the current post-Uruguay Round FDI regime is to be preferred in relation to the ECJ, the former has, nevertheless severe deficits from a developmental perspective. These need prompt action by the international community.

**JEL codes:** F02, 10, F40

**Keywords:** globalisation, foreign direct investment, trade flows, WTO

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## **I Introduction**

This paper selectively reviews the role of FDI in the present state of the world economy - how it affects economic development and well being in rich and poor countries. Multinational companies are normally the vehicles for FDI and are central to the current globalisation processes. The key analytical and policy question examined in the paper is whether these companies and their overseas investment need to be regulated at the national or the international level, in order to address market failures, as well as to otherwise enhance their potential contribution to world welfare. The paper will start by examining two kinds of regulatory regimes: first the current regime and second, a new regime proposed by the European community and Japan at the WTO to institute fresh global rules of the game which will effectively allow multinationals unfettered freedom to invest where they like, whenever they like, how much and in what products. Such a regime has been proposed by the aforementioned countries at the Working Group on Trade and Investment at the WTO. Although after the failure of the WTO ministerial meeting in September 2003 at Cancun, the discussion of the so-called Singapore issues (which include investment) has been suspended, the proposal of the European community and Japan is still on the table and will sooner or later be taken up again, perhaps as early as the next WTO ministerial meeting in Hong Kong, 2005. It is argued here, that this proposal is neither in the interests of developing countries nor that of most people in the advanced countries. Rather it represents sectional interest in advanced economies.<sup>2</sup> The main burden of the paper will be to argue that the proposed EEC-Japan (hereafter called the ECJ) regime for regulating FDI by multinational corporations is sub-optimal for both rich and poor countries. The paper will outline an alternative inclusive regime, which will be more compatible with world welfare than the ECJ proposal.

The main concentration of this paper is therefore on the regulation or control of FDI in order for it to help maximise long-term productivity growth in developing economies. Restriction on capital flows is a controversial subject with an enormous literature.<sup>3</sup> Many economists now accept that in the circumstances of developing countries, controls on short-term capital flows such as international portfolio flows are justified. Indeed, Stiglitz (2000, 2004), takes the IMF to task for advocating capital account liberalization to developing countries before the Asian crisis. He suggests that the case for such liberalization is not supported either by sound economic theory or by empirical studies. In view of the particular structural features of developing economies, he favours capital controls on short-term flows in many instances. Stiglitz is very critical of the IMF for its ideological blindness, which made it eschew capital controls from its armoury of macro-economic policy tools.

As for FDI, Stiglitz (2000) makes it clear that his strictures against the IMF for not recommending controls on short-term flows to developing countries apply much less to the case of FDI. However, in his 2004 paper he takes a more sceptical view, even of FDI, and suggests reasons why the latter may not benefit developing countries (DCs). This paper will go further and suggest that there are powerful arguments for appropriate regulation of FDI at both the national and international levels, so as to ensure the benefit for the DCs.

It is important to note that apart from the DC governments and the multinationals, there is increasingly a significant third player in this arena, namely the workers in advanced countries. Many employees and trade unionists in advanced countries (ACs) regard multinational investment in DCs as a major cause of their own severe labour market deficits – high unemployment, de-industrialisation and wage dispersion. This claim is supported by populist politics as well as some serious economists (see for example Wood 1994; Bluestone and Harrison 1982). A significant issue referred to in this paper, albeit briefly for reasons of space, is whether there is a regulatory framework for multinationals which can both protect the developmental interests of poor countries and help towards removing the labour market deficiencies in advanced countries.

The paper is organized as follows. The first part of the paper outlines the relevant stylised facts about multinational investment and provides an analytical description of the current regulatory regime as well as the ECJ's proposed new order. In the second part, the implications of these regimes are examined for various aspects of economic development, including economic growth and stability, policy autonomy, transfer of technology. In view of its importance and for the sake of completeness, the next part sketches out the implications of current trends in multinational investment for workers in advanced countries and outlines how outcomes can be improved by appropriate regulation. The last part of the paper sums up the argument and provides a developmental audit of alternative regulatory regimes.

## **II Stylized Facts Concerning Multinationals and FDI**

There have been enormous changes in the amounts and the pattern of capital flows from industrial countries to emerging economies in the 1980s and the 1990s compared with the 1960s and 1970s. At the same time, there has also been a sea-change in developing countries' perspective on, and attitude towards, FDI. In the earlier period, developing countries were often hostile towards

multinational investment and sought to control multinational companies' activities through domestic and international regulations. However, during the last two decades emerging countries have been falling over themselves to attract as much multinational investment as they can. It will be suggested below that this enormous shift in developing countries' stance toward multinational investment is closely related to the changes in the pattern of capital flows. The former is both the cause and the consequence of the latter. It will further be argued that developing countries find the new profile of international capital flows profoundly unsatisfactory from a developmental perspective.

The most important characteristics of international capital flows to developing countries during the last two decades include the following. (The relevant tables are given in the Appendix.)

- There has been an enormous increase in financial resource flows to developing countries during the last three decades as the world economy has liberalised and become financially more integrated. World Bank figures indicate that net resource flows to all developing countries rose from a mere US \$11billions or so in 1970 to more than US \$80b in 1980 and to just over US \$100 billions in 1990.
- Net resources flows to developing countries recorded a quantum leap between 1990 and 1995, rising to nearly US \$240 billions in the latter year. There was a further sharp increase in the next two years until the Asian crisis. There have been reduced net resource flows subsequently (Appendix Tables 1 and 3; Table 3, which reports only on selective inflows and has been constructed on a somewhat different basis than Table 1, provides for the most recent period).
- Appendix Table 1 also provides information on the changing sources of the external resource flows to developing countries during the last three decades. The table suggests that in the 1970s, long-term debt was the predominant source of finance. In the 1980s, as a consequence of the debt crisis, this source became relatively less important compared with before and the significance of FDI, as well as that of government grants, rose. In the 1990s FDI has emerged as a predominant source of external finance for developing countries. As Table 3 indicates, in 2001, net FDI inflows into developing countries was several orders of magnitude larger than either net portfolio flows or net debt flows.
- The IMF data reported in Table 2 in the Appendix enables us to distinguish between private and official flows<sup>3</sup>. The important point

which emerges from this table is that most of the increase in capital flows to developing countries in the 1990s has been due to private rather than official flows. Between 1990 and 1996 private flows were on average nearly 8 times as large as official flows.

- Appendix Table 4 reports data from the World Bank on developing countries' shares in global FDI, in capital market flows, and, for a comparative perspective, it also reports these countries' share in global output and international trade for each of the years from 1991 to 2000. The table indicates that developing country shares both in global FDI and capital market flows have become much smaller since the Asian crisis. However, these countries' shares in global output and trade in the corresponding period have not declined but remained much the same.
- Inward FDI flows accounted on average for 5% of advanced countries gross fixed capital formation during the late 1980s and for most of the 1990s. However, there was a sharp increase in this share in 1998: inward FDI's contribution in these countries rose from 6.2% in 1997 to 10.9 % in 1998. For developing countries inward FDI, during the 1990s was relatively more important in relation to the gross fixed capital formation than for developed countries (See Table 5 in Appendix).
- FDI flows to developing countries are highly concentrated. Ten countries accounted for nearly three-quarters of the total FDI inflows in 2000 (World Bank 2001, page 38).

This pattern of capital flows, including that of FDI, has important substantive implications for developing countries. As noted above, the decline of grants and other official flows has meant that private capital, particularly in the form of FDI, has become a major source of external finance for these countries. At the same time, analysis and evidence suggest that developing countries' need for external finance has greatly increased. This is in part due to the liberalisation of trade and capital flows in the international economy. UNCTAD (2000) suggests that, because of these structural factors, developing countries have become more balance-of-payments constrained than before: the constraint begins to bite at a much slower growth rate than was the case previously in the 1970s and 1980s. In these circumstances it is not surprising that developing countries have radically changed their attitude towards FDI. There has also, therefore, been intense competition among these countries for attracting FDI.

Apart from this important role of FDI as a main source of external finance for DCs, its traditional task on the real side of the economy continues to be important. It is one of the main sources of technological development and technology transfer to DCs. To minimize their cause and to compete more efficiently in the international economy, many multinational companies have “fragmented” production between countries and formed international supply chains. Multinational companies also engaged in fragmentation of the production and the formation of international supply chain (Milberg, 2003). These issues and this implication for a multilateral investment regime will be taken up below.

### **III The Current Investment Regime**

The current post-WTO investment regime is shaped by Uruguay Round Agreements. The hallmark of the Uruguay Round Agreements (which established the WTO) has been that apart from trade liberalization, these agreements have also extended multilateral rules and disciplines to a number of policy areas affecting industrial development and competitiveness with regard to both goods and services. Such policies -- generally defined as industrial policies -- have been extensively used for the last three decades notably by fast growing countries in the East Asia to foster exports and to achieve rapid structural change and economic growth. However, the following agreements have restricted such industrial and export promotion policies:

- Agreement on Subsidies and Countervailing Measures;
- Agreement on Trade-Related Investment Measures (TRIMs);
- Understanding on Balance of Payments;
- Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs);
- General Agreement on Trade in Services (GATS);
- Decisions on Measures in Favour of Least Developed Countries;
- Subsidies and Countervailing Measures.

In order to see how these provisions affect the policy space of DCs, it may be useful to carry out a mental exercise by asking the question, which of the industrial and export promotion policies undertaken by Japan and Korea during their industrialization drive would have been impermissible had the Uruguay Round Agreements been in force then. It will be useful to recall the during the periods of rapid economic growth -- Japan between 1950 -1973 and Korea during the 1960s - 1970s – used the following policies:

## 1. **Export Promotion Policies**

- import restrictions, both general and specific;
- favouring particularly sectors for export promotion and in some cases particular firms for that purpose;
- seeking compliance for subsidies given to exporters by means of export targets for specific firms (the Korean case);
- interest rate subsidies and the availability of credit and foreign exchange to favoured firms that met export targets;
- general export promotion, in Japan through JETRO (Japanese external trade organization) and in Korea via KWOTRO;
- provision of infrastructure including human capital;
- taxation relief on imported inputs and on R&D expenditures;
- allowing favoured conglomerates to import capital goods and foreign technology and to raise cheaper finance on international markets;

## 2. **Industrial Policy Measures**

- a) lax enforcement of competition policy, including the extensive use of cartels.<sup>4</sup>
- b) government creation and promotion of conglomerates in Korea;<sup>5</sup>
- c) tax concessions to corporations to increase investment;
- d) promotion of a close, long term relationship between finance and industry which was critical to the implementation of the industrial policy<sup>6</sup>;
- e) labour repression to ensure labour peace in a period of gigantic structural change (this applies to Korea rather than to Japan)<sup>7</sup>;
- f) establishment of state industries to enhance industrial development (this again applies to Korea rather than to Japan);
- g) administrative guidance used extensively both in Japan and Korea.

Which of these policies would have fallen foul of the Uruguay Round Agreements had these been in operation at the time? The short answer is that had Japan and Korea implemented these policies in the post-Uruguay Round period a good number of those in section I - though not all - would not have been permitted. Most of those in section 1 would have been allowed, provided they had been skilfully operated. The two countries would have had to tailor their interventions to be compatible with the new trading rules. Specifically, these rules allow subsidies for technological development, as long as they are non-specific. Other subsidies would have needed to have been given in the form of regional aid; or to small and medium enterprises. However, Japan and Korea would not have been able to provide generalized protection of the kind they implemented as a background to the other more targeted policies.



Thus, the current trading and investment regime for multinational corporations has important drawbacks for DCs in that it forecloses important policy options which the highly successful East Asian economies used during their economic development.

#### **IV Proposed ECJ Regulatory Regime**

Although the full details of the proposed ECJ regulatory scheme are not yet available, it will certainly go further in restricting the DC policy options than the current WTO provisions outlined above. The purpose of the proposed ECJ regime would appear to be to establish an agreement on investment similar to that which the OECD failed to conclude five years ago – the so called multilateral agreement on investment (MAI). This suggests, as noted by Singh and Zammit (1999) that the ECJ proposal would involve the following kind of elements.

- the right of establishment for foreign investors;
- the principles of 'most-favoured nation' (mfn) treatment;
- the principle of 'national treatment';
- investment protection, including matters relating to expropriation and the transfer of capital;
- additional disciplines relating to, among other matters, entry, stay, and work of key personnel;
- abolition of performance requirements imposed by host governments on foreign investors in order to secure economic benefits for the country as a whole;
- multilateral rules on investment incentives; and
- binding rules for settling disputes.

Thus, ECJ will be a regime with high standards of investor protections and strong disciplines against restrictions on the free flow of FDI activity, among WTO member countries. The United States agrees with the need for a treaty with high standards, but is sceptical whether this is possible within the WTO. In view of the almost universal membership of the WTO and its consensus rules of procedure, the US feels that it would only be possible to negotiate there a multilateral agreement with low standards. Nevertheless, the US does not oppose discussions and negotiations on the subject at the WTO, if member countries wish to pursue these.

The original MAI was all embracing in its definition of investment. As the OECD (1997) noted, the scope of the proposed Treaty went "beyond the traditional notion of FDI to cover virtually all tangible and intangible assets which applies to both pre-establishment and post-establishment". The

abandoned OECD agreement therefore included, among other things, intellectual property as well as portfolio investment.

The present motivation of advanced countries for confining their proposed MAI type agreement at the WTO to just foreign direct investment is not difficult to surmise. In the aftermath of the Asian crisis, it has been widely recognised that the volatility of short-term capital flows often leads to serious economic and financial problems for developing countries. There is therefore an emerging consensus that it may be prudent for the governments of these countries to restrict such flows.

Advanced countries are, therefore, wise to lower their sights and exclude short-term and other controversial capital flows from the purview of the ECJ, and seek agreement only on FDI. It is widely believed on the basis of the experience of the debt crisis in the 1980s and the subsequent Mexican, Asian and other crises in the 1990s that, compared with debt and portfolio investment, FDI, apart from its other merits, is the safest source of funds for developing countries. It is thought to neither add to a country's debt, nor (being bricks and mortar) can it be quickly withdrawn from the country. The proponents therefore expect that an MAI, concerned only with FDI, would be much more acceptable to developing countries. This issue, however, is more complicated than might appear at first sight, and will therefore be discussed more fully below.

## **V FDI as a Major Source of External Finance**

As indicated above, an important characteristic of FDI today is that it has become a prominent source of external finance for developing countries. Leaving aside other characteristics of FDI (to be discussed later), we shall consider it here first simply as a source of finance, and examine its implications for the balance-of-payments and for macroeconomic management of the economy. In orthodox analyses, FDI, apart from all the other supposed advantages, is regarded as a stable source of finance (UNCTAD 1999; Lipsey 1999). In contrast to portfolio investments, FDI by definition is supposed to reflect a long term commitment as it involves normally a stake of 10% or more in a host country enterprise, together with managerial control.<sup>8</sup> In view of the latter element, the presumption is that the inflow of foreign capital in this form will be more stable than portfolio investments. The latter are easier to liquidate and following an internal or external shock, investors may quickly withdraw such funds from the host country.

There are, however, important arguments to suggest that the presumption of stability in *net* FDI inflows may not be correct. First, the distinction between FDI and portfolio investment has become very much weaker with the growth of derivatives and hedge funds. As Claessens *et al.*, (1993) observe in their World Bank study, even at a more elementary level it is easy to see how a long-term "bricks and mortar" investment can be converted into a readily liquid asset: "Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows." Another reason why FDI may be volatile is because a large part of a country's measured FDI according to the IMF balance-of-payment conventions usually consists of retained profits. As profits are affected by the business cycle, they display considerable volatility. This also prevents FDI from being anti-cyclical and stabilising unless the host and home country economic cycles are out of phase with each other. That may or may not happen.

Further, there is evidence that, like other sources of finance, FDI flows can also at times come in surges. Apart from their contribution to volatility, these FDI surges, as those for example of portfolio investment can lead to equally undesirable consequences such as exchange rate appreciation and reduced competitiveness of a country's tradable sector.

The World Bank paper referred to above came to the conclusion that: "long-term flows are often as volatile as short- term flows, and the time it takes for an unexpected shock to a flow to die out is similar across flows."<sup>9</sup> However, a more recent study (UNCTAD, 1998), found that between 1992 and 1997 FDI was relatively more stable than portfolio flows, but there were important exceptions. The latter included Brazil, South Korea and Taiwan.

Quite apart from the question of the comparative volatility of FDI and other flows, there are other important implications of FDI for a host country's balance of- payments. These derive from the fact that an FDI investment creates foreign exchange liabilities not only now but also into the future. This characteristic leads to the danger that unfettered FDI may create a time profile of foreign exchange outflows (in the form of dividend payments or profits repatriation) and inflows (e.g., fresh FDI) which may be time inconsistent. Experience shows that such incompatibility, even in the short run, may easily produce a liquidity crisis. The evidence from the Asian crisis countries with the latter suggests that it could in turn degenerate into a solvency crisis with serious adverse consequences for

economic development.<sup>6</sup> Professor Kregal (1996) sums up the balance-of-payments implications of FDI in the following terms: "...while portfolio flows may have a more direct impact on short-term reserve management and exchange rate policy, FDI may have both a short and a longer-term structural influence on the composition of a country's external payment flows. While financial innovation allows FDI to have an impact in the short run which is increasingly similar in terms of volatility to portfolio flows, the more important aspect is the way it may mask the true position of a country's balance-of-payments and the sustainability of any particular combination of policies ... accumulated foreign claims in the form of accumulated FDI stocks may create a potentially disruptive force that can offset any domestic or external policy goals." (Kregal, 1996).

These considerations suggest that, in order to avoid financial fragility which is likely to follow from unfettered FDI, the governments would need to monitor and regulate the amount and timing of FDI. Since the nature of large FDI projects (whether or not for example these would produce exportable products or how large their imports would be) can also significantly affect the time profile of aggregate foreign exchange inflows and outflows, both in the short and long term, the government may also need to regulate such investments. To the extent that the ECJ would not permit such regulation of FDI, it would subject developing economies to much greater financial fragility than would otherwise be the case.

It could in principle be argued that, even if the financial fragility point is conceded, an ECJ may still benefit developing countries by generating greater overall FDI which could compensate for the increased financial fragility. However, this proposition is of doubtful validity. We saw earlier that there has been a huge increase in FDI in the 1990s. This occurred without any MAI and was clearly a product of a number of other factors.<sup>10</sup> Similarly, there does not seem to be any connection between regulatory constraints on FDI and the total amount of FDI which a country may be able to attract. Malaysia and China, (see Braunstein and Epstein, 1999), to illustrate, are large recipients of FDI despite having significant control and regulation over FDI projects.

## **VI FDI, Technology Transfer, Spill-over and ECJ**

Apart from FDI as a source of finance, two of the most important ways in which a DC may benefit from such investments is through (a) transfer of technology and (b) from spill overs. The latter refer to the indirect impact of FDI on raising productivity in local firms. These firms may be helped by foreign investment in a variety of ways, including the demonstration effect of the new technology and the enhancement of the quality of inputs which such investment may promote.

On the other hand, there may be few positive or even negative spill-overs, if FDI leads to local firms being forced out of the market because of greater competition.

Both issues of technology transfer and spill-overs have been widely studied and there exists on these subjects a large and controversial literature. The main lesson which comes from these writings, however, is that a country is more likely to benefit from multinational investment if it is integrated into its national development and technological plans (see further Dunning, 1994; Freeman, 1989; Milberg, 1999; South Centre, 2000; etc.) This is the reason why, other than Hong Kong, most successful Asian countries (including China and Malaysia as seen above), have not allowed unfettered FDI but have extensively regulated it.

An interesting recent study by Agosin and Mayer (2000) investigates an important aspect of the spill-overs issue by asking the question whether FDI in a host country "crowds in" further investment by local firms or "crowds out" existing investments of these firms as a consequence of increased competition and hence lower profits. The two authors' research covered the period 1970-1996 and included host countries from all three developing regions, Africa, Asia and Latin America. The results of the econometric exercise suggest that over this long period there was a strong "crowding in" in Asia, "crowding out" in Latin America and more or less neutral effects in Africa. Agosin and Mayer conclude:

"The main conclusion that emerges from this analysis is that the positive impacts of FDI on domestic investment are not assured. In some cases, total investment may increase much less than FDI, or may even fail to rise when a country experiences an increase in FDI. Therefore, the assumption that underpins policy toward FDI in most developing countries - that FDI is always good for a country's development and that a liberal policy toward MNEs is sufficient to ensure positive effects - fails to be upheld by the data."

They go on to note: "...the most far-reaching liberalizations of FDI regimes in the 1990s took place in Latin America, and that FDI regimes in Asia have remained the least liberal in the developing world... Nonetheless, it is in these countries that there is strongest evidence of CI (crowding in). In Latin America, on the other hand, liberalization does not appear to have led to CI."

The policy implications of this analysis of FDI in relation to technology and spillovers reinforce the message of the last section: developing countries need to

regulate FDI closely in order for it to promote economic development and not to hinder it.

### **A. Market Failures**

In broad analytical terms, the case for such government interventions in the FDI process lies in various kinds of market failures. Co-ordination problems abound in relation to investment, including foreign investment, and in the presence of non-existent or incomplete markets typical in a developing economy, governments need to intervene to address co-ordination failures. As the UNCTAD Secretary General R. Ricupero (1999) observed: "Significant market failures characterize the TNC investment process in its relationship to developing countries. The first (kind of market failures) arise from information or co-ordination failures in the investment process, which can lead a country to attract insufficient FDI, or the wrong quality of FDI. The second arises when private interests of investors diverge from the economic interests of host countries." (p.xxv, parenthesis added)

Milberg (1999) calls attention to another kind of market failure in relation to FDI which again calls for government intervention. He observes: "Location decisions of firms may deviate from those predicted by comparative advantage for a number of reasons. Firms may put national characteristics ahead of relative cost considerations. Also, to the extent that heightened capital mobility has coincided with growing global excess capacity, trade liberalization may not bring the price adjustment necessary to convert a relative productivity advantage to an advantage in terms of absolute money costs. When currency values do not respond to trade imbalances in the expected fashion, then the price adjustment implied by the theory of comparative advantage may also be inoperative."

### **B. Government Failures**

It may be argued that these market failures may turn out to be less important than government failures. That is certainly true in some cases, but it must be remembered that the developing world also contains a large number of highly successful governments, the so-called 'developmental states' in the newly industrializing countries (NICs). If developing countries are to attract the right kind of FDI, in the right amounts, and to be able to obtain the maximum benefit from these, they need to guide the process and therefore must have effective states (see further Amsden, 2001). For otherwise, they will not receive sufficient FDI and may be more harmed than helped by what they get.

## VII International Merger Movement, FDI and Developing Countries

The world economy has been undergoing a gigantic merger movement over the last decade, probably the largest ever<sup>11</sup>. An outstanding characteristic of this merger wave is the high incidence of cross-border mergers and acquisitions (M&As). Indeed, such mergers and corporate take-overs are an important vehicle for FDI flows between industrial countries. However, cross-border merger activity involving developing countries, although quite small by the standards of advanced countries, has greatly expanded as well during the last three years. (See Table 5 in the Appendix for the sales and purchases of cross-border M&As for the 1990s.) The data in Table 5 are, however, at an aggregate level - for the world as a whole and for the main regions. UNCTAD (1999) carried out a more detailed analysis of the incidence of cross-border M&As in developing countries. It found that if China (which among developing countries has not only been the largest recipient of FDI but most of its investment has also been "green field", that is, new) is excluded, the share of M&As in the accumulated FDI rises from 22% during 1988 to 1991 on average to 72% in the period 1992 to 1997.

This preferred mode of entry of FDI raises troubling questions in relation to its costs and benefits for developing countries. It also raises difficult questions for ECJ. When FDI takes the form of green field investment, it represents a net addition to the host country's capital stock. However, FDI entry via an acquisition may not represent any addition at all to the capital stock, output or employment. In the medium term there may be more investment by the acquiring firm if the acquisition is deemed successful. How beneficial FDI is to developing countries in the long term, if it takes predominantly the form of cross-border take-overs of domestic firms by foreign corporations, is ultimately an empirical question on which there is so far little hard evidence.

Nevertheless, cross-border take-overs raise difficult issues for ECJ. If FDI is occurring through take-overs, would the ECJ require that an advanced country corporation should be able to purchase any host country corporation on the stock market without let or hindrance, (except in relation to firms protected by national defense or other similar considerations)? This important issue does not appear to have been directly addressed in ECJ. However, going by the analogy with the green field investment where essentially the ECJ would permit any home country corporation to invest in any activity in a host country (subject to the usual caveats), it would follow that a foreign company should be able to acquire any domestic company as a form of FDI. From a developing country perspective such a procedure would have very negative consequences. There is a large literature which suggests that corporate takeovers take place only to a

limited extent on the basis of performance, but largely on the basis of size. Research for the U.S. and the U.K. shows that, in the market for corporate control, the large, relatively unprofitable companies have a much greater chance of survival than the small, profitable ones.<sup>10</sup> Thus, under ECJ, if FDI takes the form of acquisition of host country corporations on the stock market, the net result could be that of the best DC corporations being acquired by the much larger multinationals even though the latter would not be as efficient as the acquired corporations.

The international merger movement raises another important area of concern for DCs. This relates to the question of unequal competition between large multinationals and big domestic corporations in these countries. Even the largest DC corporations tend to be much smaller than the industrial country multinationals. The current large merger wave is likely to make this disparity even bigger. By means of these world-wide mergers and tie-ups, the advanced country corporations are able to integrate their international operations. This may be a source of genuine technical economies of scale, but evidence indicates that in most industries average cost curves are L-shaped, that is to say, after a threshold size which is relatively small and which most of these giant corporations would already have achieved even before mergers, costs do not fall as the size of the firm increases. The economies which nevertheless the multinationals are able to achieve through integration are those relating to bulk buying of inputs, reduced cost of capital. To the extent that these economies depend on the market power of the multinationals in relation to inputs, the cost saving measures are not necessarily welfare enhancing; furthermore, these "pecuniary economies" create barriers to entry which makes the markets less contestable.<sup>12</sup>

During the last 50 years, Japan, as well as many NICs in Asia and Latin America, were able to foster the development of big businesses to the advantage of these countries' overall economic development. This has usually been achieved through various kinds of state support. These large domestic corporations, which are privately owned, have often been the leaders in the diffusion of new technologies and the adaptation of imported technologies to domestic circumstances.<sup>13</sup> However, in the current international economic environment these firms are likely to be handicapped in three significant ways:

- a) through the limiting of state aid as part of WTO disciplines;
- b) through the increased size and market power both in the product and input markets of large multinationals; and
- c) through increased barriers to entry and contestability which the last international merger



boom of the 1990s has created.(Tichy 2001)

It is normal for multinationals to complain that there is no 'level playing field' between themselves and national corporations which are government supported; hence, the multinationals' demand for "national treatment". However, the actual situation is quite the opposite; the playing fields are tilted in favour of multinationals who have considerable market power. The current international merger movements is making these fields more unequal even from the perspective of the *large* developing country corporations.

The mechanical application of the sacred WTO principle of 'national treatment' in the circumstances set out above would clearly lead to perverse results which would both harm economic development in developing countries as well as lead to global economic inefficiency. The remedy in these circumstances may lie in competition authorities in developing countries being exempted from the formal or informal application of the doctrine of national treatment.

To provide a simple illustration, it should be perfectly legitimate for a developing country competition authority to allow large domestic firms to merge so that they can go some way toward competing on more equal terms with multinationals from abroad. Even if the amalgamating national firms are on the horizontal part of the L-shaped static cost curve, bigger size may still promote dynamic efficiency for the reason that firms need to achieve a minimum threshold size to finance their own R & D activities. The competition authority may therefore quite reasonably deny national treatment to the multinationals and prohibit their merger activity (because they are already large enough to achieve either static or dynamic economies of scale in this sense). In these circumstances, a violation of the doctrine of national treatment is likely to be beneficial both to economic development and to competition.

### **VIII The Right to Economic Development and ECJ**

It may be argued against the analysis and proposals outlined above that these run contrary to the cherished WTO 'principles' such as national treatment and market access, as well as attempt to reopen agreements already settled such as the Agreement on Trade-Related Investment Measures (TRIMS). This is certainly one side of the ledger. There is, however, the other side which unfortunately is completely ignored by the proponents of ECJ. This concerns the ultimate goals of the WTO and their relationship to that organisation's procedural principles such as national treatment.

The Preamble to the WTO notes that "trade and economic endeavour should be conducted with a view to raising the standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand". It is further stated that "there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development". Full employment and economic development are not only the ultimate goals of the WTO but these have also been repeatedly endorsed by the international community. In 1995, 117 Heads of State or Government attending the Copenhagen Social Summit endorsed the Copenhagen Declaration, which put primary emphasis on the promotion of full employment and poverty reduction. More recently similar declaration have been made at the Millennium Summit at the UN and other fora. Indeed, the right to a decent living has virtually acquired the status of a universal human right.

If experience and analysis show that the primary goals of WTO are being harmed rather than helped by specific measures such as TRIMS, or the equal application to all countries of a particular procedural principle such as national treatment, it is the latter which should be changed. It is the primary goals rather than the procedural principles of an international organization which should dominate especially as the former are widely endorsed by the world community as a whole.

## **IX ECJ, FDI and Advanced Economies**

It has been suggested above that unfettered FDI as envisaged in ECJ can lead to financial fragility in developing countries and harm their development prospects. However, what would be its implications for the citizens of advanced countries? It would be useful to discuss these briefly, even if the main focus of this paper is on developing countries.

There are good reasons to believe that although there are gains to the multinationals and their managers from ECJ as it gives them a license to invest anywhere they like, it does not necessarily greatly benefit the citizens of advanced countries. With the free mobility of capital provided by ECJ, and labour being essentially immobile, the balance of power shifts decisively towards capital in these countries. Apart from its unfavourable implications for the distribution of income between labour and capital, such a shift may also leads to job insecurity and low labour standards. The employers in a high-waged, high- labour standards countries may simply threaten to take their investments to a low- waged, low-labour standard host country. Large multinational corporations may be able to achieve much of their cost saving

objectives without actually having to carry out the threat, as long as the threat was credible in the first place. There is a growing analytical and empirical literature on this subject which broadly confirms this intuition.<sup>14</sup>

More broadly, the footloose FDI is not helpful in establishing harmonious co-operative relations between labour and capital in advanced economies. However, developing countries, by their efforts to control the process of FDI in order to increase their gains from it and to reduce losses, also indirectly do service to citizens and workers in advanced countries. Essentially, these measures amount to throwing the proverbial 'sand in the wheels' of too much capital mobility. This probably helps to slightly re-address the balance between capital and labour in advanced countries.

In a series of papers this author has suggested that in the present circumstances of the world economy, there would be enormous gains for both the North and the South from purposeful economic co-operation, as that could lead to faster global economic growth. The application of that analysis to the case of FDI would suggest that with its appropriate regulation by both developed and developing countries, within a broader framework of other North/South co-operation policy measures, could greatly increase the net gains from FDI to each group of countries. This would however, involve the abandonment of ECJ and establishing institutional arrangements for active co-operation between nation states in a number of different spheres, including FDI.<sup>15</sup>

## **X Bilateral and Multilateral Investment Treaties**

To attract FDI, developing countries have entered into a large number of bilateral investment treaties (BITs) with developed as well as other developing countries. Ganesan (1998) reports that by January 1997 there were 1,330 such treaties in over 162 countries. This compares with less than 400 at the beginning of the 1990s. Ganesan notes that these treaties were popular with developing countries because they provided for "national treatment to foreign investors in the post-establishment phase only, and do not place any restrictions on host countries in following their own FDI policies. This is because the aim of BITs is the protection and equitable treatment of FDI after the investment has taken place in consonance with the host countries' laws and regulations."

The advocates of ECJ make a number of arguments for replacing BITs by multilateral treaties which it may be useful to examine. The first is a transactions costs argument which suggests that everybody would gain from the lower

transaction costs involved in a multilateral agreement. This suggestion is essentially one of bureaucratic neatness and centralisation, and is not convincing. As Hoekman and Saggi (1999) note in their World Bank paper: "Regarding the costs imposed by the multitude of BITs on multinational firms, it seems that the major proportion of the transactions costs associated with FDI is likely to arise from differences in language, culture, politics, and the general business climate of a host country. Familiarising oneself with the investment laws of a country seems trivial in contrast to these more daunting challenges that exist regardless of whether the country is a signatory to a multilateral or a bilateral investment agreement."

The second, in some ways related argument made by ECJ enthusiasts, is to suggest that a multilateral agreement would provide a more secure framework for multinationals and thereby lead to greater FDI than now. This argument has already been briefly examined earlier although in a different context, but that analysis remains relevant. As was noted, there has been an enormous increase in FDI in the 1990s which has evidently occurred under the regime of BITs. Investments protection is normally provided in these treaties by provisions for private international arbitration. Evidence suggests, however, that this has seldom been resorted to with the parties usually settling their disputes prior to arbitration. A central point is that investment protection for investors is also essentially guaranteed by the fact that there is enormous competition between developing countries for FDI and no country would wish to acquire a poor reputation with investors. There is nothing to suggest that a multilateral agreement would provide more protection which would translate into more overall FDI. The main determinants of FDI, a wide range of research suggests, are the level of a country's per capita income, its rate of growth, and its physical and human capital infrastructure.<sup>13</sup> As noted earlier, countries such as China and Malaysia have been able to attract enormous amounts of FDI despite their comparatively illiberal investment regimes. The protection to investors provided by the BITs as well as the reputational concerns of developing countries has clearly been regarded as adequate.

One argument in favour of multilateralism which has more validity is that of unequal power between advanced countries and some very poor developing countries which may lead the latter to having to agree to onerous terms in their BITs. The suggestion is that such countries would gain from a multilateral treaty where they would collectively have more influence. This, however, presupposes that a multilateral treaty on investment which is finally negotiated would be development friendly. If it is not, and there can not be any assurance that such a treaty would necessarily emerge from the WTO process, the poor developing

countries would be better off with the BITs notwithstanding their shortcomings, than with a multilateral treaty of the ECJ kind.

## **XI Conclusion**

Very briefly, the central conclusion which follows from the analysis of this paper is that ECJ, despite its important concession of confining itself to only one source of external finance namely FDI, is a flawed proposal both from the perspective of developing and developed countries. Its shortcomings are particularly serious with respect to developing countries as it essentially ignores the developmental dimension altogether. Developing countries would be better off with their existing bilateral treaties (BITs) than with a multilateral agreement of the kind represented by ECJ. The paper has, however, emphasized that although the current post-Uruguay Round FDI regime is to be preferred in relation to the ECJ, the former has, nevertheless severe deficits from a developmental perspective which need prompt attention and rectification by the international community.

### **Notes**

<sup>1</sup> This paper is based on the authors previous papers on the subject, Singh and Zammit, 1999; Singh 2001, 2003, particularly on Singh 2001.

<sup>2</sup> Jagdish Bhagwati (1998) forcefully argues this view in relation to capital account liberalisation and suggests that such liberalisation only benefits financial interests on Wall Street and officials of the U.S. Treasury.

<sup>3</sup> For recent influential contributions to the subject, see Fischer 2003; Stiglitz 2004; Summers 2000.

<sup>4</sup> See further Amsden & Singh 1994.

<sup>5</sup> See Chang (1994).

<sup>6</sup> Johnson et al 1989.

<sup>7</sup> See further Yoo and Chang (1992).

<sup>8</sup> This is the empirical definition of FDI adopted by many countries to distinguish it from portfolio flows.

<sup>9</sup> Claessens *et al* (1993), p26.

<sup>10</sup> This point is discussed further below.

<sup>11</sup> This section is in part based on Singh and Dhumale (1999). For previous merger waves in the U.S. and U.K., see Golbe and White (1998); Hughes and Singh (1980). 10 See Singh (1971, 1975); Schwarz (1982); Cosh, Hughes, Lee and Singh (1989)

<sup>12</sup> For a comprehensive discussion of the economies of scale and of scope, and of multiplant economies of scale, see Scherer and Ross (1990).

<sup>13</sup> See further Amsden,(1989) and Singh (1995a)

<sup>14</sup> For a recent review see Burke and Epstein (2000).

<sup>15</sup> See further Singh (1995b, 1977, 1999b); Singh and Zammit (2000, 2004).

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## APPENDIX

**TABLE 1: NET CAPITAL FLOWS TO DEVELOPING COUNTRIES, 1970 TO 1998.**  
(US\$ billions)

	<i>1970</i>	<i>1980</i>	<i>1990</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
Net flow of long-term debt (excl. IMF) <sup>1</sup>	6.9	65.2	43.4	77.0	87.6	118.7	82.9
Foreign direct investment (net)	2.2	4.4	24.5	95.5	119.0	163.4	155.0
Portfolio equity flows	0.0	0.0	3.7	32.1	45.8	30.2	14.1
Grants (excl. technical cooperation)	2.2	13.2	29.2	32.6	29.2	25.7	23.0
Total net resource flows	11.3	82.8	100.8	237.2	281.6	338.0	275.0

1 Bank loans, bonds, official (bilateral and multilateral) loans.

**Source:** World Bank, Global Development Finance, 1999; data for 1995 is from Global Development, Finance, 1997; and 1996 is from Global Development Finance, 1998.

**TABLE 2: NET PRIVATE AND OFFICIAL CAPITAL FLOWS: DEVELOPING COUNTRIES**  
*1984–1989, 1990–1996*  
(US\$ billions, annual averages)

	<i>1984–1989</i>	<i>1990–1996</i>
Net private capital flows <sup>1</sup>	17.8	129.4
Net direct investment	12.2	57.9
Net portfolio investment	4.9	51.1
Other net investment	0.6	20.4
Net official flows	27.2	16.8
Change in reserves <sup>2</sup>	5.1	–54.8

1 Because of data limitations, “other net investment” may include some official flows.

2 A minus sign indicates an increase.

**Source:** IMF, World Economic Outlook, 1998.

**TABLE 3: NET CAPITAL FLOWS TO DEVELOPING COUNTRIES, 1997-2003.**  
**SELECTED FLOWS**

	<b>(US\$ billions)</b>						
	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002e</b>	<b>2003f</b>
Current account balance	-91.4	-113.6	-10.7	61.9	27.6	48.3	26.2
as % GDP	-1.5	-2.0	-0.2	1.0	0.5	0.8	0.4
<b>Financed by:</b>							
Net equity flows	196.4	181.9	194.3	186.7	177.6	152.3	158.0
Net FDI inflows	169.3	174.5	179.3	160.6	171.7	143.0	145.0
Net portfolio equity inflows	26.7	7.4	15.0	26.0	6.0	9.4	13.0
Net debt flows	102.1	57.4	13.9	-1.0	3.2	7.2	5.0

*Note:* e = estimate; f = forecast

*Source:* World Bank Global Development Finance 2003, Analysis and Statistical Appendix, table 1.1, page 8, adapted.

**TABLE 4: DEVELOPING COUNTRY FLOWS OF FDI, CAPITAL MARKET FLOWS, OUTPUT AND TRADE AS PERCENTAGES OF GLOBAL TOTALS, 1991-2000.**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
In global capital market flows	9.7	9.4	9.4	9.0	9.0	9.8	10.8	6.2	4.7	5.5
In global FDI flows	22.3	27.4	29.5	35.2	32.3	34.9	36.5	25.9	18.9	15.9
In global output	19.8	19.2	19.7	20.0	20.7	22.1	23.2	21.6	21.7	22.5
In global trade	26.5	28.3	28.3	28.4	29.5	31.3	32.4	30.7	30.7	33.4

*Source:* World Bank 2001, table 2.3 page 37, adapted.

**TABLE 5: INWARD FDI FLOWS AS A PERCENTAGE OF GROSS FIXED CAPITAL FORMATION DEVELOPING AND DEVELOPED COUNTRIES 1988-1998. (Percentage)**

	Developed countries	Developing countries
1988-1993 ( <i>Annual Average</i> )	4.0	4.6
1994	3.5	8.3
1995	4.5	7.6
1996	4.8	9.1
1997	6.2	10.8
1998	10.9	11.5

*Source:* UNCTAD, World Investment Report, Cross-border Mergers and Acquisitions and Development (2000), Annex table B.5. Page 306, adapted.

**TABLE 6: CROSS-BORDER M&AS: SALES AND PURCHASES,  
BY REGION, 1990-1999 (US\$ billions)**

	Sales					Purchases				
Region/ economy	1990	1995	1997	1998	1999	1990	1995	1997	1998	1999
<b>Developed countries</b>	<b>134.2</b>	<b>164.6</b>	<b>234.7</b>	<b>445.1</b>	<b>644.6</b>	<b>143.2</b>	<b>173.7</b>	<b>272.0</b>	<b>511.4</b>	<b>677.3</b>
<i>of which:</i>										
European Union	62.1	75.1	114.6	187.9	344.5	86.5	81.4	142.1	284.4	497.7
United States	54.7	53.2	81.7	209.5	233.0	27.6	57.3	80.9	137.4	112.4
Japan	0.1	0.5	3.1	4.0	15.9	14.0	3.9	2.7	1.3	9.8
<b>Developing Countries</b>	<b>16.1</b>	<b>15.9</b>	<b>64.3</b>	<b>80.7</b>	<b>63.4</b>	<b>7.0</b>	<b>12.8</b>	<b>32.4</b>	<b>19.2</b>	<b>41.2</b>
<i>of which:</i>										
Africa	0.5	0.2	1.7	0.7	0.6	-	0.1	-	0.2	0.4
Latin America and the Caribbean	11.5	8.6	41.1	63.9	37.2	1.6	4.0	10.7	12.6	24.9
Europe	-	-	-	-	0.3	-	-	-	-	-
Asia	4.1	6.9	21.3	16.1	25.3	5.4	8.8	21.7	6.4	15.9
Pacific	-	0.1	0.3	-	0.1	-	-	-	-	-
<b>Central and Eastern Europe<sup>a</sup></b>	<b>0.3</b>	<b>6.0</b>	<b>5.8</b>	<b>5.1</b>	<b>10.3</b>	<b>-</b>	<b>0.1</b>	<b>0.3</b>	<b>1.0</b>	<b>1.6</b>
<b>World<sup>b</sup></b>	<b>150.6</b>	<b>186.6</b>	<b>304.8</b>	<b>531.6</b>	<b>720.1</b>	<b>150.6</b>	<b>186.6</b>	<b>304.8</b>	<b>531.6</b>	<b>720.1</b>

a includes the countries of the former Yugoslavia.

b includes amounts that cannot be allocated by region.

*Source:* UNCTAD, World Investment Report, 2000.