OVERVIEW

FDI TRENDS AND PROSPECTS

FDI recovery to gain momentum in 2011

Global foreign direct investment (FDI) inflows rose modestly by 5 per cent, to reach $1.24 trillion in 2010. While global industrial output and world trade are already back to their pre-crisis levels, FDI flows in 2010 remained some 15 per cent below their pre-crisis average, and nearly 37 per cent below their 2007 peak.

UNCTAD predicts FDI flows will continue their recovery to reach $1.4–1.6 trillion, or the pre-crisis level, in 2011. They are expected to rise further to $1.7 trillion in 2012 and reach $1.9 trillion in 2013, the peak achieved in 2007. The record cash holdings of TNCs, ongoing corporate and industrial restructuring, rising stock market valuations and gradual exits by States from financial and non-financial firms' shareholdings, built up as supporting measures during the crisis, are creating new investment opportunities for companies across the globe.

However, the post-crisis business environment is still beset by uncertainties. Risk factors such as the unpredictability of global economic governance, a possible widespread sovereign debt crisis and fiscal and financial sector imbalances in some developed countries, as well as rising inflation and signs of overheating in major emerging market economies, may yet derail the FDI recovery.

Emerging economies are the new FDI powerhouses

Developing economies increased further in importance in 2010, both as recipients of FDI and as outward investors. As international production and, recently, international consumption shift to developing and transition economies, TNCs are increasingly investing in both efficiency- and market-seeking projects in those countries. For the first time, they absorbed more than half of global FDI inflows in 2010. Half of the top-20 host economies for FDI in 2010 were developing or transition economies.

FDI outflows from developing and transition economies also increased strongly, by 21 per cent. They now account for 29 per cent of global FDI outflows. In 2010, six developing and transition economies were among the top-20 investors. The dynamism of emerging-market TNCs contrasts with the subdued pace of investment from developed-country TNCs, especially those from Europe. Their outward investment was still only about half of their 2007 peak.

Services FDI subdued, cross-border M&As rebound

Sectoral patterns. The moderate recovery of FDI inflows in 2010 masks major sectoral differences. FDI in services, which accounted for the bulk of the decline in FDI flows due to the crisis, continued on its downward path in 2010. All the main service industries (business services, finance, transport and communications and utilities) fell, although at different speeds. FDI flows in the financial industry experienced one of the sharpest declines. The share of manufacturing rose to almost half of all FDI projects. Within manufacturing, however, investments fell in business-cycle-sensitive industries such as metal and electronics. The chemical industry (including pharmaceuticals) remained resilient through the crisis, while industries such as food, beverages and tobacco, textiles and garments, and automobiles, recovered in 2010. FDI in extractive industries (which did not suffer during the crisis) declined in 2010.

Modes of entry. The value of cross-border M&A deals increased by 36 per cent in 2010, but was still only around one third of the previous peak in 2007. The value of cross-border M&As into developing economies

doubled. Greenfield investments declined in 2010, but registered a significant rise in both value and number during the first five months of 2011.

Components of FDI. Improved economic performance in many parts of the world and increased profits of foreign affiliates lifted reinvested earnings to nearly double their 2009 level. The other two FDI components – equity investment flows and intra-company loans – fell in 2010.

Special funds. Private equity-sponsored FDI started to recover in 2010 and was directed increasingly towards developing and transition economies. However, it was still more than 70 per cent below the peak year of 2007. FDI by sovereign wealth funds (SWFs) dropped to $10 billion in 2010, down from $26.5 billion in 2009. A more benign global economic environment may lead to increased FDI from these special funds in 2011.

International production picks up

Indicators of international production, including foreign sales, employment and assets of TNCs, showed gains in 2010 as economic conditions improved. UNCTAD estimates that sales and value added of foreign affiliates in the world reached $33 trillion and $7 trillion, respectively. They also exported more than $6 trillion, about one-third of global exports. TNCs worldwide, in their operations both at home and abroad, generated value added of approximately $16 trillion in 2010 – about a quarter of total world GDP.

State-owned TNCs in the spotlight

State-owned TNCs are causing concerns in a number of host countries regarding national security, the level playing field for competing firms, and governance and transparency. From the perspective of home countries, there are concerns regarding the openness to investment from their State-owned TNCs. Discussions are underway in some international forums with a view to addressing these issues.

Today there are at least 650 State-owned TNCs, constituting an important emerging source of FDI. Their more than 8,500 foreign affiliates are spread across the globe, bringing them in contact with a large number of host economies. While relatively small in number (less than 1 per cent of all TNCs), their FDI is substantial, reaching roughly 11 per cent of global FDI flows in 2010. Reflecting this, State-owned TNCs made up 19 of the world's 100 largest TNCs.

State-owned TNCs constitute a varied group. Developing and transition economies are home to more than half of these firms (56 per cent), though developed countries continue to maintain a significant number of State-owned TNCs. In contrast to the general view of State-owned TNCs as largely concentrated in the primary sector, they are diversified and have a strong presence in the services sector.

Uneven performance across regions

The rise of FDI to developing countries masks significant regional differences. Some of the poorest regions continued to see declines in FDI flows. Flows to Africa, least developed countries (LDCs), landlocked developing countries (LLDCs) and small island developing States (SIDS) continued to fall, as did those to South Asia. At the same time, major emerging regions, such as East and South-East Asia and Latin America, experienced strong growth in FDI inflows.

FDI flows to *Africa* fell by 9 per cent in 2010. At $55 billon, the share of Africa in total global FDI inflows was 4.4 per cent in 2010, down from 5.1 per cent in 2009. FDI to the primary sector, especially in the oil industry, continued to dominate FDI flows to the continent. It accounted for the rise of Ghana as a major host country, as well as for the declines of inflows to Angola and Nigeria. Although the continuing pursuit of natural resources, in particular by Asian TNCs, is likely to sustain FDI flows to sub-Saharan Africa, political uncertainty in North Africa is likely to make 2011 another challenging year for the continent as a whole.

Although there is some evidence that intraregional FDI is beginning to emerge in non-natural resource related industries, intraregional FDI flows in Africa are still limited in terms of volume and industry diversity. Harmonization of Africa's regional trade agreements and inclusion of FDI regimes could help Africa achieve more of its intraregional FDI potential.

Inflows to *East Asia, South-East Asia and South Asia* as a whole rose by 24 per cent in 2010, reaching $300 billion. However, the three subregions experienced very different trends: inflows to ASEAN more than doubled; those to East Asia saw a 17 per cent rise; FDI to South Asia declined by one-fourth.

Inflows to China, the largest recipient of FDI in the developing world, climbed by 11 per cent, to $106 billion. With continuously rising wages and production costs, however, offshoring of labour-intensive manufacturing to the country has slowed down, and FDI inflows continue to shift towards high-tech industries and services. In contrast, some ASEAN member States, such as Indonesia and Viet Nam, have gained ground as low-cost production locations, especially for low-end manufacturing.

The decline of FDI to South Asia reflects a 31 per cent slide in inflows to India and a 14 per cent drop in Pakistan. In India, the setback in attracting FDI was partly due to macroeconomic concerns. At the same time, inflows to Bangladesh, an increasingly important low-cost production location in South Asia, jumped by 30 per cent to $913 million.

FDI outflows from South, East and South-East Asia grew by 20 per cent to about $232 billion in 2010. In recent years, rising FDI outflows from developing Asia demonstrate new and diversified industrial patterns. In extractive industries, new investors have emerged, including conglomerates such as CITIC (China) and Reliance Group (India), and sovereign wealth funds, such as China Investment Corporation and Temasek Holdings (Singapore). Metal companies in the region have been particularly active in ensuring access to overseas mineral assets, such as iron ore and copper. In manufacturing, Asian companies have been actively taking over large companies in the developed world, but face increasing political obstacles. FDI outflows in the services sector have declined, but M&As in such industries as telecommunications have been increasing.

FDI flows to *West Asia* in 2010 continued to be affected by the global economic crisis, falling by 12 per cent, but they are expected to bottom out in 2011. However, concerns about political instability in the region are likely to dampen the recovery.

FDI outflows from West Asia dropped by 51 per cent in 2010. Outward investment from West Asia is mainly driven by government-controlled entities, which have been redirecting some of their national oil surpluses to support their home economies. The economic diversification policies of these countries has been pursued through a dual strategy: investing in other Arab countries to bolster their small domestic economies; and also investing in developed countries to seek strategic assets for the development and diversification of the industrial capabilities back at home. Increasingly this policy has been pursued with a view to creating productive capabilities that are missing at home, such as motor vehicles, alternative energies, electronics and aerospace. This approach differs from that of other countries, which have generally sought to develop a certain level of capacity at home, before engaging in outward direct investment.

FDI flows to *Latin America and the Caribbean* increased by 13 per cent in 2010. The strongest increase was registered in South America, where the growth rate was 56 per cent, with Brazil particularly buoyant. FDI outflows from Latin America and the Caribbean increased by 67 per cent in 2010, mostly due to large cross-border M&A purchases by Brazilian and Mexican TNCs.

Latin America and the Caribbean also witnessed a surge of investments by developing Asian TNCs particularly in resource-seeking projects. In 2010, acquisitions by Asian TNCs jumped to $20 billion, accounting for more than 60 per cent of total FDI to the region. This has raised concerns in some countries in the region about the trade patterns, with South America exporting mostly commodities and importing manufactured goods.

FDI flows to *transition economies* declined slightly in 2010. Flows to the Commonwealth of Independent States (CIS) rose marginally by 0.4 per cent. Foreign investors continue to be attracted to the fast-growing local consumer market, especially in the Russian Federation where flows rose by 13 per cent to $41 billion. In contrast, FDI flows to South-East Europe dropped sharply for the third consecutive year, due partly to sluggish investment from EU countries.

South–East interregional FDI is growing rapidly. TNCs based in transition economies and in developing economies have increasingly ventured into each other's markets. For example, the share of developing host countries in greenfield investment projects by TNCs from transition economies rose to 60 per cent in 2010 (up from only 28 per cent in 2004), while developing-country outward FDI in transition economies increased more than five times over the past decade. Kazakhstan and the Russian Federation are the most important targets of developing-country investors, whereas China and Turkey are the most popular destinations for FDI from transition economies. Such South–East interregional FDI has benefited from outward FDI support from governments through, among others, regional cooperation (e.g. the Shanghai Cooperation Organization) and bilateral partnerships.

FDI flows to the poorest regions continue to fall

In contrast to the FDI boom in developing countries as a whole, FDI inflows to the 48 *LDCs* declined overall by a further 0.6 per cent in 2010 – a matter of grave concern. The distribution of FDI flows among LDCs also remains highly uneven, with over 80 per cent of LDC FDI flows going to resource-rich economies in Africa. However, this picture is distorted by the highly capital-intensive nature of resource projects. Some 40 per cent of investments, by number, were in the form of greenfield projects in the manufacturing sector and 16 per cent in services.

On the occasion of the 2011 Fourth United Nations Conference on the Least Developed Countries, UNCTAD proposed a plan of action for investment in LDCs. The emphasis is on an integrated policy approach to investment, technical capacity-building and enterprise development, with five areas of action: public-private infrastructure development; aid for productive capacity; building on LDC investment opportunities; local business development and access to finance; and regulatory and institutional reform.

Landlocked developing countries (LLDCs) saw their FDI inflows fall by 12 per cent to $23 billion in 2010. These countries are traditionally marginal FDI destinations, and they accounted for only 4 per cent of total FDI flows to the developing world. With intensified South–South economic cooperation and increasing capital flows from emerging markets, prospects for FDI flows to the group may improve.

FDI inflows to *small island developing States (SIDS)* as a whole declined slightly by 1 per cent in 2010, to $4.2 billion. As these countries are particularly vulnerable to the effects of climate change, SIDS are looking to attract investment from TNCs that can make a contribution to climate change adaptation, by mobilizing financial and technological resources, implementing adaptation initiatives, and enhancing local adaptive capacities.

FDI to developed countries remains well below pre-crisis levels

In 2010, FDI inflows in developed countries declined marginally. The pattern of FDI inflows was uneven among subregions. Europe suffered a sharp fall. Declining FDI flows were also registered in Japan. A gloomier economic outlook, austerity measures and possible sovereign debt crisis, as well as regulatory concerns, were among the factors hampering the recovery of FDI flows. Inflows to the United States, however, showed a strong turnaround, with an increase of more than 40 per cent.

In developed countries, the restructuring of the banking industry, driven by regulatory authorities, has resulted in a series of significant divestments of foreign assets. At the same time, it has also generated new FDI as assets changed hands among major players. The global efforts towards the reform of the financial

system and the exit strategy of governments are likely to have a large bearing on FDI flows in the financial industry in coming years.

The downward trend in outward FDI from *developed countries* reversed, with a 10 per cent increase over 2009. However, this took it to only half the level of its 2007 peak. The reversal was largely due to higher M&A values, facilitated by stronger balance sheets of TNCs and historic low rates of debt financing.

INVESTMENT POLICY TRENDS

National policies: mixed messages

More than two-thirds of reported investment policy measures in 2010 were in the area of FDI liberalization and promotion. This was the case for Asia in particular, where a relatively high number of measures eased entry and establishment conditions for foreign investment. Most promotion and facilitation measures were adopted by governments in Africa and Asia. These measures included the streamlining of admission procedures and the opening of new, or the expansion of existing, special economic zones.

On the other hand, almost one-third of all new measures in 2010 fell into the category of investment-related regulation and restrictions, continuing its upward trend since 2003. The recent restrictive measures were mainly in a few industries, in particular natural resource-based industries and financial services. The accumulation of restrictive measures over the past years and their continued upward trend, as well as stricter review procedures for FDI entry, has increased the risk of investment protectionism.

Although numerous countries continue to implement emergency measures or hold considerable assets following bail-out operations, the unwinding of support schemes and liabilities resulting from emergency measures has started. The process advances relatively slowly. As of April 2011, governments are estimated to hold legacy assets and liabilities in financial and non-financial firms valued at over $2 trillion. By far the largest share relates to several hundred firms in the financial sector. All this indicates a potential wave of privatizations in the years to come.

The international investment regime: too much and too little

With a total of 178 new IIAs in 2010 – more than three new treaties per week – the IIA universe reached 6,092 agreements at the end of the year. This trend of treaty expansion is expected to continue in 2011, the first five months of which saw 48 new IIAs, with more than 100 IIAs currently under negotiation. How the FDI-related competence shift from EU member States to the European level will affect the overall IIA regime is still unclear (EU member States currently have more than 1,300 BITs with non-EU countries). At least 25 new treaty-based investor–State dispute settlement cases were initiated in 2010 and 47 decisions rendered, bringing the total of known cases to 390, and those closed to 197. The overwhelming majority of these cases were initiated by investors from developed countries, with developing countries most often on the receiving end. The 2010 awards further tilted the overall balance in favour of the State, with 78 cases won against 59 lost.

As countries continue concluding IIAs, sometimes with novel provisions aimed at rebalancing the rights and obligations between States and firms, and ensuring coherence between IIAs and other public policies, the policy discourse about the future orientation of the IIA regime and how to make IIAs better contribute to sustainable development is intensifying. Nationally, this manifests itself in a growing dialogue among a broad set of investment stakeholders, including civil society, business and parliamentarians. Internationally, inter-governmental debates in UNCTAD's 2010 World Investment Forum, UNCTAD's Investment Commission and the joint OECD-UNCTAD investment meetings serve as examples.

With thousands of treaties, many ongoing negotiations and multiple dispute-settlement mechanisms, today's IIA regime has come close to a point where it is too big and complex to handle for governments and investors alike. Yet it offers protection to only two-thirds of global FDI stock and covers only one-fifth of possible bilateral investment relationships. To provide full coverage a further 14,100 bilateral treaties would be required. This raises questions not only about the efforts needed to complete the global IIA network, but also about the impact of the IIA regime and its effectiveness for promoting and protecting investment, and about how to ensure that IIAs deliver on their development potential.

Intensifying interaction between FDI policies and industrial policies

FDI policies increasingly interact with industrial policies, nationally and internationally. At the *national level*, this interface manifests itself in specific national investment guidelines; the targeting of types of investment or specific categories of foreign investors for industrial development purposes; investment incentives related to certain industries, activities or regions; and investment facilitation in line with industrial development strategies. Countries also use selective FDI restrictions for industrial policy purposes connected to the protection of infant industries, national champions, strategic enterprises or ailing domestic industries in times of crisis.

At the *international level*, industrial policies are supported by FDI promotion through IIAs, in particular when the respective IIA has sector-specific elements. At the same time, IIA provisions can limit regulatory space for industrial policies. To avoid undue policy constraints, a number of flexibility mechanism have been developed in IIAs, such as exclusions and reservations for certain industries, general exceptions or national security exceptions. According to UNCTAD case studies of reservations in IIAs, countries are more inclined to preserve policy space for the services sector, compared to the primary and manufacturing sectors. Within the services sector, most reservations exist in transportation, finance and communication.

The overall challenge is to manage the interaction between FDI policies and industrial policies, so as to make the two policies work for development. There is a need to strike a balance between building stronger domestic productive capacity on the one hand and preventing investment and trade protectionism on the other. Better international coordination can contribute to avoiding "beggar thy neighbour" policies and creating synergies for global cooperation.

CSR standards increasingly influence investment policies

Over the past years, corporate social responsibility (CSR) standards have emerged as a unique dimension of "soft law". These CSR standards typically focus on the operations of TNCs and, as such, are increasingly significant for international investment as efforts to rebalance the rights and obligations of the State and the investor intensify. TNCs in turn, through their foreign investments and global value chains, can influence the social and environmental practices of business worldwide. The current landscape of CSR standards is multilayered, multifaceted, and interconnected. The standards of the United Nations, the ILO and the OECD serve to define and provide guidance on fundamental CSR. In addition there are dozens of international multi-stakeholder initiatives (MSIs), hundreds of industry association initiatives and thousands of individual company codes providing standards for the social and environmental practices of firms at home and abroad.

CSR standards pose a number of systemic challenges. A fundamental challenge affecting most CSR standards is ensuring that companies actually comply with their content. Moreover, there are gaps, overlaps and inconsistencies between standards in terms of global reach, subjects covered, industry focus and uptake among companies. Voluntary CSR standards can complement government regulatory efforts, but they can also undermine, substitute or distract from these. Finally, corporate reporting on performance relative to CSR standards continues to lack standardization and comparability.

Governments can play an important role in creating a coherent policy and institutional framework to address the challenges and opportunities presented by the universe of CSR standards. Policy options for promoting CSR standards include supporting the development of new CSR standards; applying CSR standards to government procurement; building capacity in developing countries to adopt CSR standards; promoting the uptake of CSR reporting and responsible investment; adopting CSR standards as part of regulatory initiatives; strengthening the compliance promotion mechanisms of existing international standards; and factoring CSR standards into IIAs. The various approaches already underway increasingly mix regulatory and voluntary instruments to promote responsible business practices.

While CSR standards generally aim to promote sustainable development goals, in the context of international production care needs to be taken to avoid them becoming barriers to trade and investment. The objective of promoting investment can be rhymed with CSR standards. Discussions on responsible investment are ongoing in the international community; for example, in 2010, G-20 leaders encouraged countries and companies to uphold the Principles for Responsible Agricultural Investment (PRAI) that were developed by UNCTAD, the World Bank, IFAD and FAO, requesting these organizations to develop options for promoting responsible investment in agriculture.

NON-EQUITY MODES OF INTERNATIONAL PRODUCTION AND DEVELOPMENT

International production, today, is no longer exclusively about FDI on the one hand and trade on the other. Non-equity modes (NEMs) of international production are of growing importance, generating over $2 trillion in sales in 2010, much of it in developing countries. NEMs include contract manufacturing, services outsourcing, contract farming, franchising, licensing, management contracts and other types of contractual relationships through which TNCs coordinate activities in their global value chains (GVCs) and influence the management of host-country firms without owning an equity stake in those firms.

From a development perspective, both NEM partnerships and foreign affiliates (i.e. FDI) can enable host countries to integrate into GVCs. A key advantage of NEMs is that they are flexible arrangements with local firms, with a built-in motive for TNCs to invest in the viability of their partners through dissemination of knowledge, technology and skills. This offers host economies considerable potential for long-term industrial capacity building through a number of key channels of development impact such as employment, value added, export generation and technology acquisition. On the other hand, by establishing a local affiliate through FDI, a TNC signals its long-term commitment to a host economy. Attracting FDI is also the better option for economies with limited existing productive capacity.

NEMs may be more appropriate than FDI in sensitive situations. In agriculture, for example, contract farming is more likely to address responsible investment issues – respect for local rights, livelihoods of farmers and sustainable use of resources – than large-scale land acquisition.

For developing country policymakers, the rise of NEMs not only creates new opportunities for productive capacity building and integration into GVCs, there are also new challenges, as each NEM mode comes with its own set of development impacts and policy implications.

The TNC "make or buy" decision and NEMs as the "middle-ground" option

Foremost among the core competencies of a TNC is its ability to coordinate activities within a global value chain. TNCs can decide to conduct such activities in-house (internalization) or they can entrust them to other firms (externalization) – a choice analogous to a "make or buy" decision. Internalization, where it has a cross-border dimension, results in FDI, whereby the international flows of goods, services, information and other assets are intra-firm and under full control of the TNC. Externalization results in either arm's-length trade, where the TNC exercises no control over other firms or, as an intermediate "middle-ground" option,

in non-equity inter-firm arrangements in which contractual agreements and relative bargaining power condition the operations and behaviour of host-country firms. Such "conditioning" can have a material impact on the conduct of the business, requiring the host-country firm to, for example, invest in equipment, change processes, adopt new procedures, improve working conditions, or use specified suppliers.

The ultimate ownership and control configuration of a GVC is the outcome of a set of strategic choices by the TNC. In a typical value chain, a TNC oversees a sequence of activities from procurement of inputs, through manufacturing operations to distribution, sales and aftersales services. In addition, firms undertake activities – such as IT functions or R&D – which support all parts of the value chain.

In a fully integrated company, activities in all these segments of the value chain are carried out in-house (internalized), resulting in FDI if the activity takes place overseas. However, in all segments of the value chain TNCs can opt to externalize activities through various NEM types. For example, instead of establishing a manufacturing affiliate (FDI) in a host country, a TNC can outsource production to a contract manufacturer or permit a local firm to produce under licence.

The TNC's ultimate choice between FDI and NEMs (or trade) in any segment of the value chain is based on its strategy, the relative costs and benefits, the associated risks, and the feasibility of available options. In some parts of the value chain NEMs can be substitutes for FDI, in others the two may be complementary.

NEMs are worth more than $2 trillion, mostly in developing countries

Cross-border NEM activity worldwide is estimated to have generated over $2 trillion of sales in 2010. Of this amount, contract manufacturing and services outsourcing accounted for $1.1–1.3 trillion, franchising for $330–350 billion, licensing for $340–360 billion, and management contracts for around $100 billion.

These estimates are incomplete, including only the most important industries in which each NEM type is prevalent. The total also excludes other non-equity modes such as contract farming and concessions, which are significant in developing countries. For example, contract farming activities by TNCs are spread worldwide, covering over 110 developing and transition economies, spanning a wide range of agricultural commodities and accounting for a high share of output.

There are large variations in relative size. In the automotive industry, contract manufacturing accounts for 30 per cent of global exports of automotive components and a quarter of employment. In contrast, in electronics, contract manufacturing represents a significant share of trade and some three-quarters of employment. In labour-intensive industries such as garments, footwear and toys, contract manufacturing is even more important.

Putting different modes of international production in perspective, cross-border activity related to selected NEMs of $2 trillion compares with exports of foreign affiliates of TNCs of some $6 trillion in 2010. However, NEMs are particularly important in developing countries. In many industries, developing countries account for almost all NEM-related employment and exports, compared with their share in global FDI stocks of 30 per cent and in world trade of less than 40 per cent.

NEMs are also growing rapidly. In most cases, the growth of NEMs outpaces that of the industries in which they operate. This growth is driven by a number of key advantages of NEMs for TNCs: (1) the relatively low upfront capital expenditures required and the limited working capital needed for operation; (2) reduced risk exposure; (3) flexibility in adapting to changes in the business cycle and in demand; and (4) as a basis for externalizing non-core activities that can often be carried out at lower cost by other operators.

NEMs generate significant formal employment in developing countries

UNCTAD estimates that worldwide some 18–21 million workers are directly employed in firms operating under NEM arrangements, most of whom are in contract manufacturing, services outsourcing and franchising

activities. Around 80 per cent of NEM-generated employment is in developing and transition economies. Employment in contract manufacturing and, to a lesser extent, services outsourcing, is predominantly based in developing countries. The same applies in other NEMs, although global figures are not available; in Mozambique, for instance, contract farming has led to some 400,000 smallholders participating in global value chains.

Working conditions in NEMs based on low-cost labour are often a concern, and vary considerably depending on the mode and the legal, social and economic structures of the countries in which NEM firms are operating. The factors that influence working conditions in non-equity modes are the role of governments in defining, communicating and enforcing labour standards and the sourcing practices of TNCs. The social responsibility of TNCs has extended beyond their own legal boundaries and has pushed many to increase their influence over the activities of value chain partners. It is increasingly common for TNCs, in order to manage risks and protect their brand and image, to influence their NEM partners through codes of conduct, to promote international labour standards and good management practices.

An additional concern relates to the relative "footlooseness" of NEMs. The seasonality of industries, fluctuating demand patterns of TNCs, and the ease with which they can shift NEM production to other locations can have a strong impact on working conditions in NEM firms and on stability of employment.

NEMs often make an important contribution to GDP

The impact of NEMs on local value added can be significant. It depends on how NEM arrangements fit into TNC-governed GVCs and, therefore, on how much value is retained in the host economy. It also depends on the potential for linkages with other firms and on their underlying capabilities.

In efficiency seeking NEMs, such as contract manufacturing or services outsourcing, it is possible for value capture in the host economy to be relatively small compared to the overall value creation in a GVC, when the scope for local sourcing is limited and goods are imported, processed and subsequently exported, as is often the case in the electronics industry, for example. Although value captured as a share of final-product sales price may be limited, it can nevertheless represent a significant contribution to the local economy, adding up to 10–15 per cent of GDP in some countries.

Local sourcing and the overall impact on host-country value added increases if the emergence of contract manufacturing leads to a concentration of production and export activities (e.g. in clusters or industrial parks). The greater the number of plants and the more numerous the linkages with TNCs, the greater will be the spillover effects and local value added. In addition, clustering can reduce the risk of TNCs shifting production to other locations by increasing switching costs.

NEMs can generate export gains

NEMs are inextricably linked with international trade, shaping global patterns of trade in many industries. In toys, footwear, garments, and electronics, contract manufacturing represents more than 50 per cent of global trade. NEMs can thus be an important "route-to-market" for countries aiming at export-led growth, and an important initial point of access to TNC governed global value chains, before gradually building independent exporting capabilities. Export gains can be partially offset by higher imports, reducing net export gains, where local value added is limited, especially in early stages of NEM development.

NEMs are an important avenue for technology and skills building

NEMs are in essence a transfer of intellectual property to a host-country firm under the protection of a contract. Licensing involves a TNC granting an NEM partner access to intellectual property, usually with contractual conditions attached, but often with some training or skills transfer. International franchising

transfers a business model, and extensive training and support are normally offered to local partners in order to properly set up the new franchise with wide-ranging implications for technology dissemination.

In some East and South-East Asian economies in particular, but also in Eastern Europe, Latin America and South Asia, technology and skills acquisition and assimilation by NEM companies in electronics, garments, pharmaceuticals, IT-services and business process outsourcing (BPO) have led to their transformation into TNCs and technology leaders in their own right.

Although technology acquisition and assimilation through NEMs is a widespread phenomenon, this is not a foregone conclusion, especially at the level of second and third tier suppliers, where linkages may be insufficient or of low quality. A key factor is the absorptive capacity of local NEM partners, in the form of their existing skills base, the availability of workers that can be trained to learn new skills, and the basic prerequisites to turn acquired skills into new business ventures, including the regulatory framework, the business environment and access to finance. Another important factor is the relative bargaining power of TNCs and local NEM partners. Both factors can be influenced by appropriate policies.

Social and environmental pros and cons of NEMs

Concerns exist that cross-border NEMs in some industries may be a mechanism for TNCs to circumvent high social and environmental standards in their production network. Pressure from the international community has pushed TNCs to take greater responsibility for such standards throughout their global value chains. There is now a significant body of evidence to suggest that TNCs are likely to use more environmentally friendly practices than domestic companies in equivalent activities. The extent to which TNCs guide NEM operations on social and environmental practices depends, first, on their perception of and exposure to legal liability risks (e.g. reparations in the case of environmental damages) and business risks (e.g damage to their brand and lower sales); and, secondly, on the extent to which they can control NEMs. TNCs employ a number of mechanisms to influence NEM partners, including codes of conduct, factory inspections and audits, and third-party certification schemes.

NEMs can help countries integrate in GVCs and build productive capacity

The immediate contributions to employment, to GDP, to exports and to the local technology base that NEMs can bring help to provide the resources, skills and access to global value chains that are prerequisites for long-term industrial capacity building.

A major part of the contribution of NEMs to the build-up of local productive capacity and long-term prospects for industrial development is through the impact on enterprise development, as NEMs require local entrepreneurs and domestic investment. Such domestic investment, and access to local or international financing, is often facilitated by NEMs, either through explicit measures by TNCs providing support to local NEM partners, or through the implicit guarantees stemming from the partnership with a major TNC itself.

While the potential contributions of NEMs to long-term development are clear, concerns are often raised (especially with regard to contract manufacturing and licensing), that countries relying to a significant extent on NEMs for industrial development risk remaining locked-in to low-value-added segments of TNC-governed global value chains and remaining technology dependent. In such cases, developing economies would run a further risk of becoming vulnerable to TNCs shifting productive activity to other locations, as NEMs are more "footloose" than equivalent FDI operations. The related risks of "dependency" and "footlooseness" must be addressed by embedding NEMs in the overall development strategies of countries.

The right policies can help maximize NEM development benefits

Policies are instrumental for countries to maximize development benefits and minimize the risks associated with the integration of domestic firms into NEM networks of TNCs. There are four key challenges for

policymakers: first, how to integrate NEM policies into the overall context of national development strategies; second, how to support the building of domestic productive capacity to ensure the availability of attractive business partners that can qualify as actors in global value chains; third, how to promote and facilitate NEMs; and fourth, how to address negative effects of NEMs.

NEM policies appropriately embedded in industrial development strategies will:

- ensure that efforts to attract NEMs through building domestic productive capacity and through facilitation and promotion initiatives are directed at the right industries, value chains and specific activities or segments within value chains;
- support industrial upgrading in line with a country's development stage, ensuring that firms move to higher value-added stages in the value chain, helping local NEM partners reduce their technology dependency, develop their own brands, or become NEM originators in their own right.

An important element of industrial development strategies that incorporate NEMs are measures to prevent and mitigate impacts deriving from the "footlooseness" of some NEM types, balancing diversification and specialization. Diversification ensures that domestic companies are engaged in multiple NEM activities, both within and across different value chains, and are connected to a broad range of NEM partners. Specialization in particular value chains improves the competitive edge of local NEM partners within those chains and can facilitate, in the longer term, upgrading to segments with greater value capture. In general, measures should aim at maintaining and increasing the attractiveness of the host country for TNCs and improve the "stickiness" of NEMs by building up local mass, clusters of suppliers, and the local technology base. Continuous learning and skills upgrading of domestic entrepreneurs and employees are also important to ensure domestic firms can move to higher value-added activities should foreign companies move "low end" production processes to cheaper locations.

Improving the capacity of locals to engage in NEMs has several policy aspects. Pro-active entrepreneurship policies can strengthen the competitiveness of domestic NEM partners and range from fostering start-ups to promoting business networks. Embedding entrepreneurship knowledge into formal education systems, combined with vocational training and the development of specialized NEM-related skills is also important. A mix of national technology policies can improve local absorptive capacity and create technology clusters and partnerships. Access to finance for domestic NEM partners can be improved through policies reducing borrowing costs and the risks associated with lending to SMEs, or by offering alternatives to traditional bank credits. Facilitation efforts can also include initiatives to support respect for core labour standards and CSR.

Promoting and facilitating NEM arrangements depends, first, on clear and stable rules governing the contractual relationships between NEM partners, including transparency and coherence. This is important, as NEM arrangements are often governed by multiple laws and regulations. Conducive NEM-specific laws (e.g. franchising laws, rules on contract farming) and appropriate intellectual property (IP) protection (particularly relevant for IP-intensive NEMs such as licensing, franchising and often contract manufacturing) can also help. While the current involvement of investment promotion agencies in NEM-specific promotion is still limited, they could expand their remit beyond FDI to promote awareness of NEM opportunities, engage in matchmaking services, and provide incentives to start-ups.

To address any negative impacts of NEMs, it is important to strengthen the bargaining power of local NEM partners vis-à-vis TNCs to ensure that contracts are based on a fair sharing of risks and benefits. The development of industry-specific NEM model contracts or negotiation guidelines can contribute to achieving this objective. If TNCs engaged in NEMs acquire dominant positions, they may be able to abuse their market power to the detriment of their competitors (domestic and foreign) and their own trading partners. Therefore, policies to promote NEMs need to go hand in hand with policies to safeguard competition. Other public interest criteria may require attention as well. Protection of indigenous capacities and traditional

activities, that may be crowded out by a rapid increase in market shares of successful NEMs, is essential.

In the case of contract farming for instance, policies such as these would result in model contracts or guidelines supporting smallholders in negotiations with TNCs; training on sustainable farming methods; provision of appropriate technologies and government-led extension services to improve capacities of contract farmers; and infrastructure development for improving business opportunities for contract farmers in remote areas. If contract farming was given more pride of place in government policies, direct investment in large-scale land acquisitions by TNCs would be less of an issue.

Finally, home-country initiatives and the international community can also play a positive role. Home-country policies that specifically promote overseas NEMs include the expansion of national export insurance schemes and political risk insurance to also cover some types of NEMs. Internationally, while there is no comprehensive legal and policy framework for fostering NEMs and their development contribution, supportive international policies range from relevant WTO agreements and, to a limited extent, IIAs, to soft law initiatives contributing to harmonizing the rules governing the relationship between private NEM parties or guiding them in the crafting of NEM contracts.

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Foreign direct investment is a key component of the world's growth engine. However, the post-crisis recovery in FDI has been slow to take off and is unevenly spread, with especially the poorest countries still in "FDI recession". Many uncertainties still haunt investors in the global economy. National and international policy developments are sending mixed messages to the investment community. And investment policymaking is becoming more complex, with international production evolving and with blurring boundaries between FDI, non-equity modes and trade. The growth of NEMs poses new challenges but also creates new opportunities for the further integration of developing economies into the global economy. The *World Investment Report 2011* aims to help developing-country policymakers and the international development community navigate those challenges and capitalize on the opportunities for their development gains.

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