*MERIT-Infonomics Research Memorandum series*

*Multinational Firms, Regional Integration and Globalising Markets: Implications for Developing Countries*

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*2001-036*

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# Multinational Firms, Regional Integration and Globalising Markets: Implications for Developing Countries

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October 2001


## Abstract

It is axiomatic that the potential of FDI to act as a catalyst for economic development varies by its motivation, and the competence level and scope of foreign-owned affiliates. This chapter seeks to examine the effect of regional integration (RI) on MNE strategies while acknowledging other globalisation-related developments.

We examine MNE strategies in developing countries in four scenarios; (1) in a non-RI, pre-liberalised environment; (2) with RI in a pre-liberalised environment (3) in a non-RI, post-liberalisation scenario, (4) RI in a post-liberalisation scenario. We also distinguish between least developed countries (LDCs), and intermediate developing countries, within North-South and South-South RI.

Liberalisation and a shift in policy orientation have had a greater affect on MNE strategies than integration. Globalisation of MNE activity and liberalisation has led to a downgrading of MNE activity in most LDCs. Much of the gains in FDI flows have been a result of redistribution, associated with privatisation. Countries with a threshold level of domestic capability and more efficient institutions have benefited from increases in the quality of FDI. RI schemes have reinforced these trends, benefiting those countries that have a viable domestic sector, and have created the appropriate multilateral institutions to exploit cross-border efficiencies. In general, South-South RI in a post-liberalised world has had limited benefits for LDCs relative to intermediate developing countries. RI schemes need to be seen as an opportunity to respond gradually to globalisation in a controlled and stepwise- manner, and not as an alternative to multilateralism.


Forthcoming in: (Robert Devlin and Antoni Estevadeordal, eds) Trade and Regional Integration in the Development Agenda, Brookings Institution, Washington DC, 2002

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## 1. Introduction

Policy makers in the developing world are once again enthralled by the concept of regional integration (RI), and its potential benefits. This has led to a revival of previously unsuccessful or dormant schemes and the establishment of a clutch of new agreements. Part of this renewed enthusiasm has to do with the benefits that have accrued to members associated with various European RI schemes and NAFTA, and in particular, the experience of Mexico in NAFTA.

It is not a coincidence that this renewed interest in RI has occurred while the concept of globalisation pervades our understanding of the world economy. The two are not unrelated, and some have argued that RI projects appear to represent an opportunity to redress the inequities of multilateral agreements (Baldwin 1997), and to increase their autonomy from outside forces (Vernon 1996). In other words, RI schemes are seen as a response to globalisation. There are several similarities between globalisation and RI. Both are processes closely associated with cross-border economic activity, although globalisation is more a consequence of increased cross-border activity, while RI is intended to cause it. The proliferation of cross-border activity is regarded as a primary symptom of globalisation. Both globalisation and RI are believed to provide opportunities for more rapid economic growth, associated in large part with increased FDI and trade that are consequent from increased opportunities to exploit economies of scale.

This chapter seeks to examine the effect of RI on MNE strategies. However, other developments have also significantly affected MNE strategies, and these need to be taken into account. Three powerful influences are highlighted. First, globalisation has changed the capacity and the means by MNEs to organise and coordinate their spatially distributed affiliates. Second, a broad policy shift has occurred in most developing countries from import-substituting towards export- and FDI- driven outward orientation. Third, most countries are involved in multilateral liberalisation within the framework of multilateral institutions.

Therefore, MNE strategies in developing countries are examined in four separate situations; (1) in a non-RI, pre-liberalised environment; (2) with RI in a pre-liberalised environment; (3) in a non RI, post-liberalisation scenario, (4) with RI in a post-liberalisation scenario. Furthermore, it is a mistake to assume that all developing countries are homogenous. This chapter distinguishes between two groups of developing countries. Group I consist of least developed countries (LDCs) with little or no domestic industrial capacity. Group II countries possess an intermediate level of domestic capacity. These are contrasted here with industrialised countries, which are referred to as Group III.

In this chapter, I will argue the following points. First, successful regional integration (a là EU, NAFTA) has been a consequence of globalisation, a reinforcement of de facto integration (by globalisation) with de jure integration (regional integration). Second, successful RI schemes and countries that have participated in globalisation share a number of similarities. Both RI and globalisation are ongoing processes rather than events. Successful RI projects have been marked by considerable efforts in development of institutions in the participating economies through structural adjustment, and the creation of appropriate cross-border institutions over a long period of time. Third, FDI does not drive economic growth, although it may help enhance it. FDI is not a sine qua non for development. Fourth, the response of MNEs to RI schemes is profit driven, and the net effect of RI schemes on the quality of their investments may well be negative, particularly for Group I countries. RI does not necessarily substitute or overcome the inequities of globalisation, at least as far as the activities of MNEs are concerned. However, the structural adjustment necessary for de facto RI helps to position countries to participate more effectively in globalisation.

## 2. The Challenges of Globalisation and Regional Integration

### 2.1 Globalisation as an institution building process.

Although the term 'globalisation' is a much-abused one, it is generally accepted that it is an ongoing process, rather than an event. Economic globalisation as used here implies the growing interdependence of locations and economic units across countries and regions. While a large literature has mushroomed describing the increasingly interwoven nature and cross-border dependence of locations and firms, it is by no means so for all locations, firms or industrial sectors.

Perspectives on globalisation vary quite considerably and depend on the unit of analysis. Nonetheless, it is manifest that cross-border interdependence between firms, institutions and locations has increased dramatically over the last 50 years and is likely to continue in this vein. It is not simply the presence of MNEs and their level of trade that defines a country's involvement in globalisation, but the extent to which the economy at large is inextricably linked to the rest of the world. I want to emphasise that dependency on non-national actors is not the same thing as interdependence. Through much of modern history, economies have been dependent on others as customers or suppliers. But this had largely been an arms-length relationship. Termination of a relationship might have had adverse effects, but not disastrous ones. In an interdependent relationship, important components of production are co-located, such that the failure of one prevents the other from functioning. Interdependence includes both firm and non-firm actors. By non-firm actors, I mean privately and publicly controlled organisations that determine the knowledge infrastructure that supplements and supports firm-specific economic activity. 'Knowledge infrastructure' is used in the sense proposed by Smith (1997) as being 'generic, multi-user and indivisible' and consisting of public research institutes, universities, organisations for standards, intellectual property protection, etc. that enables and promotes science and technology development. These non-firm actors are also increasingly interwoven across borders and rely on non-domestic actors for crucial inputs, unlike in the past when every country's non-firm sector was sovereign and independent.

Globalisation cannot be credited as a primarily MNE- driven process. MNEs are simply the most visible of these processes. True, MNEs have sought to overcome cross-border market failures in their search for efficiencies, but there are numerous other concurrent and inter related events including technological developments (new technologies), political events (such as the Cold War), economic liberalisation, and the associated development of supranational institutions and regulations.

It is not my intention to delve into the complexities of cause and effect of globalisation. What I wish to highlight is that globalisation is very much associated (inter alia) with changes in the political economy and changes in their frame of reference. At the risk of oversimplification, the last half-century represents a volte face in terms of policy perspectives. Prior to WWII, nation states were de facto inviolable, individual and sovereign entities with clearly defined borders in both a political and economic sense. Well before import-substituting arguments were formalised, the centrepiece of economic growth has been the concept of national self-sufficiency. Dating at least as far back as the first industrial revolution, every nation state has considered it essential to possess national capacity in so-called 'essential' industries. Inward FDI was largely controlled and limited in its scope, unless it met stringent conditions that promoted the self-sufficiency view by enhancing the host country's domestic sector.

Today - whether voluntarily or through World Bank-sanctioned structural adjustment programs -the view is largely the opposite. Policies are oriented towards export-led growth and increased cross-border specialisation and competition, and most countries are now trying to promote economic growth through FDI and international trade – what has been referred to as the 'New Economic Model' (NEM) (Reinhardt and Peres 2000). This wave of liberalisation is part of the new, received wisdom that is focused on tackling the deep-rooted causes that underlie market distortions. Unfortunately, countries prefer to view their task as 'getting the prices right' because this allows them to avoid root-and-branch restructuring.

Liberalisation has happened gradually through the Triad countries over the post WWII era, but much more suddenly within the developing countries. Policies among European countries, for instance, have gradually evolved over 50 years, while almost all of the developing world have attempted to restructure since the late 1980s, and along with the formerly centrally planned economies, only seriously during the 1990s.

The point here is that developing countries find themselves in a new multilateral milieu, but one in which they have little experience. They have hitherto operated their economies on a national basis, and by looking inward they have been able to minimise exposure to external shocks. Institutions continue to remain largely independent and national. By institutions I mean the 'sets of common habits, routines, established practises, rules, or laws that regulate the interaction between individuals and groups' (Edquist and Johnson 1997). Institutions create the milieu within which economic activity is undertaken and establish the ground rules for interaction between the various economic actors, and represent a sort of a 'culture'. Institutions are both formal and informal, and will probably have taken years – if not decades – to create and sustain. To modify and develop institutions is a complex and slow process, particularly since they cannot be created simply by government fiat. Such change is even more complex where the new institutions require synchronisation between countries. The Triad countries have taken 50 years to adjust and reform institutions, but even here there is inertia. The EU, for instance, has failed to reform its agricultural sector. Norway remains largely mired in an import-substituting world, with a strong tendency towards central planning and state-owned economic actors (Narula 2002).

Liberalisation is an important force in economic globalisation since it requires a multilateral view on hitherto-domestic issues and promotes interdependence of economies. It is implicit within this view that FDI and MNE activity can be undertaken with much greater ease than previously. This view is enforced because countries have explicitly sought to encourage MNE activity as a source of much-needed capital and technology. In addition to financial crises, the general warming of the attitudes towards FDI emanate from an accelerating pace of technical change and the emergence of integrated production networks of MNEs (Lall 2000).

## 2.2 Comparing globalisation and regional integration

Despite being the object of numerous studies, there is no clear consensus on the universality of the welfare effects of regional integration (see e.g., Baldwin and Venables 1995). Much of the empirical work has been undertaken for various European integration schemes and NAFTA, which point to a positive impact for participants, but rather few studies have been undertaken on almost a 100 other 'lesser' integration schemes. The continued proliferation of south-south integration schemes is a matter of some consternation (see Baldwin 1997). Indeed, Venables (2000) argues that under certain situations, regionalism promotes divergence (see also Venables' contribution to this Volume). It should be noted, however, that much of this (more economics-focused) work has concentrated on trade effects, with the effects on FDI being rather neglected, despite the anticipated benefits from RI being associated with trade and investment.

From an economics perspective, the static and dynamic gains from regional integration schemes result in both long and short run economic gains. This is due, inter alia, to improved economies of scale and scope, increased efficiency through the rationalization and reallocation of activities of firms, and improved inter-regional linkages (Eden 2001). The improved economic conditions are also expected to positively influence inflows of FDI. These positive externalities will, of course, vary by types of RI. At one extreme, there are shallow integration schemes, which essentially involve the reduction of tariff and non-tariff barriers between member countries. A vast majority of regional integration schemes in developing countries fall into this category. Other agreements relax restrictions on government procurement and cross-border FDI, as is the case with NAFTA.

At the other extreme, deep integration schemes may include common industrial policies, elimination of all intra-regional tariff and non-tariff barriers, and the adoption of common external barriers, and may progress as far as monetary and political union. Most prominent of these is the European Union initiative, which has itself evolved over time from a rather limited free trade agreement to a political and economic union. The net benefits of accession to regional integration schemes vary by the depth of integration. It is axiomatic that the benefits from membership in shallow agreements that have been in place for a short period are unlikely to prove as beneficial as deep integration agreements that have been implemented for a long period.

There are a number of inescapable parallels and similarities between regional integration and globalisation, which deserve attention, especially since the current RI schemes are being undertaken with globalisation as a backdrop. The big difference is this: RI schemes are attempts at social and economic engineering, while globalisation has been almost a virtuous intertwining of a variety of social, political and technological developments and events. However, the most significant similarity is that both create larger de facto markets from several de jure smaller ones (Narula 1999). In addition to creating larger markets, RI, like liberalisation, is expected to generate benefits from rationalisation of economic activity across borders by exploiting differences in comparative advantage.

Regional integration, like globalisation, is an ongoing process. Countries cannot simply 'jump' from non-integration to deep integration. RI also requires the modification of existing institutions and the establishment of new ones. Despite it being primarily a north-north scheme, the experience of European integration is instructive for several reasons. First, European political economy mirrors the policy shift typical of developing countries today, except that it has occurred gradually rather than suddenly. Second, it illustrates the effects of moving from a shallow agreement to an increasing level of intensity of integration, a professed aim of several developing country RI schemes. In addition, there exists a series of concentric agreements within European regional integration. Apart from the EU, there are associated agreements within the framework of the European Economic Area linking the European Free Trade Area (EFTA) with the EU, as well as numerous associate members amongst the Central and Eastern European countries. That is, there are (or have been) considerable differences in development levels between participants. Third, it allows us to observe developments over a longer-term perspective, unlike NAFTA (arguably the only other RI scheme that has experienced some level of success) which has a much shorter history. Nonetheless, we should note two important distinctions. First, these schemes have been primarily North-North or North-South, and second, much of RI was initiated prior to the advent of global liberalised markets. Regional integration in the case of the EU can be regarded as a preliminary experiment in multilateralism, a kind of mini-globalisation.

Particular emphasis needs to be drawn to the European experience on building institutions. Even the most shallow RI scheme requires a considerable transition period. Institutions need to adjust, if they are not to experience adverse shock. There needs to be an alignment of institutions and economic structures amongst members, and this is primarily the reason there have been multi-track membership trajectories for various applicant countries to join the EU. Countries such as Sweden and Finland did not require a long transition period for full membership, while Poland and the Czech Republic seem to need considerably longer, and Bulgaria longer still. Not all sectors can evolve towards the common standard at the same rate, and various transition periods and exceptions are marked out for particular sectors.

In other words, it seems that a certain congruence of economic systems and relevant institutions must exist as a pre-condition for successful RI. It is for this reason that considerable investment has been made (through the structural and framework programmes) to achieve such a convergence between member countries of the EU. The level of convergence required for shallow agreements may be much less, but the point is very much the same.

In a sense, RI acts as a catalyst for convergence, and hence globalisation. Certainly, in the case of EU integration this has been an explicit objective. At its heart there has been a belief that cooperation by (both firm and non-firm) economic actors across the various European countries represents a means by which the technological and economic gap between the various participants (as well as relative to the US) might be narrowed.

**3. Multinationals and economic development**

FDI is regarded as a primary – and explicit - means by which growth can be promoted. Further it is axiomatic that the availability of foreign capital and technology is an important means for economic catch-up. However, although inward FDI does not represent the only option available to developing countries, given their urgency and limited resources it may represent the most efficient option (Narula and Dunning 2000). This is for at least four reasons. First, the costs of acquiring technological and organisational know-how through arms-length means is an expensive undertaking, and given the shortage of capital this option is not open to many developing country governments with limited resources. Second, liberalised markets mean that firms, ceteris paribus, are likely to be more eager to maintain control of their assets and internalise the market for themselves, either through wholly owned subsidiaries or in joint ventures. Third, infant industry protection is de rigeur in creating a domestic sector from scratch, and protected markets are a limited option within the framework of WTO. Fourth, the resources, complementary clusters and assets necessary to support a viable and strong domestic sector are also capital and knowledge intensive. The role of competition in fostering viable domestic industry is an especially important point. This is best illustrated by the failure of the import-substituting programme in a large number of countries to achieve just this objective.

FDI, however, is not a sine qua non for economic development. There are three other conditions that need to be satisfied:

1. Does the kind of FDI being attracted generate significant spillovers?

2. Does the domestic sector have the capacity to absorb these spillovers? It is perhaps worth adding (in the case of LDCs particularly) that there needs to be a domestic sector.
3. Is the FDI that is being attracted, a substitute or complementary to domestic industry?

It is true that the determinants of economic development are similar to the determinants of FDI, but this does not mean that there is a simple cause and effect between them. Particular types of FDI tend to be attracted to countries with certain levels of economic development and appropriate economic structures (see Narula and Dunning 2000 for a review). But simply to 'pump' a country full of FDI will not lead to its catapulting to a higher stage of development.

Indeed, the presence and condition of the domestic sector is crucial. If no domestic sector were to exist (say, in a LDC) there can no opportunity to absorb spillovers from FDI: In a perfectly liberalised world, MNEs have no incentive to encourage the development of domestic firms to meet their needs because other MNEs would be able to do so, either through imports or FDI. In an extreme case, there may actually be no FDI inflow, because MNEs will prefer to locate production in a regionally optimal location and simply import. Thus, FDI in a completely liberalised milieu does not necessarily lead to growth in the domestic sector. The benefits of FDI only occur when there is domestic investment, and where the domestic investment has the ability to internalise the externalities from FDI.

Nonetheless, such an idealised world does not exist, but the point is that FDI is not a guarantee of growth. FDI and economic development are highly correlated phenomena, both being strongly dependent on the specific resources, institutions, economic structure, political ideologies and social and cultural fabric of countries. The kind of FDI activity a country might attract (or wish to attract) at different stages of development, are different (Dunning and Narula 1996, Narula 1996). Indeed, these two issues are closely related. Although every individual investment is a unique event, both the type of investment and the stage of economic development of the host country allow us to generalise that the situation currently faced by the least developed countries is fundamentally different from the catching-up and converging countries (Narula and Dunning 2000).

I wish to emphasise that the availability of foreign-owned capital (either portfolio or direct) for developing countries is not at issue here. There have been capital flows of both kinds to viable projects in the LDCs, particularly in extractive industries, and through privatisation programmes. Nonetheless, in general, these activities do not provide much opportunity for technological spillovers and beneficial externalities. In other words, it is not

FDI activities that are hard to attract, but certain kinds of FDI. There are two (interrelated) perspectives from a micro-level that need to be considered. First, there is considerable variation in the motivation for the investment. Second, from a MNE perspective, there is considerable variation in the types of subsidiaries. The following sub-sections discuss this assertion in some detail.

## 3.1 Motives for multinational investment and developing countries

It is generally acknowledged that there are four main motives for investment: to seek natural resources; to seek new markets; to restructure existing foreign production through rationalisation, and to seek strategically related created assets. These in turn can be broadly divided into two types. The first three represent motives which are primarily asset-exploiting in nature: that is, the investing company's primary purpose is to generate economic rent through the use of its existing firm-specific assets. The last is a case of asset-augmenting activity, whereby the firm wishes to acquire additional assets which protect or augment their existing created assets in some way.

In general, LDCs are unlikely to attract much asset-augmenting FDI. Such investment is primarily an activity undertaken in intermediate industrialising economies and industrialised economies. While there has been an increase in the location of asset-augmentation activity in some developing countries during the last decade, this continues to be the exception rather than the rule. This is simply because the human resources, technological capabilities and organisational skills that these countries (or their firms) possess tend to be in relatively low-technology and natural resource intensive sectors which have become 'generic' over time (Dunning et al 1998).

### *Resource seeking FDI*

Resource seeking FDI is a case where existing national technological assets and knowledge infrastructure do not play a significant role in determining FDI inflows. Where a region or country possesses an absolute advantage in a given scarce resource, it is in a strong position to extract rent from the MNE, despite the absence of infrastructure or a domestic sector. Where the resource sought is a natural one, the marginal cost of its extraction to both parties is close to zero. As such, the location is able to generate economic rent depending on the resource's rarity and accessibility in other locations.

Resource-seeking investment generally (but not always) implies low-value adding activity and low capital expenditure on plant and equipment (extractive industries being the exception). Such FDI is more footloose. A purely resource-seeking investment is not normally tightly integrated into the investing firm's organisational structure: indeed MNEs rarely engage in complete internalisation of raw material markets, preferring instead to conclude non-equity agreements with foreign firms or to purchase their inputs at arms-length prices.

In general, FDI in LDCs is often almost entirely resource seeking. Since there are few other L advantages to offer MNEs, this is often the only kind of FDI present. Where vertical forward integration and further value adding does occur, either to exploit markets or to access other L-advantages, the 'stickiness' of the investment increases.

*Market-seeking FDI*

Market seeking FDI only gains prominence in situations where the local or adjacent markets provide access to significant opportunities to achieve production economies of scale. This requires not only a sizeable population, but also the ability of the market to support (within a reasonable time frame) the expected demand on which the investment is based. In addition though, there is often a 'follow-the-leader' strategic response by other firms, whereby a market that might have supported two or three competitors is inundated with a larger number of new entrants than the market can efficiently support. The case of both the Chinese and the Indian automobile market represent examples of such a scenario, where despite the potential for high demand levels, few participants are actually able to make a profit. This is not the case with all sectors – investments in food and personal products for instance are much more likely to achieve economies of scale, since these products have a relatively low-income elasticity of demand. Indeed, the automobile industry may represent a special case in these countries, for what is now described as aggressive market-seeking investments in developing countries, in many cases, began life as defensive import-substituting investments. These were only permitted under certain stringent conditions, but the MNE normally expected to have access to a captive protected market in return.

Market seeking FDI is largely based on a single central locational advantage. Its presence or absence is stage-dependent, but is essentially an exogenous event, with one exception. Membership of a free trade area allows countries that have small domestic markets to expand their de facto market size.  In such situations, however, several formerly sovereign markets become integrated, and the choice of location then rests on other L-advantages.  This may have detrimental effects too: once sanctions against South Africa were lifted, a certain hollowing out of market seeking FDI in neighbouring countries was observed as a result of their free trade agreements with South Africa.

*Efficiency seeking and strategic asset-seeking FDI*

These two types of investment are similar in that they both normally require a certain threshold level of created assets and are generally regarded as being associated with the process of globalisation. It is no surprise that they are generally associated with middle-income and industrialising countries, but especially in the case of asset-seeking FDI, with the industrialised countries.

As such, efficiency seeking investment in the least developed countries is an ambiguous concept, although, for many years, MNEs have engaged in export-oriented resource-seeking investment, which is de facto efficiency-seeking FDI. Moreover, efficiency investment - in the sense that different aspects of manufacturing activity are located in particular locations to exploit the economies of cross-border specialisation and the uneven distribution of immobile created assets- is a relatively new phenomenon

In both of these types of investments, the role of sub-national clusters and the agglomeration of related activities is significant. The externalities available to countries that are home to centres of agglomeration, or possess the necessary science and technology infrastructure necessary to attract asset-augmenting FDI, are considerably different from countries which primarily attract asset-exploiting FDI. It should be noted that even where centres of excellence or agglomeration exist in a given industry, this does not imply that further knowledge intensive investments will be attracted to the same location by virtue of a single cluster existing, unless clear spillovers or externalities exist. Nonetheless, countries that have (the basis for) agglomerative economies are the ones likely to receive such FDI.

## 3.2 Typology of MNE Subsidiaries

Although there are several typologies of affiliates, they serve different purposes. In particular, attention has primarily been focused on first-world MNEs located in first world locations. Some of these typologies have tended to examine particular aspects of value adding activity, or particular industries. We will utilise a typology based on previous work by Pearce (1989, 1999) and Doz (1986), but modified for our purposes.

The nature of the activities undertaken by a subsidiary and its potential level of embeddedness in the host economy vary according to 1) the level of competence of the subsidiary; and 2) the scope of its activities (Benito et al 2001).

*****Figure 1 about here*****

Figure 1 illustrates our typology of subsidiaries according to these two scales. A typical value added chain can be viewed from a 'level of competence' perspective consisting of 'strategic' and 'operational' elements. Activities such as sales and manufacturing are operational in nature, while R&D centres and headquarters functions are strategic in nature. In general, strategic elements tend to be located close to locations which are regarded as important to the MNE. Following Bartlett and Ghoshal (1989), there is a close link between the influence of the subsidiary and the strategic importance of its local environment. Strategic elements perform a critical role in a network of units, adding value through contributing their own expertise as well as by coordinating the flow of knowledge within the network. Second, there is considerable variation between subsidiaries in the scope of their activities, with certain subsidiaries performing single and specialized activities, and others performing a larger variety and of greater value (Figure 1).

*Truncated miniature replicas (TMR)*

As their name implies, truncated miniature replicas are essentially a duplication of the parent firm, although perhaps not with the same scale of production and not all of the various components of value adding activity. Typically, they do not undertake basic research but may modify and adapt products originally developed by the parent. Although TMRs vary in the extent to which they are truncated, generally speaking, they tend to have a low or medium level of competence (Figure 1). TMRs tend to have an extensive market scope, in the sense that they have a large product range, but supply a limited and isolated market (Pearce 1999). TMRs tend to have a considerable degree of autonomy in their activities, although the parent company exerts overall strategic control. This means, for instance, that the parent decides new additions to the product range. They are nationally responsive and apart from a few advantages derived from being part of a MNE network, such as lower cost of capital and technology, they are similar to other indigenous firms. Their primary motive is market-seeking and most often associated with import-substituting programs. The parent-affiliate relationship is weakly developed and the two are essentially independent of each other.

*Rationalised affiliates*

Rationalised affiliates are much more closely integrated into the MNE network. Their operations are based on an efficiency seeking motivation, aimed at optimising costs over multiple locations and often produce a small range of products. There is a strategic interdependence between the MNE network and the affiliate. Pearce (1989, 1999) distinguishes between two types of rationalised affiliates: the Rationalised Production Subsidiary (RPS) and the World Product Mandate subsidiary (WPM). Pearce and Tavares (1998) propose a further sub-classification of WPMs in Regional Product Mandate (RPM) subsidiaries and Sub-Regional Product Mandate (SRPM) subsidiaries. Fundamentally, an RPS is part of the MNEs global strategy and is engaged in the production of a particular value-adding aspect based on specific competitive advantages of the RPS relative to other subsidiaries. Its products are often intermediate goods, or products or services complementary to other RPS. R&D is typically not associated with an RPS and control over its operations is exerted from headquarters. Its activities are confined to operating activities, but not strategic ones.

WPM subsidiaries, on the other hand, have a greater strategic role, more decision-making power, and are often engaged in higher value-adding activity. They are based on a strategic asset-seeking motivation, as well as an efficiency-seeking one. WPMs maintain global or regional control over a particular product line or functional area, and are designated 'centres of excellence'. That is, 'strategic' activities such as R&D and headquarters functions are included in the affiliate's responsibilities and it exerts control over other affiliates in the same region or worldwide.

RPMs and SRPMs are truncated versions of WPMs, in that they have a broader mandate towards a region (such as participants of a RI scheme) or a sub-region (say, the Nordic countries, South Asia). They are designed to be responsive in particular to a smaller catchment area. RPMs and SRPMs aim to meet particular market needs that may be unique to a given group of countries, because the region or sub-region requires services and products that need to be differentiated from other RPMs and SRPMs, or because local conditions require a greater responsiveness (Pearce and Tavares 1998).

*Single-activity affiliates*

Single activity affiliates are a cross between TMRs and RPSs. On the one hand, they represent an extreme version of a TMR, in that they undertake a single aspect of value adding activity. In other words, they are severely truncated. On the other hand, such affiliates may in fact be part of a company's rationalised strategy: the comparative advantage of the location is best suited for such activities. Nonetheless, a differentiation needs to be made particularly in the developing country scenario, as such affiliates are often marginal to the firm, in terms of strategic importance, unlike RPS subsidiaries which may also be specialised in one form of activity. They are ‘generic’ in the sense that there are often numerous such affiliates in various developing country locations, and while there may be a dependence, they contribute nothing unique to the assets of the firm and are easily substituted. These affiliates are not involved in decision-making or strategic planning, and are virtually at arms-length to the MNE.

Such affiliates typically tend to be engaged at the extremes of the value-adding chain. The first type are trading affiliates, engaged in trading activities, and, in the limit, in marketing and after-sales service. The second sub-category is resource-extractive affiliates. Resource-extractive affiliates are at the other end of the value chain, engaged solely in acquiring (primarily through extractive activity) scarce or otherwise valuable crude resources, for the express purposes of exporting these raw materials for use in other locations, whether by another affiliate, or by an unrelated firm.

It bears repeating that there is considerable variation between industrial sectors, individual MNEs as well as host and home country factors. For instance, in the food and beverages sectors, subsidiaries are organised primarily as TMRs. MNEs with greater international exposure and dependence on foreign markets are more inclined towards RPS or WPMs.

It is axiomatic that subsidiary roles evolve over time, due both to internal, MNE-specific factors and to changing non-firm exogenous developments, including liberalisation of markets and regional integration (Mariotti and Piscitello, 2001; Birkinshaw and Hood, 2000).

The changing external environment will inevitably induce some changes in subsidiary roles. Once an MNE rationalizes the number of subsidiaries or reorganizes the activities across borders, the remaining and/or new units will likely experience changes in scope and areas of responsibility. Increases in scope can typically be found when the number of subsidiaries are rationalized or local conditions encourage localization of activities (Birkinshaw, 1996). Similarly, the scope may be narrowed to focus on specific activities and build expertise within the selected area (Surlemont, 1998;). Hence, changes in scope are often related to both organizational and spatial considerations.

**4. MNE strategies, Liberalisation and regional integration**

In this section we will examine MNE strategies in response to liberalisation and regional integration in four scenarios: (1) in a pre-liberalised environment; (2) participation in a RI scheme in a pre-liberalised environment (3) in a post-liberalisation scenario (4) participation in a RI scheme in a post-liberalisation scenario. We consider three groups of countries. Group

I countries are least developed with little or no domestic capability. Group II are developing countries which possess an intermediate domestic capability, while Group III are industrialised countries which have a high domestic capability and are home countries of MNEs. There are a finite number of RI schemes possible between these three groups, as illustrated by Figure 2. We will examine each of our scenarios from every practical option for developing countries.

******FIGURE 2 ABOUT HERE******

4.1 MNE strategies in a non-RI, non-liberalised world

Let us take the situation of countries prior to liberalisation, i.e., where import-substituting policies are in force. Group I countries tend to be host to single-activity subsidiaries. In Group II and III, MNEs respond to investment opportunities primarily by establishing miniature replicas, although the extent to which they are truncated varies considerably between countries. The extent of truncation is determined by:

1. The size of the local market in terms of potential and actual demand;
2. The extent to which the MNE is afforded a monopoly;
3. The stringency of the import-substituting regime. Different countries applied different local content requirements, and barriers on the imports of intermediate goods;
4. The capacity of domestic industry to supply local content;
5. The stringency of foreign ownership restrictions and the risk of expropriation. Ownership is significant to the MNE because it determines its ability to control the activities of the subsidiary, and the use of its technological assets. Where domestic industry is weak or non-existent, ownership restrictions also influence whether foreign-based suppliers might also be able to engage in FDI to manufacture local content;
6. The cost of capital relative to that available on international markets (or at home), and restrictions on where capital must be borrowed;
7. The potential to generate rent; and restrictions on repatriation of dividends and interest payments to the rest of the MNE in hard currency.

This list is partial, and these factors interrelated. Numerous trade-offs exist between these factors. For instance, where local demand is large and rent-generation opportunities high (such as in China), MNEs are willing to accept greater restrictions on ownership (than say

Peru). IBM's decision to divest from India in the mid-1970s was triggered by increased local content requirements, and a potential loss of majority ownership. The issue in this case was control, rather than ownership: during the same period, IBM's Indonesia subsidiary was a shell company, while its operations locally were undertaken by a domestically-owned company. However, IBM had full operational and strategic control of the Indonesian firm.

But by far the most important determinant on truncation, and thereby the scope of activities and competence level of the subsidiary (since broadly speaking most countries maintained similar import-substituting regulations prior to the mid-1980s) are associated with market size, and capacity and capability of domestic industry. Group I countries without a domestic sector and with low demand were host to the most truncated subsidiaries, often to the point of being single-activity subsidiaries. Activities were primarily in sales and marketing, and natural resource extraction. Larger Group II and Group III countries (for much of Europe still maintained some form of import-substitution into the 1970s, and non-EU countries such as Norway, well into the 1980s) with domestic technological capacity (such as Brazil and India) were host to the least truncated subsidiaries, often with R&D departments. Nonetheless, products manufactured by these TMRs were either obsolete in the home country or designed domestically strictly for local competition, or for a limited export market (Mortimore 1998). In Group II, competition was considerably limited, domestic productivity low, and in many cases, economies of scale were not reached. Production costs are therefore higher than equivalent imports, tariff and non-tariff barriers induced market imperfections, allowing for rent-generation.

## 4.2 Shallow regional integration with non-liberalisation

Assume an RI scheme that proposes a common internal tariff and a (higher) common external tariff, such that this de facto enlarges the market, while maintaining an import-substituting (pre-liberalisation) stance.

*Group I-Group II and Group II-Group III RI schemes.*

First, take the case of RI between countries A and B at different levels of domestic capability. Assume that Country B is at a lower level (whether Group I or II) than Country A (Group II or III). Country A's existing TMRs might see an increase in the scope of their activities. Country B might see an upgrading of its single-activity subsidiaries to TMRs, as market size increases. In addition, there may be a redistribution effect to take advantage of differences in comparative advantage. Broadly speaking, however, this will be relatively small with shallow integration, depending upon the extent and sectors for which intra-regional barriers decline. It will also be lower with a Group I – Group II RI scheme, than with a Group II-III RI scheme. In either case there will be a net increase in FDI to both countries, and an increase in competence and scope of subsidiary activity. There will be no crowding-out of domestic investment, and possibly a crowding-in in the case of country A that has the technological capability to nurture domestic sector. Intra-regional FDI will occur, primarily from A to B, depending on the industry, but this is relatively minor, particularly where Country A is a Group II country, in the form of single-activity subsidiaries to exploit resources in Country A, or as sales affiliates. With a Group II-III RI scheme, intra-regional FDI will be greater, but primarily downwards, and to exploit differences in comparative advantage (such as the maquiladoras in Mexico).

Broadly speaking, however, investments in shallow agreements will tend to be 'local' with the objective of accessing individual local markets separately, rather than combined markets. This is borne out by investments in the earlier stages of NAFTA and the EU. Much of the earlier FDI in European RI in the 1970s was of a defensive local market-exploiting nature (Dunning 1997). Investments in each country were primarily associated with its domestic market, and with overcoming barriers to imports.

The evidence points to a potential for a greater scope of MNE activities in a non-liberalisation RI scenario for Group I and Group II countries, regardless of whether the RI was South-South or North-South. In the case of Group I countries, certainly, MNEs invested in response to RI where otherwise little or no FDI might be attracted. However, opportunities – due to import substitution and alternative possibilities in Country A – are limited for sequential FDI and upgrading. Potential for a higher quality and quantity of FDI does not however mean that spillovers and externalities are internalised. Where domestic firms are able to internalise spillovers and improve their capabilities, for instance, by becoming efficient suppliers to MNEs, this acts as a reinforcing mechanism for the upgrading of the MNEs' competence levels. If the efficiency of the TMR approaches international levels, it is possible that the subsidiary in Country A is upgraded to a SRPM or RPM.

*Intra-Group I RI schemes*

Second, take the case of a regional integration between group I countries with similar comparative advantages. Neither A nor B, on its own possesses sufficient location advantages to attract TMRs, but together their combined market size may justify TMRs in some sectors. This will be in either basic sectors such as resource processing and food sectors, in other words, Hecksher-Ohlin industries. There is little likelihood, however, that affiliates will improve domestic capacity, mainly because the domestic sector is non-existent.

4.3 MNE strategies after liberalisation

Most South-South agreements established prior to the liberalisation of the 1990s were de facto inoperational, as were most North-South agreements, with the exception of Mexico-US FTA. Therefore, in a sense, liberalisation was undertaken in a de facto un-integrated environment. Liberalisation as undertaken by most developing countries has had the following consequences for MNE activity:

1. Floating currencies, removal of exchange restrictions and subsequent devaluation;
2. Reduction of tariff and non-tariff barriers to manufactured imports;
3. Reduction of local content requirements for incumbent MNEs;
4. Removal of export requirements from MNEs;
5. Reduction of direct and indirect subsidies to domestic industry;
6. Privatisation of some state-owned assets.

However, as discussed earlier, liberalisation is one facet of globalisation. Globalisation has affected the ownership assets of MNEs in that it has changed the way in which they organise and undertake cross-border activities. This is not just a result of the global wave of economic liberalisation and regional integration (particularly NAFTA and EU) but also a result of inter alia, the increasing enforceability of transactions across borders, increased competition, the growing need for competences in multiple technologies and improved information and communications technologies.

Although the amount of total FDI stock directed towards developing countries may have increased, an increasing proportion of new investment is of a kind that requires the use of specialised created assets, and therefore tends to be directed to the developed and wealthier developing countries with the necessary level of technological assets. On the one hand, MNEs seek more specialised inputs, and on the other, more countries offer generic inputs. Liberalisation has meant that a much larger (possibly twice as much as two decades previously) pool of countries offer 'generic' location advantages such as access to natural assets and basic infrastructure. The problem of too many countries chasing a limited amount of FDI is exacerbated by the competition between provinces and regions within countries, which offer their own set of incentive schemes to funnel scarce investments to their locations (Mytelka 1996). Countries and provinces are therefore under pressure to 'give away' bigger investment incentives in order to attract the FDI that is often central to their development strategies. There is a danger that due to the increased competition, countries may give away more than the potential benefits that accrue from the MNE activity (Mytelka 1996, McIntyre et al 1996).

It is important to realise that the process of liberalisation has increasingly become an exogenous event with a pervasive influence beyond any single country's control (Narula and Dunning 2000). Although the opening up or liberalisation of any particular country is a country-specific (and therefore endogenous) event, the benefit that accrues to the country from this event is a function of how many other countries have also liberalised. Furthermore, membership of multilateral institutions such as the WTO (as well as free trade areas and other forms of economic integration) obliges the participating countries to conform their liberalisation policies to a common standard. Membership of multilateral blocs can affect an involuntary change in policy, since, with increasingly few countries still operating within a command economy or a import-substituting regime, there are few opportunities for such countries to engage in economically sound non-market arrangements.

To sum up, globalisation has affected the spatial distribution of MNE activity on a multi-country, international level as well as on an individual country basis. This is due not just to liberalisation in an individual country, but also due to liberalisation as a multi-country phenomenon. Combined with the changing nature of MNEs' ownership-specific assets, this has led to a reorganisation of MNE activities within countries and across countries.

The strategies of MNEs in any given developing country can be affected vis-à-vis their operations in three possible ways:

1. New and/or upgraded affiliates: There are opportunities for new FDI inflows, firstly through new initial investment, resulting in new subsidiaries that did not exist previously, and secondly through sequential investment as firms upgrade the scope and competence of existing subsidiaries. In a static and simplistic view, this leads to an increase in total capital (i.e., domestic investment plus foreign investment).
2. Downgrading of subsidiaries: MNEs may divest their operations in response to better location advantages elsewhere, or reduce the intensity of operations by lowering the level of competence and/or scope of their subsidiary. Total capital in this scenario may decrease.
3. Redistribution effect: There is the possibility for a redistribution effect, with total capital staying constant. That is, sectors that were dominated by domestic capital may be transferred to foreign ownership.

Of course, in reality it is hard to separate these three effects, since these developments are hard to measure, not least because individual countries and MNEs are idiosyncratic and path dependent. Firms may take particular strategic decisions because of long-term and non-economic considerations, and policies of countries may vary between sectors and sub-sectors.

Nonetheless, there are certain broad trends which can be observed. It is clear, for instance, that the erosion of the kind of location advantages associated with protected trade and investment regimes has had far reaching consequences. Although the benefits of liberalisation in terms of encouraging inward FDI are notable, some MNEs have divested in response to liberalisation where the initial MNE activity was to overcome tariff and non-tariff barriers. Since the conclusion of NAFTA, for example, defensive import substitution FDI in Canada has fallen sharply. Although information on divestment in developing countries has not been systematically collected, it is likely that, since proportionally more FDI prior to liberalisation was defensive market seeking, this phenomenon might be a significant one. It is important to note that although data suggests that there was a drastic decline in FDI stocks in Group I countries in the late 1980s, this reflects in part the devaluation of domestic currencies relative to the dollar. Thus, while the property, plant and equipment, and the scope and competence of an affiliate in, say, Argentina or Chile may have remained identical pre- and post-liberalisation, its value on the books of the MNE may have declined in hard currency terms. Nonetheless, a wide variety of Group I countries have seen a decline in the quality of TMR subsidiaries, particularly in sectors where the low productivity of affiliates' production was supported through trade barriers-induced market distortions. MNEs have taken advantage of liberalisation to exploit production capacity in fewer locations to exploit economies of scale, especially where local consumption patterns are not radically different to justify local capacity and where transportation costs are not prohibitive. This has meant that some TMRs have been downgraded to sales and marketing affiliates. Except for sectors where policy-induced distortions persist, FDI now largely reflects comparative advantages. Group I countries with abundant natural resources now receive much more resource-seeking FDI, and less upstream FDI in manufacturing (ECLAC 2001).

Countries with superior 'non-generic' locational assets – in other words, Group II – tend to receive such higher value adding, knowledge intensive FDI. Countries without the capacity – both in terms of infrastructure and necessary skilled human capital - are unlikely to be hosts to RPS, RPMs or WPMs. Deepening of affiliate activity is increasingly associated with the location's ability to be integrated with the rest of the MNE and its ability to provide unique knowledge-intensive inputs not available elsewhere. Data published by ECLAC

(2001) suggests that FDI activity in Latin America– with the exception of Mexico and the Caribbean - continues to focus on serving local markets and traditional resource-seeking activities.

In other words, domestic capacity – whether in the form of knowledge infrastructure or efficient domestic industrial sector - is a primary determinant of high competence foreign affiliates. Some countries have succeeded in attracting such FDI, notably Mexico, and the Caribbean Basin (ECLAC 2000, 2001, Mortimore 2000). In addition to providing domestic capabilities and a threshold level of infrastructure, these countries have invested in developing knowledge infrastructure (although to a lesser extent in the case of Mexico). More importantly, these countries have had long-term bilateral agreements with the US. Like incentives, bilateral ties are not on their own sufficient conditions to attract FDI, but studies have shown that the longer they persist, the greater their effect (Mudambi 1998 Blonigen and Davies 2000).

An important avenue through which redistribution effects of FDI can be seen is through privatisation. Between 1988 and 1999, $107.3 billion worth of privatised firms had been acquired through cross-border M&A. The share of Latin America and the Caribbean was roughly 79.8% (UNCTAD 2000). In other words, during this period, about 20% of the total inflows to this region were associated with privatisation. Overall, liberalisation has been very beneficial to MNEs. Privatisation, in particular, has allowed foreign investors to acquire fully operational (albeit often inefficient) firms in countries at relatively low cost, due inter alia to depreciation of exchange rates of the recipient economies. From a national perspective, inflows from privatisation represent a single, one-off phenomenon - MNE acquisitions through privatisation schemes may initially generate a large initial infusion of capital, but subsequent inflows are by no means guaranteed. Indeed, in many cases state-owned companies that have been most attractive to FDI have often been the more efficient ones, requiring relatively little in the way of upgrading. It should be noted that a majority of privatisations are in the services sector. Furthermore, because MNEs intend to generate some rents from these investments, the net inflows can be expected to be significantly smaller in subsequent years. As such, the net effect on the economy is possibly neutral, and FDI represents simply a redistribution of assets from domestic to foreign capitalists or from the state to foreign firms[i].

## 4.4 Regional integration after liberalisation.

*Intra-Group I RI*

Take the case of two Group I countries undertaking shallow integration after liberalisation. Let us assume that this implies common external barriers, but relatively free (or at least lower) intra-regional trade barriers. This gives MNEs (and domestic firms) an opportunity to exploit scale economies in market seeking investment. Thus, an MNE may consider a TMR where two single activity affiliates might previously have existed. But such an operation can either be in country A or in country B. Assuming similar factor endowments and de facto freedom of movement of goods and services, the decision is often based on incentives and subsidies. Such contests can only erode the net benefits of FDI. In general, RI will have no influence on the spatial distribution of resource-seeking investments, since these are already based on comparative advantage.

*Group I-Group II RI*

Here, a clearer variation in endowments and location advantages exist. An RI–driven reorganisation of MNE activity is certainly possible with the higher competence activities in the Group II country (‘A’) and lower factor-endowment type activities in the Group I country (‘B’). However, liberalisation in neighbouring countries means that – unless external barriers are very high – the MNE may yet prefer to locate higher competence in country C located outside the boundaries of the RI. However, the determining factor whether Country A becomes host to a RPM subsidiary is the efficiency of its existing operations relative to other countries, and only secondarily, its participation in a RI scheme.

*North-South RI*

Although redistribution of MNE activity follows along similar lines to Group I-Group II integration, there are two obvious advantages of participation in a North South scheme that are not evident in a Group I-II RI. First, the Group III country (‘A’) is home to a large group of MNEs who are more likely to invest in Country B. The technological gap is much larger, and the pool of potential spillovers greater. Furthermore, such intra-regional FDI is more likely to be efficiency-seeking. Second, Country A provides a much larger market. Thus in terms of linkages, and simply in terms of FDI, there is a greater order of magnitude in terms of benefits. As an example, Mexico with NAFTA has enjoyed increased FDI flows, both from within NAFTA and from its agreement with the EU. This has two advantages that (say) Mercosur does not have. First, NAFTA provides it access to the US. Certainly, many EU firms would not have invested in Mexico if it provided ease of access to, say, Honduras, or Brazil. Second, the EU, the US and Canada are home countries of a majority of the largest MNEs. South-South RI schemes do not always have the managerial, technological or capital capacity within the region to lead to an increase of intra-regional FDI of the same order of magnitude. In addition, MNEs from the South are themselves interested in improving their global competitiveness since they too must survive in global markets. Ceteris paribus, improved or cheaper access to another developing country is not in itself sufficient incentive, unless that location enjoys some considerable advantage over other developing countries.

I have taken the example of a two-country RI for illustrative purposes. It is self-evident that a larger group of participants obviously acts as a more powerful magnet for investment, although coordinating policy across a larger group is fraught with complications. I have also had to assume that RI schemes have been implemented uniformly. Unfortunately, this is rarely the case. There are certain limitations that are associated with achieving even the most modest gains from RI. First, there is the lack of common institutions, and the lack of political consensus in creating these. Take for instance the various and overlapping Latin American RI schemes, some of whose members have been in the throes of regional integration on a sporadic basis for over two decades. A recent study by the Inter-American Development Bank (2000) highlights the various problems in regulatory and institutional frameworks between Latin American countries. For instance, a truck carrying goods from Brazil to Chile requires 200 hours for a 3500 Km journey, of which 50% is spent in the two border crossings. As I have highlighted before, the development of common institutions is a slow and gradual process. It is here that the benefit of a history of regional integration attempts and a similarity of cultures helps the most. Previous cooperative institution building allows countries to continue in that vein, but political differences and a lack of congruity in goals means that RI schemes remained largely incomplete.

A second limitation of actual RI schemes compared to the stylised one is that there is rarely conformity to a common external barrier that is higher than the (common) internal barriers. A third related limitation is the reluctance to agree amongst members about structural adjustment. Each country wishes to maintain its national champions and ‘status’ projects, such that considerable duplication exists. Achieving consensus as to how to rationalise this is avoided by excluding such sensitive sectors from agreements. For instance, one industry in Latin America, which might benefit from intra-RI rationalisation of production is the automobile sector. However, in the case of the Mercosur countries which are hosts to a sizable presence of MNEs producing automobiles for each domestic market dating back to the import-substituting era, there is some reluctance to allow intra-regional free access (Mortimore 1998). This was also the case initially with European integration. Until the early 1980s, much of FDI was defensive market seeking, and intra-European FDI was considerably low, as each country maintained its national champions. European firms are significant home countries for MNEs- indeed, many European countries are net outward investors but not to other European countries. European MNEs possess significant ownership-specific assets (whether technological, managerial or through privileged access to complementary assets) not available to developing country firms. This means that prior to RI there was already a large untapped potential for intra-European activity. Secondly, the presence of such large and competitive firms implies location-specific advantages in the form of institutions, infrastructure and other economic actors that can act as a 'magnet' to foreign (whether intra- or extra-regional) MNEs, quite apart from the attractions of a large market. However, intra-EU FDI and rationalisation of production within the EU only took place after considerable efforts were made by the European Commission to 'push' EU firms to rationalise and create trans-European efficiency of their activities (Narula 1999). Member countries provided EU firms a grace period of protection within which to improve their competitiveness, after which market forces would decide which players survived, (in theory) regardless of national origin.

**5. Conclusions**

This paper has tried to illustrate how the strategies of MNEs have responded to globalisation and attempted to evaluate MNEs' response to regional integration separately in both a pre and post-liberalisation environment.

From the MNEs' perspective, liberalisation has had a greater effect on their strategies than regional integration. Globalisation of MNE activity and liberalisation of countries has led to a downgrading of MNE activity in most LDCs and some more advanced developing countries. Much of the gains in FDI flows have been a result of redistribution, associated with the transfer of state and privately owned domestic firms to foreign ownership. Only a handful of countries have seen an improvement in the quality of FDI. These countries have a threshold level of domestic capability and infrastructure, as well as institutions that are more efficient. In general, RI schemes have reinforced these trends, benefiting those countries that have developed their domestic sector and worked towards creating the appropriate multilateral institutions to exploit cross-border efficiencies. Furthermore, these countries have been involved in North-South RI schemes.

The objective of development strategies in both pre- and post-liberalisation phases has been to develop and sustain the competitiveness of domestic industry. Liberalisation has brought with it more MNE-friendly policies, with the objective of leveraging FDI for capacity building. However, the quality of FDI and the potential for spillovers varies considerably, depending on the motivation for FDI and the kind of subsidiary. In general, there has been a downgrading of MNE activity in most Group I countries and some Group II countries. Much of the gains in FDI flows have been a result of redistribution, associated with the substitution of state and privately owned domestic firms to foreign ownership, and the gains therefrom are dubious from a developmental perspective. The only countries that have attracted 'the right kind' of FDI have been those that have the appropriate knowledge infrastructure, sound, stable economic policies and the potential for a competitive domestic sector. MNE subsidiaries do not develop in isolation from the domestic sector. In other words, participants of South-South agreements are unlikely to receive much FDI over and above that which they might have received in the first place in a post-liberalised world, based on their comparative advantage, and indeed, may suffer from negative redistribution effects. It is important to emphasise that the analysis here has focused solely on MNE strategies,: there can be (and are) considerable other benefits from participation in RI schemes through other mechanisms.

For most developing countries, RI on the heels of liberalisation has not improved matters, except possibly for Group II countries in South-South RI schemes, and within North-South RI schemes. In other words, the situation has improved for the 'haves' and not the 'have-nots'. Regional integration improves only one type of location advantage: RI are associated with increases in de facto market size, and thus, logically, the largest benefit from increased FDI are those that are motivated by efforts to acquire access to these markets. This is no different from the advantages that liberalisation is purported to offer. From the MNEs perspective, liberalisation is a bigger 'pull' than a smaller, closed club of regional integration unless that club offers some unique advantage not available elsewhere. Besides increases in market size are rarely achieved in most South-South RI schemes, because the multilateral institutions necessary to promote de facto cross-border efficiencies are simply not present. RI schemes have a completely different outcome post- and pre-liberalisation vis-à-vis MNE strategies, and RI simply reinforces changes in MNE strategies in response to liberalisation, rather than counteracting them. Our reading of the secondary evidence on RI is broadly in line with the findings of Blomstrom and Kokko (1997), who concluded that the greater the liberalisation associated with RI, and the stronger the location advantages, the more likely it is that RI will lead to increased FDI inflows.

The sudden change from import-substituting to multilateral liberalisation has taken most countries by surprise (Mortimore 2000). They need to respond to globalisation, but this requires time and new institutions that are responsive to multilateral issues and an interdependent world. However, institution building is a slow and gradual process. This is where RI provides long-term benefits, because it potentially allows countries to gradually respond to globalisation in a controlled – and stepwise- manner. Adjusting institutions and improving intra-regional efficiencies with a small group of similar countries should logically be easier to respond to immediately than to the entire membership of the WTO. RI should be regarded as a stepping-stone to globalisation. To elucidate, RI offers developing countries a window of opportunity to dampen the shock of entry into a fully multilateral and globalising world, by 'practising' on a smaller version. Mexico is illustrative of the slow and gradual process of structural adjustment. Mexico has undertaken increasing RI within NAFTA while also deepening its integration with other partners such as the EU. This is acknowledged as part of a broader integration into the world economy (ECLAC 2000). The danger of course, is that RI schemes can act as an excuse to return to a pre-liberalisation world of excessive protection.

Additionally, development policies need to integrate a more sophisticated view of FDI. As Mortimore (2000) illustrates well, although Latin American countries have succeeded in attracting a large quantity of FDI, it has thus far ignored the issue of quality of FDI. Additionally, Mortimore points out that there is a failure to fully integrate and coordinate domestic capacity improvement goals with FDI policies.

RI can be seen to be a useful policy tool in promoting competitiveness if exploited carefully, and within an integrated development policy agenda. Although RI per se may not have any great benefit for Group I countries in terms of quality of FDI, or in terms of direct spillovers to their domestic sectors, there are other reasons to participate. First, RI does increase FDI flow (albeit of limited quality) and help the least developed countries escape the vicious cycle of poverty. Increased resource-seeking investment and market seeking investment is better than no investment at all. Second, it does allow them to prepare for greater liberalisation, allowing for a gradual widening and deepening of cross-border interdependence. The reasons that countries do not enjoy greater welfare benefits from RI are the same as those that limit the benefits from liberalisation in general: Firstly, the lack of a threshold level of domestic capabilities (Borzenstein et al 1998), secondly, the lack of long term political stability (Freeman and Lindauer 1999) and thirdly, the absence of efficient institutions, both domestic and multilateral. Participation in an RI scheme creates an imperative to improve at least some of these and in many cases acts as a catalyst to escape structural inertia and lock-in (Hannan and Freeman 1984). Fourthly, like liberalisation, the costs of non-participation in a genuinely integrated RI scheme are high, particularly when most other countries are doing so.

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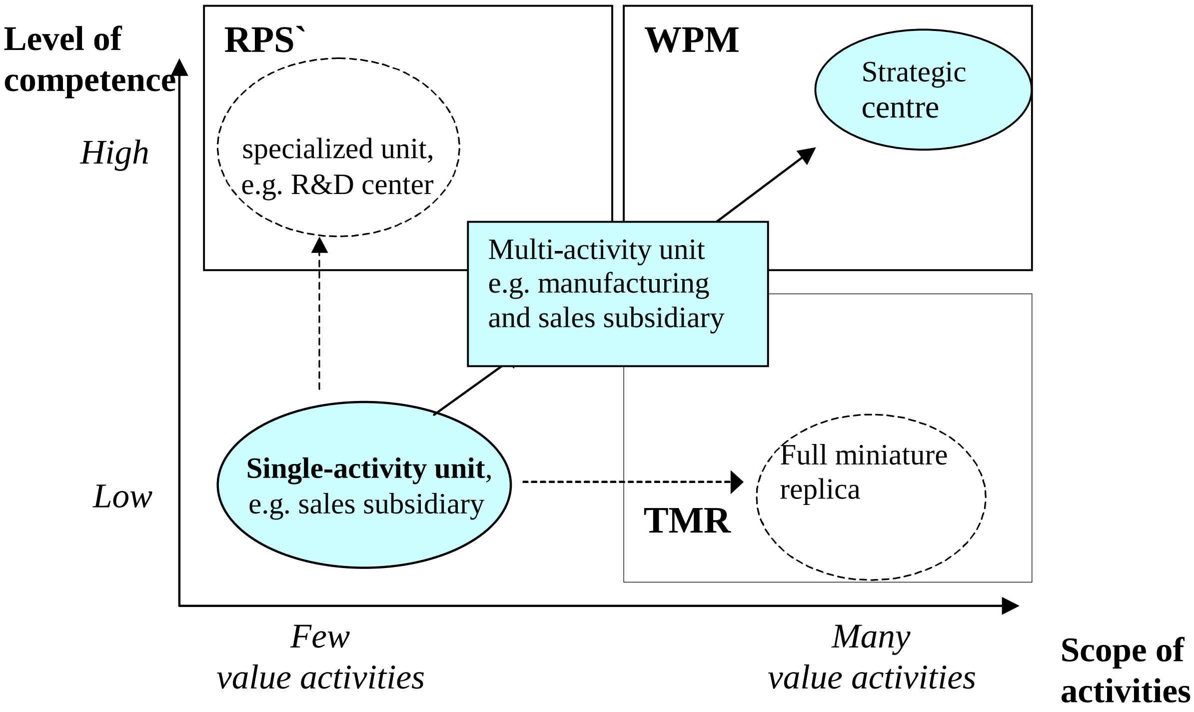


Source: based on Benito et al (2001)

Figure 1: Typology of MNE Subsidaries

| | | | |
|---|---|---|---|
| **Group III** | Group I-III integration (e.g., Costa Rica-Canada FTA) | Group II-Group III RI (Mexico in NAFTA, Spain, Portugal and Greece in the EU,) | Intra Group III RI (e.g., EFTA, Canada-US FTA) |
| **Group II** | Group I-Group II RI (Uruguay and Paraguay in Mercosur) | Intra-Group II RI (e.g., Brazil and Argentina in Mercosur) | |
| **Group I** | Intra-Group I RI (e.g., Andean community, Caricom, CACM) | | |
| | **Group I** | **Group II** | **Group III** |

<u>Figure 2: Different combinations of regional integrations</u>

[i] Much of the state-owned assets acquired by MNEs are in services and infrastructure.  It needs to be acknowledged that such investments have an important welfare effect.

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