INTERNATIONAL LABOUR OFFICE

Governing Body

GB.291/ESP/2
291st Session

Geneva, November 2004

Committee on Employment and Social Policy **ESP**

SECOND ITEM ON THE AGENDA

Trade, foreign investment and productive employment in developing countries

1. International trade and foreign investment have important effects on employment and labour conditions in developing countries. [1] An adequate understanding of these effects is of critical importance in formulating effective national employment strategies in developing countries in today's globalizing world, as well as in identifying feasible policies at the international level that could facilitate employment promotion. At its March 2004 session, in discussing the Global Employment Agenda (GEA), the Committee requested the Office to prepare a paper reporting on the current state of knowledge on the effects of trade and foreign investment on employment in developing countries. This paper responds to that request. [2]

Introduction

2. Since the mid-1980s, virtually all developing countries have substantially liberalized their trade and foreign investment regimes. The result has been rapid growth of cross-border flows of goods, services and capital. The effects of these developments on employment and labour standards, however, have been the subject of widespread controversy. Many observers and analysts believe they have been positive on balance. But, many critics of globalization have alleged that the growth of trade and capital flows has led to increased exploitation of workers in developing countries and a competitive dilution of labour standards globally.

3. The controversies have had the positive effect of inspiring investigative work, at the ILO as well as in other international organizations and the academic world. Although this work has not as yet resolved all relevant issues, it has substantially improved our knowledge of the employment and labour market effects of increased trade and foreign investment in

[1] See GB.286/ESP/1(Rev.). The point is also highlighted in: *A fair globalization: Creating opportunities for all,* Report of the World Commission on the Social Dimension of Globalization (Geneva, ILO, 2004); and in: *A fair globalization: The role of the ILO,* Report of the Director-General on the World Commission on the Social Dimension of Globalization to the International Labour Conference, 2004 (Geneva, ILO, 2004).

[2] Some of the issues discussed in this paper were also discussed in: GB.282/WP/SDG/2; GB.283/WP/SDG/1; GB.285/WP/SDG/2; and GB.286/ESP/3.

developing countries. In what follows, this paper attempts to provide a summary view of the current state of knowledge and of unresolved issues and policy implications.

Trade and foreign investment: The main developments

4. For most developing countries, the process of trade liberalization began in the mid-1980s, though a few had already started implementing liberalization policies in the early 1980s. The reforms involved replacement of non-tariff barriers by tariffs and progressive reduction of tariff rates. However, the pre-reform levels of protection were different for different countries; and though all countries have implemented liberalization policies, the degree of openness still varies substantially across countries. Broadly speaking, the pre-liberalization level of protection was significantly higher in South Asia than in other developing regions. Today, South Asia still remains the least open of the developing regions; the most open developing economies are in Latin America-Caribbean and East Asia. [3] It remains true, nevertheless, that all developing countries are much more open to trade and foreign investment today than they were in the early 1980s.

5. There were several factors that prompted widespread trade liberalization. First, the weaknesses and limitations of import substitution strategies of industrialization, pursued by a majority of the developing countries in the 1960s and the 1970s, had become manifest by the early 1980s. In sharp contrast with these experiences stood the remarkable economic and social transformation of the East Asian countries, which had pursued export-oriented strategies of industrialization. As these contrasting historical experiences became increasingly well recognized, a generally favourable climate for liberalization emerged. Second, the debt crisis faced by many developing countries in the early 1980s led to adoption of stabilization and structural adjustment programmes, under the supervision of the IMF and the World Bank, and these often incorporated programmes of liberalization of trade and foreign investment regimes. Third, the disintegration of the Soviet Union and the economic collapse of the centrally planned economies by the end of the 1980s seemed to bring into focus the perils of autarkic economic policies. Finally, important changes in the multilateral trading system were ushered in by the successful conclusion of the Uruguay Round of the GATT negotiations and the establishment of the WTO in 1994.

6. The widespread trade liberalization itself generated a momentum for liberalization of foreign investment regimes; many developing countries followed up liberalization of their trade regimes with relaxation of controls, in varying degrees, over foreign investment. Of particular significance have been the efforts made by the developing countries to attract foreign direct investment (FDI). In addition to relaxing restrictions on FDI inflows, many developing countries offered special incentives to foreign investors in the form of tax concessions, subsidies, special infrastructure facilities, etc. [4]

7. There were several reasons for the change in attitude towards FDI. First, official flows – aid and loans from bilateral and multilateral sources – was growing very slowly through the 1980s and ceased to grow altogether from the beginning of the 1990s. Moreover,

[3] Details are available in: *A fair globalization: Creating opportunities for all,* op. cit.; World Bank, *Globalization, Growth and Poverty: Building an Inclusive World Economy* (Washington, DC, World Bank, and Oxford, Oxford University Press, 2001); Oxfam, *Rigged Rules and Double Standards: Trade, globalisation and the fight against poverty* (London, Oxfam, 2002).

[4] UNCTAD, *World Investment Report, 1999,* Geneva and New York, United Nations, 1999; and G.H. Hanson, "Should countries promote foreign direct investment?", G-24 Discussion Paper No. 9, United Nations, 2002.

official flows were increasingly used to manage debt crises in the 1980s and economic crises in the 1990s. [5] Consequently, these flows became increasingly inadequate to meet the external financing requirements of developing countries, prompting them to search for investment finance from private sources in developed countries. Second, the abandonment of the Bretton Woods system of "restricted capital flows and fixed exchange rates" by the advanced industrial countries and its replacement by "free capital flows and flexible exchange rates" in the 1970s led to rapid growth of cross-border flows of private capital in the 1980s. Third, in the wake of the debt crisis, foreign investment came to be viewed as a less risky and more beneficial source of finance for developing countries than foreign borrowing. Finally, of the two forms of foreign investment, private portfolio investment (purchase of foreign bonds and equities), seeking to capitalize on short-term interest rate differentials and exchange rate fluctuations, proved to be highly volatile, and this volatility is now widely acknowledged to have been a major cause of the frequent financial crises of the 1990s. [6] In comparison, flows of foreign direct investment (FDI) showed much greater stability and hence came to be regarded as a much more appropriate form of external finance for developing countries.

8. Liberalization of trade and foreign investment regimes was also greatly encouraged and facilitated by the recent advances in transport and communication technology. These made global production systems – splitting of production of a single product into multiple stages and processes and their location in different countries – both feasible and profitable, creating new possibilities of intra-firm trade. Even outsourcing of many services, traditionally non-traded, became feasible, generating strong incentives for trade in services. The new information technology also facilitated cross-border flows of capital by vastly improving flows of information on markets and by making financial transactions speedy and low-cost.

Trade: The main trends

9. Particularly since 1990, cross-border trade in goods and services has shown rapid growth. The share of trade in world GDP increased from 38 per cent in 1990 to 50 per cent in 2000. It has declined somewhat since then but still remains around 47 per cent. This growth was associated with important changes in the commodity composition and in the nature of trade between developed and developing countries. [7] While the share of merchandise trade in total trade in goods and services remained quite stable, the share of manufactures in total merchandise trade increased steadily. By the end of the 1990s, global trade in manufactures accounted for 80 per cent of global merchandise trade and 64 per cent of global trade in goods and services. In parallel, the share of developing countries in global trade in manufactures rose, from only 12 per cent in the early 1980s to 26 per cent by the end of the 1990s. This reflected the fact that the share of manufactures in developing countries' exports to developed countries was steadily rising. An important change in the long-established international division of labour, in which developed countries exported manufactures and developing countries exported primary commodities, has clearly been under way. Indeed, the most significant effect of the widespread trade liberalization has been the growth of two-way trade in manufactures between developed and developing countries.

[5] A.K. Ghose, "Capital inflows and investment in developing countries", Employment Strategy Papers 2004/11 (Geneva, ILO, 2004).

[6] E. Prasad, K. Rogoff, S.-J. Wei and M.A. Kose, *Effects of financial globalization on developing countries* (Washington, DC, IMF, 2003).

[7] A.K. Ghose, *Jobs and incomes in a globalizing world* (Geneva, ILO, 2003).

10. However, this broad picture conceals an uncomfortable fact: while a small number of large (populous) developing countries have indeed emerged as important exporters of manufactures to developed countries, a large majority of the developing countries have remained overwhelmingly dependent on exports of primary commodities. Analysis shows that, at most, only 23 developing countries were able to shift their export base from primary commodities to manufactures. [8] Analysis also shows that these were the countries that achieved significant export growth. For the other developing countries, exports either stagnated or declined.

11. The overall effect of trade liberalization has thus been a polarization of developing countries into two groups: one group comprising a small number of large countries (accounting for 78 per cent of the population of the developing world) that has derived some benefits from trade liberalization, and the other group comprising a large number of mostly small countries that has been adversely affected by trade liberalization. The second group of countries now accounts for only 1 per cent of the world's manufactured exports and less than 3 per cent of the world's merchandise exports. The countries of this group (accounting for 18 per cent of world population) have thus become "marginalized" in the context of the global economy.

12. An important point is that though most of the poorest countries of the world (the least developed countries as defined by the United Nations) are "marginalized", not all of the marginalized countries are poor. Virtually all the petroleum-exporting countries, for example, are "marginalized" (in the sense indicated above) but are not poor. The common characteristic shared by all the "marginalized" countries is overwhelming dependence on exports of primary commodities. This suggests two main reasons for their "marginalized" status. First, international prices of many primary commodities have shown a good deal of short-run volatility and a long-term tendency to decline; the declining trend was particularly sharp in the 1990s. [9] Second, trade in agricultural products has not in fact been liberalized. [10] This is likely to have restrained the growth of global demand for these commodities and also blocked opportunities for increasing exports for some of the "marginalized" countries.

13. A critical insight that emerges from the contrasting experiences of the two groups of developing countries is that prior accumulated "manufacturing experience" has been of much importance in deriving benefits from trade liberalization. The countries that have now emerged as important exporters of manufactures had developed considerable manufacturing capacity under protectionist regimes prior to trade liberalization. The "marginalized" countries, on the other hand, had not developed such capacity [11] and were unable to shift their export base away from primary commodities even when the global demand for these commodities stagnated and prices were falling. Indeed, countries often responded to falling prices by increasing the volume of exports, thereby generating a vicious circle; in global markets, falling prices of primary commodities were associated, perversely, with growing supplies.

[8] ibid.

[9] World Bank, *Global Economic Prospects, 2004* (Appendix 2) (Washington, DC, World Bank, 2004).

[10] ibid. (Ch. 3); *A fair globalization: Creating opportunities for all,* op. cit.; *Rigged Rules and Double Standards,* op. cit.

[11] Lack of manufacturing capability, it should be noted, generally implies a lack of adequate development of infrastructure – physical (transport and communication facilities, electricity supply, etc.) and social (education facilities, legal framework, labour market and financial institutions, etc.).

FDI: The main trends

14. At the global level, accelerated growth of FDI flows commenced in the mid-1980s, but truly explosive growth occurred in the 1990s. Annual FDI inflows, for example, increased from US$44 billion in 1985 to US$202 billion in 1990, and then to US$1,500 billion in 2000. By the end of the 1990s, the flows accounted for 5 per cent of world GDP and 22 per cent of world investment. After 2000, annual FDI inflows declined rather abruptly and amounted to US$631 billion in 2002.

15. Throughout the period since 1985, developed countries were the recipients of the bulk of the global FDI inflows. The share of developing countries fluctuated around 25 per cent. The period 1990-97 was somewhat exceptional, however. This period witnessed a steady rise in developing countries' share in global FDI inflows, which reached nearly 40 per cent by 1997. These inflows financed only 3 per cent of investment in developing countries in 1990 but around 12 per cent in 1997. After 1997, in the wake of the East Asian economic crisis, there was a sharp reversal of the trends.

16. Another important fact is that, within the developing world, FDI inflows have consistently been highly concentrated in a small number of countries. Significantly, moreover, the developing countries that have accounted for the bulk of the FDI inflows are those that have emerged as important exporters of manufactures to developed countries, suggesting a strong linkage between trade and FDI flows. [12] Throughout the 1990s, the "marginalized" developing countries received only around 8 per cent of global FDI inflows and around 23 per cent of FDI inflows to developing countries, and the least developed countries received less than 1 per cent. [13]

17. These facts are rather obviously inconsistent with a basic presumption of standard economic theory. According to this, capital is expected to flow from more developed to less developed countries. The reason is that the former have high levels of domestic saving but few opportunities for profitable investment while the latter have low levels of domestic saving but plenty of opportunities for profitable investment. Though this argument sounds plausible, what we observe in reality is something quite different: FDI flows indeed originate almost exclusively in the developed countries, but their destination also seems to be largely the developed countries.

18. However, the facts presented above relate to FDI inflows alone. And the facts change when we consider what might be called *net* FDI inflows, i.e., the difference between FDI inflows and FDI outflows, which is a true measure of flows of resources for investment. [14] These data show that investment flows have indeed been from developed to developing countries, as predicted by theory; throughout the period 1985-97, the OECD countries showed net outflows while the developing countries showed net inflows. [15] Two facts nevertheless remain. First, net FDI inflows to developing countries, which had remained stable at a low level during 1985-90, showed very rapid growth during 1990-97. Second, the bulk of the net FDI inflows went to those developing countries that were emerging as exporters of manufactures to developed countries.

[12] Ghose, 2003, op. cit.

[13] Ghose, 2004, op. cit.

[14] ibid.

[15] These patterns continued till 1999. Then there was a sudden change: both net outflows from developed countries and net inflows to developing countries fell to virtually zero in the subsequent years.

Trade and productive employment in developing countries

What does economic theory suggest?

19. Standard trade theory, built on the idea of comparative advantage, suggests that increased trade should have a favourable impact on employment in developing countries through two channels. First, it should increase the rate of economic growth by increasing specialization in production, by expanding markets (thereby generating benefits of scale economies) and by improving access to technology. Second, it should promote more intensive utilization of the relatively abundant factor of production, which, in the case of developing countries, is low-skilled labour. Overall, therefore, increased trade should increase the overall rate of employment growth and shift the pattern of labour demand in favour of low-skilled labour. It follows from this that increased trade should also reduce wage inequality, which tends to be high in developing countries.

20. However, these predictions are based on several unrealistic assumptions that cast doubt on their general validity. [16] In particular, standard trade theory assumes, implausibly, full employment and wage determination through demand-supply equilibrium in the labour market. In a typical developing country, there is substantial underemployment of low-skilled labour. The labour market also has a dualistic character, with a small formal economy, where government regulations and collective bargaining institutions determine wages, and a large informal economy, where wages tend to be based on some kind of social norm. The bulk of the high-skilled labour is employed in the formal economy while the bulk of the low-skilled labour is in the informal economy. When these factors are taken into account, the basic prediction – that increased trade should increase the rate of employment growth, particularly for low-skilled labour – still remains valid; but declining wage inequality can no longer be predicted.

21. Another important point is that standard trade theory assumes all traded goods to be producible in all trading countries. This means that its predictions are relevant only in the case of trade in manufactures, which, in principle, can be produced anywhere. It cannot be used to predict employment outcomes in cases where manufactures are exchanged for primary commodities. Production of many primary commodities requires natural resources that are not available to all countries. Exports and prices of primary commodities essentially depend on conditions of global demand alone. Increased trade still has the effect of stimulating growth (because increased earnings from trade can finance increased investment) and hence has a favourable impact on employment. But the wage effect depends essentially on movements in international prices of primary commodities; rising/falling prices result in rising/falling wages.

Empirical evidence

22. There is a fair amount of empirical evidence to show that trade growth has had a stimulating effect on GDP growth in developing countries (and trade decline tended to reduce GDP growth). [17] Since trade liberalization has generally been associated with stagnation or decline of exports in the case of "marginalized" developing countries, it

[16] Ghose, 2003, op. cit.

[17] For a review of the relevant literature and some fresh results, see A.K. Ghose, "Global economic inequality and international trade", Employment Paper 2001/12 (Geneva, ILO, 2001).

follows that trade liberalization has led to deterioration, not improvement, in employment conditions in these countries. Stagnant or declining export revenues had adverse consequences for economic growth and hence for employment growth. Moreover, inadequate economic growth, together with declining international prices of primary commodities, exerted downward pressure on wages. Unfortunately, empirical evidence and analysis of employment and wage trends in "marginalized" countries remain inadequate. Nevertheless, that such trends were unfavourable cannot be seriously doubted in view of the available evidence on poverty. The incidence of poverty showed an upward trend in many of the "marginalized" countries – located mainly in sub-Saharan Africa, Central America and the Caribbean regions. [18]

23. The manufactures-exporting developing countries – located mainly in Asia and Latin America – generally improved their trade performance, and this helped improve their growth performance. But recent ILO research shows that both growth and employment effects of trade have nevertheless been quite varied. In particular, there are rather striking differences between the emerging economies of Asia and those of Latin America. [19]

24. In the case of Asian emerging economies (such as China, India and Malaysia), employment growth in manufacturing industries accelerated both because output growth accelerated and because the composition of output changed. Export industries, which employ mostly low-skilled labour, grew faster than import-competing industries, which employ relatively more high-skilled labour. On the whole, therefore, growth of employment was faster for low-skilled labour than for high-skilled labour. So the employment effects were broadly in line with predictions of standard trade theory.

25. In the case of Latin American emerging economies (such as Brazil and Mexico), though export performance of manufacturing industries improved significantly, employment grew very slowly or even declined. Employment of low-skilled labour, moreover, tended to be more adversely affected than that of high-skilled labour. Among the proximate causes, two stand out. First, the growth of manufactured exports did not stimulate growth of manufacturing output. This suggests a stagnation or decline in domestic demand associated with the slow pace of economic growth. The slow pace of economic growth in turn resulted from the macroeconomic imbalances, including problems of external debt, carried over from the pre-liberalization period. Second, trade liberalization does not seem to have produced a clear pattern of specialization according to comparative advantage in these countries; many of their export items are relatively capital-intensive, rather than labour-intensive, products. The phenomenon has attracted some attention in the literature, but widely accepted explanations are yet to emerge. [20]

[18] M. Karshenas, "Global poverty estimates and the millennium goals: Towards a unified framework", Employment Strategy Papers 2004/5 (Geneva, ILO, 2004).

[19] Ghose, 2003, op. cit.

[20] While a variety of explanations has been offered, none has wide acceptance. See A. Wood, "Openness and wage inequality in developing countries: The Latin American challenge to East Asian conventional wisdom", in *World Bank Economic Review*, Vol. 11, No. 1, 1997; A Ravenga, *Employment and wage effects of trade liberalization: The case of Mexican manufacturing*, Working Paper 1524 (Washington DC, World Bank, 1995); R.C. Feenstra and G.H. Hanson, "Global production sharing and rising inequality: A survey of trade and wages", Working Paper 8372 (National Bureau of Economic Research, Cambridge, 2001); and A. Harrison and G.H. Hanson, "Who gains from trade reforms? Some remaining puzzles", in *Journal of Development Economics*, Vol. 51. 1999.

26. Thus the employment effect of trade liberalization has not been uniform even in the case of those developing countries that emerged as important exporters of manufactures. Irrespective of whether the employment effect was positive or negative, however, there was increased labour market turnover or churning in most cases; there were job gains and job losses and the winners and losers were not necessarily the same people.

27. Evidence suggests that the effects of trade on wages were transmitted through its effects on labour productivity. In all the emerging economies studied, real wages of both low-skilled and high-skilled labour increased. This is explained entirely by the observed increases in labour productivity and had little to do with changes in demand for different types of labour. In a majority of the cases, moreover, wage growth has been higher for high-skilled labour than for low-skilled labour so that wage inequality has increased. This too is explained by the fact that labour productivity growth was higher for high-skilled labour than for low-skilled labour. On the whole, there are good reasons to think that trade has increased wage inequality because it has served as a mechanism for international diffusion of technologies, which are widely recognized to have been skill-biased in character (use of newer technologies requires employment of higher proportion of high-skilled labour).

28. Overall, the available empirical evidence suggests that trade liberalization has been associated with deteriorating wages and conditions of work only in the case of "marginalized" developing countries. In the case of other developing countries, where trade liberalization has helped promote manufactured exports, employment trends have been varied but real wages have generally risen, suggesting improvement in labour conditions. The picture, of course, would look different if we were to focus on global changes in particular industries. For example, trade liberalization has had the effect of shifting garment production from developed to developing countries. Overall, this means that wages and labour conditions in worldwide garment production have declined. But such global trends are quite consistent with rising wages and improving labour conditions in garment production in developing countries.

29. Particular concerns have been expressed about generally low labour standards and some cases of violation of trade union rights in EPZs that have proliferated in some of the manufactures-exporting developing countries. These issues have received a great deal of attention both at the ILO and in the academic world, though information and analysis still remain inadequate. [21] The findings show that wages and working conditions in EPZs vary quite widely, and even where they are poor by some absolute standards, they are nevertheless appreciably better than those in much of the rest of the economy. Concern remains, however, that the full exercise of freedom of association is restricted by various means in several zones.

FDI and productive employment in developing countries

30. There is no well-worked-out theoretical framework for predicting employment and labour market effects of FDI inflows. But most economists believe that such inflows improve

[21] GB.286/ESP/3, op. cit.; *Wages, Benefits, Poverty Line, and Meeting Workers' Needs in the Apparel and Footwear Industries* (Washington, DC, Bureau of International Labor Affairs, US Department of Labor, 2000); T.H. Moran, *Beyond Sweatshops: Foreign Direct Investment and Globalization in Developing Countries* (Washington, DC, Brookings Institution Press, 2002); and D.K. Brown, A.V. Deardorff and R.M. Stern, "The effects of multinational production on wages and working conditions in developing countries", Working Paper 9669 (National Bureau of Economic Research, Cambridge, 2003).

employment conditions in developing countries through three main channels. First, FDI inflows are expected to increase the rate of economic growth by augmenting the overall investment rate in the recipient country. Second, FDI inflows are thought to generate significant externalities or spillover effects; such inflows tend to be associated with transfers of technology and management skills, which could conceivably induce technological change and improved management in domestic enterprises, thereby improving labour productivity. Third, jobs created by transnational corporations (TNC) affiliates – the main vehicle for FDI – are expected to be qualitatively better than those created by domestic enterprises.

31. However, empirical studies have so far failed to detect any unambiguous stimulating effect of FDI inflows on economic growth in the context of developing countries. Some studies have found that FDI inflows stimulate economic growth only in those countries where human resource development has reached a certain threshold level. [22] Other studies have suggested that the growth-augmenting effect of such inflows depends on the degree of trade openness. [23] But more recent studies show these results to be far from robust and conclude that FDI inflows do not have any consistent growth-augmenting effect. [24]

32. This conclusion appears to be confirmed by other related findings. One such finding is that the investment-augmenting effect of FDI inflows tends to be quite small. [25] The reason is that these flows tend to crowd out investment by domestic entrepreneurs (including the government) in recipient countries. The crowding out effect is fairly obvious where FDI inflows are associated with mergers and acquisitions. But the effect is present even when the inflows finance mainly “greenfield” projects. The significance of the crowding-out effect is shown by the growth of international reserves accumulated by the countries that received substantial FDI inflows. [26] The main effect of FDI inflows in recipient countries, therefore, has not been a significant rise in the overall investment rate but a rise in the share of foreign investment in total investment.

33. Several studies have also found that spillover effects of FDI inflows are generally quite insignificant; domestic firms do not seem to derive much benefit, in the form of improvements in technology and/or management, from the presence of TNC affiliates. [27]

34. What the available empirical evidence strongly suggests, on the other hand, is that the quantity and quality of employment generated through FDI are different from those of employment generated through domestic investment. [28] Compared to domestic enterprises

[22] E. Borensztein, J. de Gregorio and J.-W. Lee, “How does foreign direct investment affect economic growth?”, in *Journal of International Economics,* Vol. 45, No. 1, 1998.

[23] V.N. Balasubramanyam, M. Salisu and D. Dapsoford, “Foreign direct investment and growth in EP and IS countries”, in *Economic Journal,* Vol. 106, No. 434, 1996.

[24] M. Carkovic and R. Levine, *Does foreign direct investment accelerate economic growth?* (University of Minnesota, 2002); and Prasad et al., op. cit.

[25] Ghose, 2004, op. cit.

[26] ibid. During 1990-2000, the period when FDI inflows to developing countries showed rapid growth, most developing countries rapidly increased their international reserves. As percentage of their GDP, their international reserves increased from 7 per cent in 1990 to 15 per cent in 2000.

[27] For a review, see Hanson, op. cit.; and Prasad et al., op. cit.

[28] R.E. Lipsey, “The labour market effects of US FDI in developing countries”, Employment Strategy Papers 2004/6 (Geneva, ILO, 2004); Hanson, ibid.; and Prasad et al., ibid.

in the same industry, TNC affiliates generally employ relatively more high-skilled labour and achieve higher labour productivity. They also pay higher wages for both high-skilled and low-skilled labour, though the wage premium tends to be higher for the high-skilled. The implication is that, in producing equivalent amounts of output, a TNC affiliate generates a lower number of jobs which are, however, of a higher quality than does a domestic firm. This finding, it may be noted, is consistent with what has been reported above about conditions of employment in EPZs.

35. When viewed together, the findings from empirical research show that employment effects of FDI inflows to developing countries are rather weak and are not unambiguously positive or negative. Such inflows at best make a weak contribution to increasing the rate of investment in recipient countries. At the same time, a rising share of FDI in total investment tends to reduce the overall employment elasticity while shifting the pattern of labour demand in favour of high-skilled labour. Rising wage inequality is also a consequence. On the positive side, a rising share of FDI in total investment leads to an improvement in the average quality of employment for both high-skilled and low-skilled labour.

36. These conclusions, of course, are tentative in nature and would need to be confirmed through more investigative work. Moreover, the conclusions should not be interpreted to mean that FDI inflows are not of much use to developing countries. The right interpretation is that FDI inflows can only complement, not substitute for, efforts to mobilize saving and investment domestically. Such inflows can help promote manufactured exports and improve labour productivity, but these gains are substantive and meaningful only in the case of those developing countries that have already achieved considerable "manufacturing experience" through their own efforts.

37. A final point is that empirical research does not show FDI inflows to be particularly sensitive to the degree of capital account liberalization of countries. [29] Indeed, the evidence suggests that FDI inflows depend less on policies in developing countries than on policies in developed countries and on global business plans of TNCs. [30] In other words, from an individual developing country's point of view, FDI inflows are exogenous to a very substantial extent. [31] It is doubtful, therefore, if developing countries' efforts to "attract" FDI inflows by offering special incentives are worthwhile, particularly since these could be discriminatory toward domestic enterprises and could also generate unhealthy competition.

Overview and issues for future work of the ILO

38. Even in a globalizing world, promotion of productive employment in developing countries remains the responsibility of national governments. This is not just because cross-border movement of people still remains severely restricted. Around 85 per cent of the world's

[29] Prasad et al., ibid.

[30] "Investment climate" in developing countries, of course, is an important determination of FDI inflows. But "investment climate" depends on parameters (e.g. level of human resource development, quality of financial and labour market institutions, quality of physical infrastructure, etc.) that can be altered only in the medium/long term. There are also factors such as geographical location and population size that are important determinants of FDI inflows, but these are not alterable through policies. Overall, the evidence suggests that policies that can be changed in the short run (those relating to interest rates or exchange rates, for example) do not have significant influence on FDI inflows.

[31] Ghose, 2004, op. cit.

workers are in developing countries, which will also account for nearly 100 per cent of its incremental workforce. Even with freer cross-border movement of people, therefore, employment promotion will remain primarily a national responsibility. This being the context, the international community needs to ensure that national governments in developing countries have the possibility of using trade and FDI as instruments of employment promotion just as national governments in developing countries have to acquire the ability to use these instruments in an effective manner.

39. Results of research essentially show that both trade liberalization and FDI inflows hold potential as instruments of employment promotion, but that realization of this potential is contingent on structural factors and complementary policies at both national and international levels. The following points in particular are worth highlighting:

- The least developed countries are not in a position to derive benefits from trade liberalization and FDI flows without substantial assistance from the international community. Liberalization of trade in agricultural products – currently being negotiated under the Doha Round – will help. Of much greater importance will be international measures for stabilization of prices of primary commodities, special market access programmes (e.g., "everything but arms" programme of the EU), and financial assistance for building of physical and social infrastructure (necessary for acquiring "manufacturing capability").

- Liberalization of trade in agricultural products under the Doha Round will also be of much importance for a number of middle-income developing countries that have so far benefited little from trade liberalization because of stagnant global demand for, and declining prices of, agricultural exports.

- Manufactures-exporting developing countries are in a position to derive benefits from trade liberalization and FDI inflows provided that they view these as components of well-defined development strategies. Past experience shows that trade liberalization does not contribute to employment growth when macroeconomic circumstances are not conducive to economic growth and/or when export expansion does not involve increased use of low-skilled labour. Past experience also shows that FDI inflows can be helpful only when they are combined with adequate efforts to mobilize domestic saving and investment.

- International rules for trade and capital flows, therefore, must leave sufficient room for developing countries to design their own liberalization programmes. This point is well recognized. The Uruguay Round trade agreements incorporated what are called Special and Differential Treatment (SDT) provisions for countries at low levels of development. But, as the report of the World Commission points out, more needs to be done. As for liberalization of the capital account, an extremely cautious approach is required, particularly since such liberalization is neither necessary nor sufficient for "attracting" FDI inflows. Developing countries also need to carefully examine the usefulness of offering special incentives to international investors.

- Empirical evidence suggests that employment in EPZs is often more remunerative than employment in many other parts of the economies concerned. Nevertheless, there clearly is scope for improvement in labour standards, particularly in the area of industrial relations.

- Trade liberalization, irrespective of its employment effects, generates adjustment costs by increasing labour market turnover. Developing countries, therefore, need to put in place labour market policies and institutions for providing adjustment assistance to those workers who are adversely affected. The need for such policies and institutions will be particularly strongly felt in the wake of the impending expiry

of the Agreement on Textiles and Clothing (ATC) at the beginning of 2005, when many developing countries are expected to face significant adjustment costs.

40. These observations suggest a large policy agenda, only some elements of which fall directly within the ILO's mandated areas of work. In other areas, which are vitally important for promotion of productive employment in developing countries, multilateral agencies other than the ILO have the lead role; the Bretton Woods institutions and the WTO have particularly important roles to play. But even in these areas, the ILO has a useful role to play through advocacy, based on its own research findings and information, as well as active promotion of inter-agency dialogue and collaboration. This approach is outlined in the Director-General's Report [32] to the International Labour Conference of 2004, and the ILO is currently engaged in efforts to strengthen its advocacy and to promote inter-agency dialogue with a focus on "enhancing the employment effects of globalization".

41. The ILO is also seeking to incorporate the research results in its advisory work at the country level. Through a number of existing programmes, it is seeking to assist governments and social partners in developing countries in assessing employment effects of actual or planned programmes of liberalization of trade and foreign investment regimes, in designing labour market policies and institutions necessary both for providing adjustment assistance to workers and for improving "investment climate", and in efforts to promote workers' rights in EPZs.

42. The Committee is invited to give guidance to the Office on future action in this field, taking into account the need –

- to continue to strengthen its own research and information gathering work on the employment outcomes of trade and foreign investment so as to strengthen its advocacy at the global level and its advisory work at the country level;
- to continue its efforts to promote dialogue and collaboration with other relevant multilateral institutions; and
- to strengthen its capacity to advise governments and social partners in developing countries on policies required to derive employment benefits from trade and FDI.

Geneva, 23 September 2004.

Submitted for discussion.

[32] *A fair globalization: The role of the ILO*, op. cit.