CHAPTER II

REGIONAL TRENDS

A. Developed countries

Developed countries invested $295 billion abroad and received $208 billion of FDI inflows in 1996. They accounted for 60 per cent of global inflows and 85 per cent of global outflows in that year, shares that have been declining slowly but steadily in the 1990s (annex tables B.1 and 2). Among the developed countries, the United Kingdom regained the second highest position in terms of both FDI inflows and outflows after the United States in 1996 (figures II.1 and II.2). Measured in terms of gross domestic product and gross (domestic) fixed capital formation, the economic contribution of inward FDI was highest in Belgium-Luxembourg, Ireland, the Netherlands, New Zealand and Sweden. On the same basis, the importance of outward FDI was highest in the Netherlands, Sweden, Switzerland and the United Kingdom (figures II.3 and II.4). On the other hand, inward FDI in Germany, Italy and Japan appears low in relation to the size and growth of their markets, though international comparisons of FDI flows are fraught with problems because of differences between the figures reported by host and home countries (box II.1).

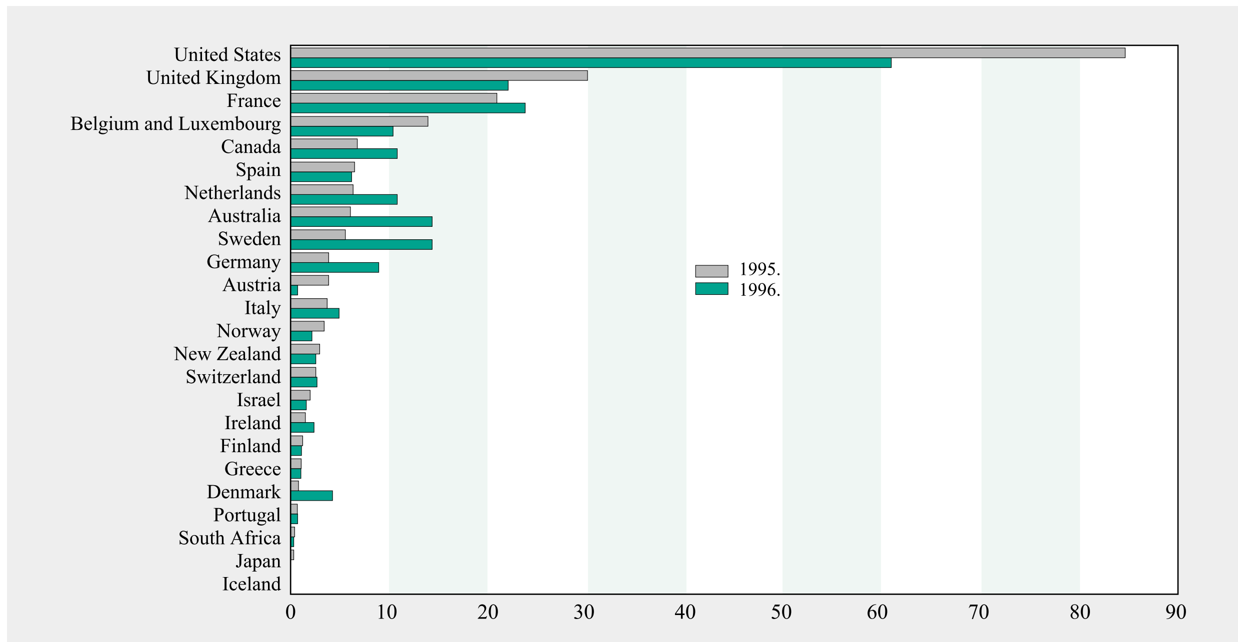
The Triad (European Union, Japan and the United States) accounted for around 90 per cent of both inflows and outflows of developed countries in 1996 (annex tables B.1 and 2). In recent years, however, developing countries have become more important, both as FDI recipients from, and investors in, the Triad (figure II.5). Outside the Triad, Australia (discussed below), Canada and Switzerland have also emerged as significant outward investors, as well as FDI recipients (figure II.2).

1. United States

In 1996, the United States was again the largest host and home country of FDI, receiving $42 billion more than the second largest host country (China) and investing abroad $31 billion more than the second largest home country (United Kingdom). United States investment inflows and outflows both reached about $85 billion (table II.1). Inflows increased by 39 per cent. Although outflows

Figure II.1. FDI flows into developed countries, 1995 and 1996

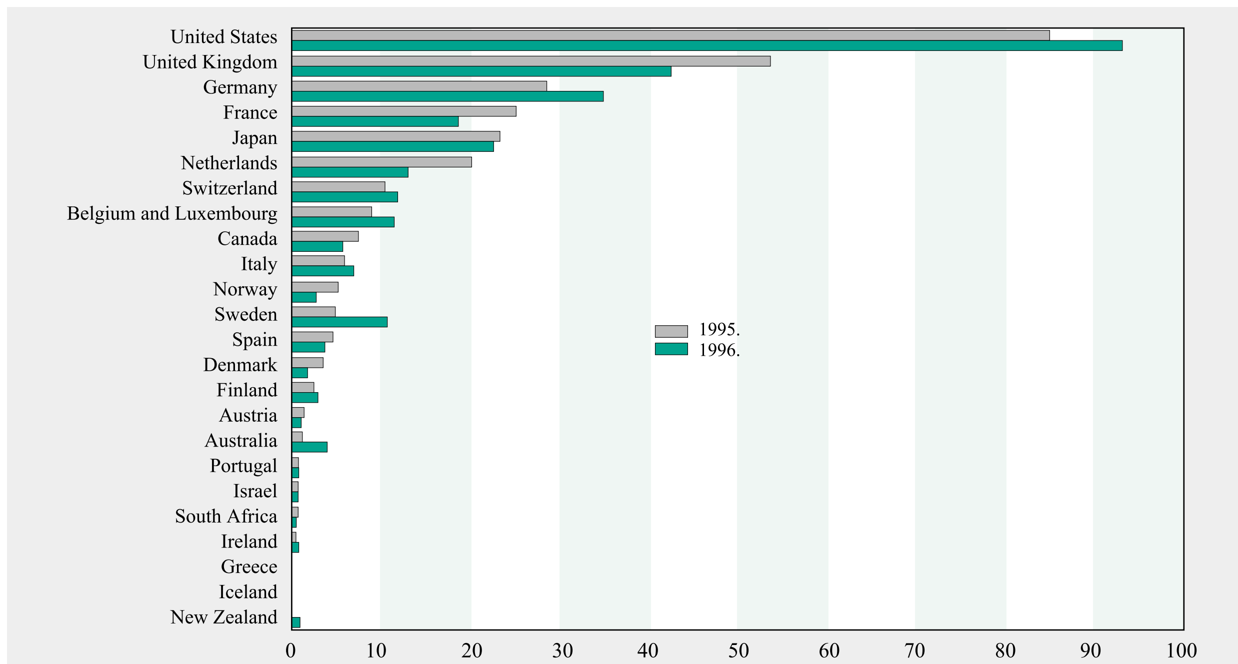
(Billions of dollars)



Source: UNCTAD, FDI/TNC database and annex table B.1.

Figure II.2. FDI outflows from developed countries, 1995 and 1996

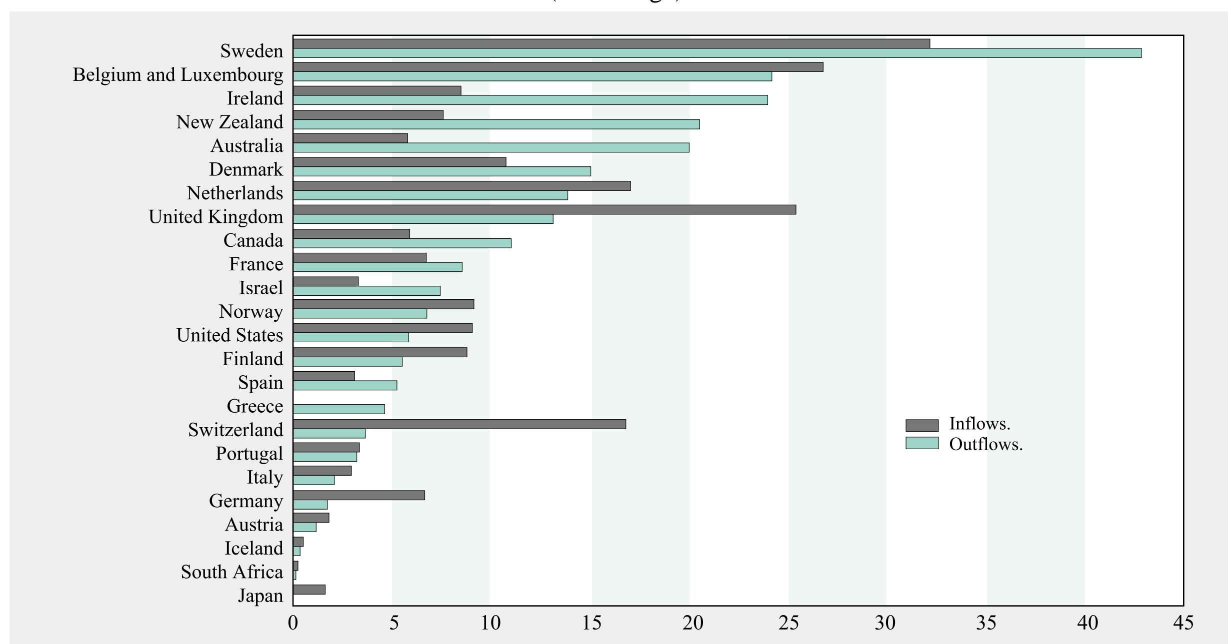
(Billions of dollars)



Source: UNCTAD, FDI/TNC database and annex table B.2.

Figure II.3. FDI inflows as a percentage of gross fixed capital formation in developed countries, 1995

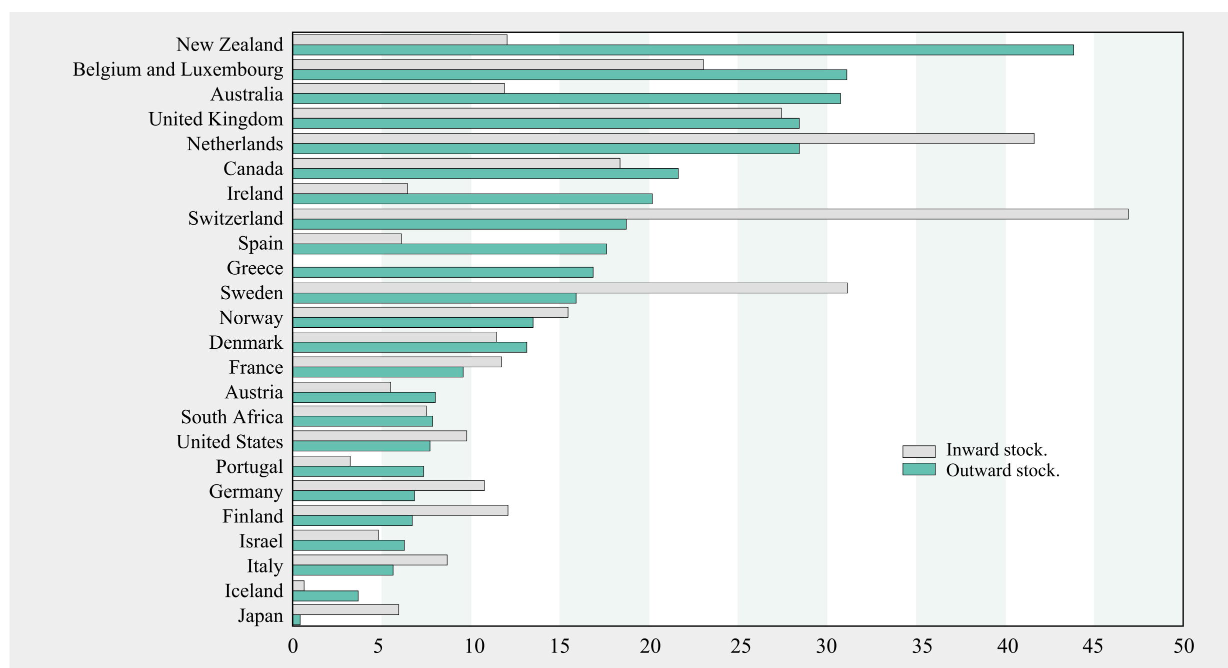
(Percentage)



Source: UNCTAD, FDI/TNC database and annex table B.5.

Figure II.4. FDI stock as a percentage of GDP in developed countries, 1995

(Percentage)



Source: UNCTAD, FDI/TNC database and annex table B.6.

Box II.1. Why do FDI flows reported by host and home countries differ?

According to a recent study by the German Bundesbank (Jost, 1997), 18 OECD countries reported FDI outflows to Germany between 1984 and 1994 three times higher than inflows reported in the balance-of-payments data of Germany ($80 billion and $21 billion, respectively). One reason for this discrepancy is different thresholds in the definition of FDI. In the German balance-of-payments data, this threshold is set at 20 per cent of the equity capital of the affiliate (before 1989, it was 25 per cent). In contrast, many other investing countries use a threshold of 10 per cent, in accordance with OECD and IMF guidelines (OECD, 1995; IMF, 1993). The higher participation threshold in Germany, however, only explains a minor part of the difference between investors and German FDI data. More important is the treatment of short-term financial operations of foreign affiliates, which until recently were not included under direct investment in Germany's statistics. Diverging valuation principles, particularly as concerns reinvested earnings, is another source of discrepancy. Some countries include unrealized book profits (i.e., valuation gains arising from changes in exchange rates), whereas others do not. The resulting difference can be considerable: the discrepancy between the lower German figures and those reported by the United States was over DM25 billion in 1984-1994 (Jost, 1997).

Italy also applies a 20 per cent threshold, whereas Japan has no definitive minimum threshold. Other reasons for discrepancies in FDI flows reported by host and home countries include differences in the treatment of unremitted branch profits, treatment of unrealized and realized capital gains and losses, methods of data collection and reporting on FDI, and treatment of real estate, construction and indirect investment by the affiliates abroad (UNCTC, 1992b, p. 15).

declined, their level was significantly above the annual average during 1991-1994 ($50 billion). European Union countries accounted for almost 68 per cent of United States inflows in 1996, slightly lower than the previous year, but their share of outflows declined more sharply (table II.1). Nonetheless, the European Union received more than two-fifths of United States FDI outflows in 1996, more than any other region in the developed world. Japan's share of United States inflows doubled in 1996, but was still far below its annual average share of one-third of these inflows during 1988-1991, the period of the Japanese investment boom in the United States. The share of developing countries in United States FDI outflows increased to 29 per cent in 1996 (table II.1), less than in the early 1990s.

Table II.1. United States: FDI inflows and outflows,[a] 1995 and 1996

(Billions of dollars and percentage)

	Inflows		Outflows	
Region/country	1995	1996[b]	1995	1996[b]
Total (Billions of dollars)	60.8	84.6	93.3	85.4
Of which (per cent):				
Developed countries	102.0[c]	99.9	72.4	66.5
Canada	7.4	8.5	8.3	9.4
European Union	71.6	67.6	49.6	43.0
Japan	8.6	16.2	1.7	3.9
Developing countries	-1.9[c]	0.1	27.4	29.1
Africa	-	-0.5	0.7	1.0
Latin America	-3.6[c]	0.2	15.7	19.7
South, East and South-East Asia	2.3	-0.5	8.8	7.5
West Asia	-0.5	1.0	1.1	0.7
Central and Eastern Europe	-	-	1.4	1.9

Source: UNCTAD, based on data provided by the United States Department of Commerce.

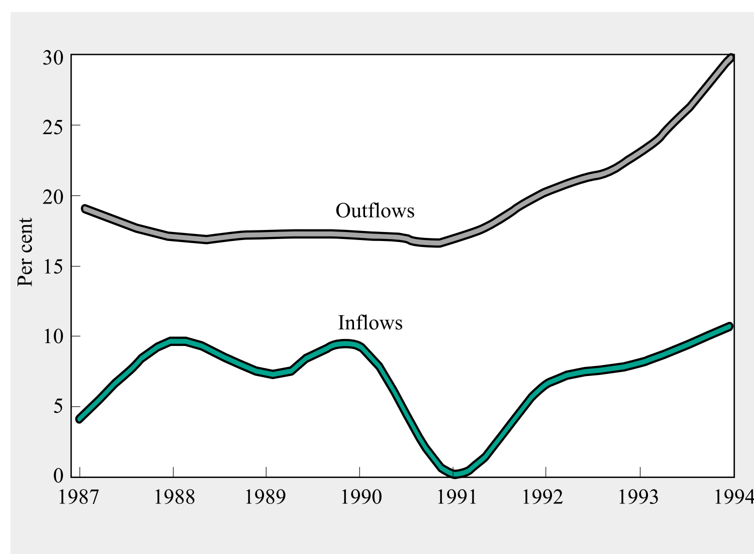
[a] Data for outflows are somewhat different from those in annex table 2 as FDI in the Netherlands Antilles is not adjusted in this table.

[b] Preliminary.

[c] Negative FDI flows from developing countries, in particular from tax haven economies in Latin America and the Caribbean.

Sustained economic growth in many countries was a major cause of high United States FDI outflows. Favourable growth prospects and large and growing consumer markets in developing countries encouraged increased interest from United States TNCs.[1] By contrast, the European Union's still sluggish economic growth in 1996 and, perhaps more importantly, the end of a major phase of adjustment by United States TNCs to regional integration in Europe, caused the European Union's share of United States FDI outflows to fall. That share declined to 43 per cent in 1996, from 50 per cent in 1995, a year when United States TNCs engaged in a number of very large mergers and acquisitions in Europe.

Figure II.5. Share of developing countries in the total FDI outflows from, and FDI flows into, the Triad, 1987-1994
(Percentage)



Source: UNCTAD, FDI/TNC database, and OECD, 1996b.

Investment inflows were stimulated by the continued strength of the United States economy and its favourable impact on profitability. In 1995, some four-fifths of new investment outlays in the United States were for acquisitions, rather than establishment of new affiliates (Fahim-Nader and Zeile, 1996). Although the dollar appreciated against the yen and some European currencies in 1996, the cost of acquiring United States-based firms in foreign-currency terms remained relatively low in 1996. The dollar-ECU exchange rate in 1996, for example, was only 8 per cent higher in 1996 than during 1993-1994.

Equity inflows accounted for nearly two-thirds of United States FDI inflows in 1995 (United States, Department of Commerce, 1996c). Reinvested earnings increased as well (by some $5 billion, to almost $14 billion in 1995). The figures for total inflows, however, conceal significant differences in approaches to investing in the United States (annex table A.8). European investors rely more on intra-company loans for financing their investments in the United States. Declining interest rates in several European countries, as well as Japan, encouraged this mode of financing. The share of FDI flows from Europe into the United States accounted for by equity inflows was well below those of other major home countries (annex table A.8). United States FDI inflows from Canada had the highest share of reinvested earnings during 1994-1995, whereas reinvested earnings by Japanese affiliates in the United States during the same period were negative.

More than a half of United States FDI outflows was financed by reinvested earnings during 1994-1995 (annex table A.8), a share that has increased in recent years. This is partly because the profitability of operations in the United States has reduced the need for foreign affiliates to remit earnings back to their parent firms and partly because foreign affiliates are using these earnings to expand their own operations abroad.

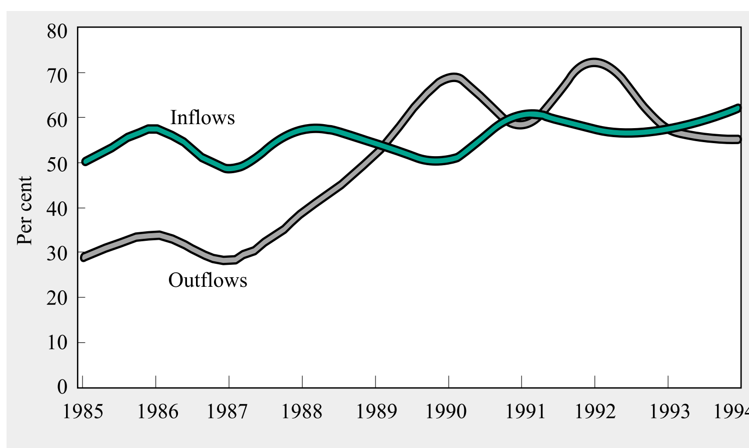
2. Western Europe

Western Europe received $105 billion and invested $176 billion abroad in 1996 (annex tables B.1 and 2). As a region the European Union continues to record the biggest FDI inflows and outflows in the world. However, the structure of European Union FDI changed significantly during the period 1990-1994. After intra-European Union FDI peaked in 1992, the official deadline for completion of the internal market, the share of non-European Union countries in total FDI outflows from the then twelve European Union members increased considerably, from 28 per cent in 1992 to 45 per cent in 1994 (figure II.6).[2] The shift towards destinations outside the European Union would have been even more pronounced if Austria, Finland and Sweden, which became European Union members in 1995, had not attracted soaring investment flows from European Union countries: indeed, European Union countries accounted for 53 per cent of all inflows received by these three countries in 1994 ($4 billion), compared with 32 per cent in 1992 ($800 million).

Among non-European Union destinations, developing countries and the United States received 13 per cent and 10 per cent, respectively, of total European Union FDI outflows (excluding reinvested earnings) in 1994 (Eurostat, 1997). However, the European Union's FDI outflows to the United States, and the United States' share of European Union outflows in 1994, were still well below the levels of the late 1980s. Likewise, the share of Central and Eastern Europe in the European Union's outflows increased only by 1.4 percentage points (to 4 per cent) between 1992 and 1994. Not surprisingly, the growth of European Union FDI in that region during the early 1990s, when "first movers" established themselves there, was not sustained. "Followers" were probably reluctant to invest in the region because of concerns regarding the speed of economic recovery in the region during the transition period. European Union FDI outflows (excluding reinvested earnings) to non-European Union members in Western Europe stagnated at $2 billion during 1992-1994, or 2 per cent of total outflows (Eurostat, 1997).

More than a half of total European Union inflows have come from European Union members over the past decade (figure II.6). Although some European Union countries continued to attract large inflows, overall European Union companies (as well as non-European Union firms) invested less in the European Union in 1994 than in the previous four years. This was partly because of slow economic growth, and possibly also because they had already adjusted to the completion of the single market. This fall-off applied especially to Japanese TNCs; European Union FDI inflows (excluding reinvested earnings) from Japan dropped to almost $2 billion in 1994 compared with almost $7 billion in 1990 (Eurostat, 1997). The same appears true, though to a lesser extent, of the most recent European Union members: FDI outflows (excluding reinvested earnings) from Austria, Finland and Sweden

Figure II.6. Share of intra-European Union[a] FDI in total European Union[a] FDI flows, 1985-1994[b]
(Percentage)



Source: Eurostat, 1997, p. 65.

[a] Twelve European Union member States only.
[b] Not including reinvested earnings.

to the European Union halved between 1990 and 1994, from $12 billion to $6 billion. Most of these trends continued in 1994-1996, as recent data on German FDI inflows and outflows suggest (table II.2).

About a half of both European Union FDI outflows and inflows during 1994-1996 were related to cross-border mergers and acquisitions (annex tables B.1, 2, 7 and 8). However, these figured far less prominently (in particular, in inflows) when compared with the importance of mergers and acquisitions in those of the non-European Union countries. This suggests that it is more difficult for foreign investors to acquire existing firms (e.g., through take-overs) in some European Union countries, such as Germany and Italy, than in other developed countries (notably the United States). On average, the European Union share of merger-and-acquisition sales of all developed countries was considerably below the corresponding share of such purchases. One exception was during the period prior to the start date for the internal market, when many non-European Union companies engaged in mergers and acquisitions in the European Union, although most deals were still among European Union companies.

3. Japan

While the recovery of Japan's FDI outflows continued in 1996 -- $23 billion (on a balance-of-payments basis) -- they were still only slightly over half their peak level of annual average outflows of $41 billion during 1989-1991. On a notification basis, FDI outflow increases were 16 per cent in 1995 and 9 per cent in 1996 (fiscal year). When total outflows approached their 1989 peak, FDI outflows in the manufacturing sector alone (based on notifications) exceeded the 1989 peak level. Both balance-of-payments and notification data underestimate FDI outflows because they do not include reinvested earnings. These are estimated to be $14 billion in manufacturing in 1994, nearly the sum of equity investment and intra-company loans reported as FDI outflows in the balance of payments and nearly twice as large as the reinvested earnings in 1989 (JETRO, 1997, pp. 31-32). If reinvested earnings were added to the reported FDI outflows in manufacturing,[3] investments in manufacturing would in 1994 have exceeded the 1989 peak.

As in 1995, Japan's outflows in 1996 were strongly focused on Asia and the United States. Most Asian host countries increased their share of Japanese FDI outflows. But China's share fell from 9 per cent to 5 per cent, on a notification basis. This was mainly because investors responded to

Table II.2. Germany: recent developments in FDI inflows and outflows, 1994-1996[a]

(DM billion)

	Inflows			Outflows		
Region	1994	1995	1996[b]	1994	1995	1996[b]
Total	2.5	17.2	1.1	27.8	55.2	38.8
European Union	4.7	8.5	1.4	14.5	34.4	18.9
Austria, Finland and Sweden	-1.2	2.3	0.3	1.6	2.8	5.4
Other Western Europe	0.7	2.3	0.8	1.8	2.0	1.3
Japan	-0.5	0.8	-0.7	0.7	0.5	1.6
North America	-1.9	3.0	0.4	4.3	5.7	8.8
Developing countries	-0.2	2.3	0.3	2.6	6.1	3.8
Central and Eastern Europe	-0.1	0.1	-	3.6	4.7	4.4

Source: data provided by Deutsche Bundesbank.

[a] The data in this table do not necessarily correspond to those in annex tables B.1 and B.2 as sources of these data are different.

[b] Do not include reinvested earnings.

fiscal policy changes (elimination of the capital-goods import duty exemption) by advancing to 1995 investments planned for 1996. The United States attracted a rising share of Japanese FDI. Outflows to Brazil in 1996 on a notification basis were more than three times their 1995 level as Japanese investors responded favourably, though with some delay, to economic stabilization and liberalization in Brazil. The engagement of Japanese investors in Central and Eastern Europe (including the Russian Federation) continued to be very weak (about 0.1 per cent of Japan's total outflows). The share of Western Europe declined by 2 percentage points -- to 15 per cent -- in 1996, but there were remarkable differences between countries in that region: Belgium and France received substantially lower investment flows from Japan, whereas the United Kingdom increased its share of Japan's outflows by 1 percentage point.

The geographical pattern of the recent Japanese FDI outflows has changed since the peak period of Japanese FDI in the late 1980s and early 1990s (table II.3). The most obvious difference is the shift from developed countries towards South, East and South-East Asia. This partly reflects the disposal of some large investments made in the United States during the late 1980s, which proved disappointing (e.g., the sell-offs of MCA, Inc. by Matsushita Electric Industrial Co. and the Rockefeller Group by Mitsubishi Estate Co. in 1995). In 1995 alone, 75 Japanese affiliates in the United States were sold off or closed (and 103 new affiliates were established) (Toyo Keizai, 1996, p. 12). The divestments also reflect changes in Japanese TNCs' strategic priority; their aim now is to maximize production efficiency and profitability, a shift which favours investment in South, East and South-East Asia. In that region, the ratio of current income to sales of Japanese affiliates is more than twice that in the United States or Europe.

Table II.3. Geographical distribution of Japanese FDI outflows, peak period and post-recession period
(Billions of dollars and percentage)

Region/country	Peak period (1989-1991)	Post-recession period (1994-1996)[a]
All countries (Billion dollars)	41.0	21
Developed countries (Per cent)	83.0	58
United States	51.0	37
European Union	23.0	13
Developing countries (Per cent)	17.0	42
South, East and South-East Asia	11.0	34
China	1.1	12
Central and Eastern Europe (Per cent)	0.1	-

Source: UNCTAD, FDI/TNC database.

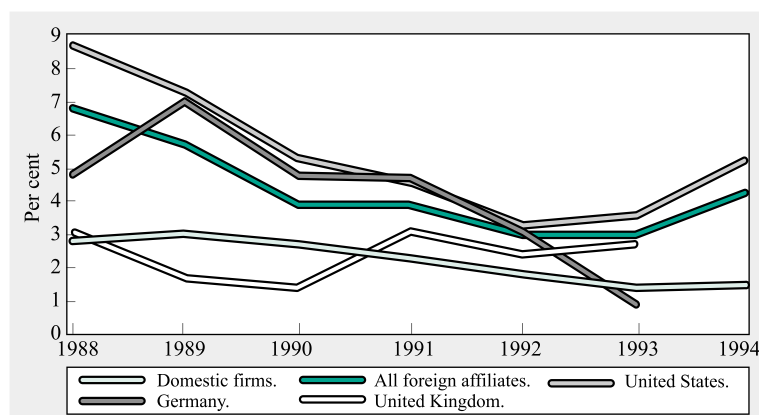
[a] The distribution share is based on the data for 1994-1995 only.

Japan is well known for being a small FDI recipient. Investment inflows peaked at around $3 billion in 1992, but dwindled thereafter, to only $42 million in 1995, when large divestments (of $700 million) by Canadian firms took place. In 1996 inflows increased to $220 million. European TNCs are the most important investors in Japan, undertaking investments of about $1 billion in 1996, a half of which originated in Germany. Hong Kong was the second largest investor after Germany in that year. The sharp drop of FDI inflows after 1992 may be attributed to the fact that Japan experienced three years of low economic growth after the burst of the "bubble economy", coupled with the appreciation of the yen until 1995.

Although total inflows are low, foreign affiliates operating in Japan have higher profits than domestic Japanese firms (figure II.7) and some TNCs, especially from the United States, have responded through FDI to profit opportunities. In 1993, investment income of United States affiliates in Japan was less than 6 per cent of their FDI stock (annex table A.9). That share doubled within two years, and the rate of return of United States FDI in Japan is now the same as the average rate of

return in all host countries. Meanwhile, reinvested earnings of United States affiliates in Japan have soared and have even exceeded equity and intra-company loans (the other two FDI components) from the United States to Japan in certain years. The rising share of earnings reinvested in Japan suggests that United States affiliates already present in Japan are becoming more confident of doing business there.

Figure II.7. Profitability[a] of foreign affiliates[b] in Japan, 1988-1994[c]
(Percentage)



Source: Japan, MITI, *Gaishi-kei Kigyo no Doko* (Tokyo, Ministry of Finance Printing Bureau, various issues).

[a] Share of current income in total sales.
[b] All foreign affiliates and three major investors.
[c] Fiscal year. The 1994 data for Germany and the United Kingdom are not available.

4. Australia

During the early 1970s, Australia, as well as New Zealand, had the highest degree of protection and the most restrictive FDI regimes among the developed countries (Anderson, 1995). By the mid-1980s, they both adopted far- reaching policies of liberalization, deregulation and privatization.[4] Investment inflows and outflows for Australia have typically paralleled the global trend: a decline, followed by a strong recovery, followed by a surge in the late 1980s. In 1994 and 1995, respectively, FDI outflows and inflows reached their highest-ever levels (annex tables B.1 and 2). The predominant sources of FDI for Australia are Europe and the United States; in 1995, they accounted for 62 per cent of the total stock (figure II.8 (a)). Japan is the third largest source country, accounting for 15 per cent of the total stock. By contrast, in 1948, the United Kingdom accounted for 95 per cent of all inflows (Australia, Bureau of Industry Economics, 1993). The decline in the importance of the United Kingdom is due to several factors, including the orientation of its investments to other European countries and the rise in investment by United States TNCs in the post-Second World War era. As with most countries, the increase in Japanese investment into Australia was consistent with the general surge in outflows from Japan during the late 1980s.

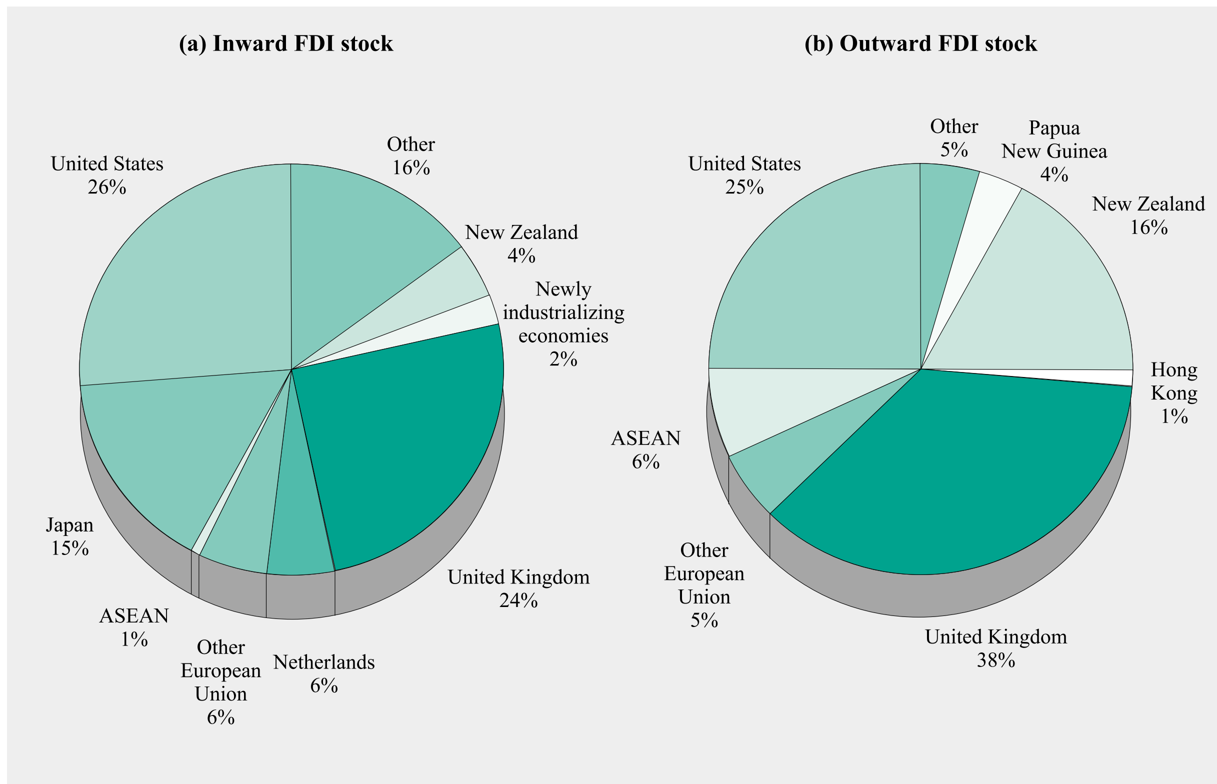
The United Kingdom is the most important destination for Australia's outward FDI, accounting for 38 per cent of its total stock as of 1995 (figure II.8 (b)). The second largest destination is the United States, followed by New Zealand.

When it comes to sectoral distribution, services and manufacturing each received over a third of Australia's total FDI inflows in 1995 (figure II.9). However, the importance of the services sector, which is soon likely to become the dominant sector for FDI,[5] is a recent phenomenon. In the late 1950s, mining and agriculture accounted for only 12 per cent of inflows, services for 11 per cent and manufacturing for 77 per cent (Australia, Bureau of Industry Economics, 1993).

The most interesting aspect of Australia's outward FDI, however, is the very low proportion of these investments in East and South-East Asia. The ASEAN countries host only 6 per cent of Australia's outward FDI stock, and Hong Kong, China accounts for 1 per cent of that stock. As recently as 1980, ASEAN countries and Hong Kong together held 46 per cent of Australia's outward stock. This decline is noteworthy for two reasons:

Figure II.8. Australia's FDI inward and outward stocks, by country, 1995

(Billions of dollars)

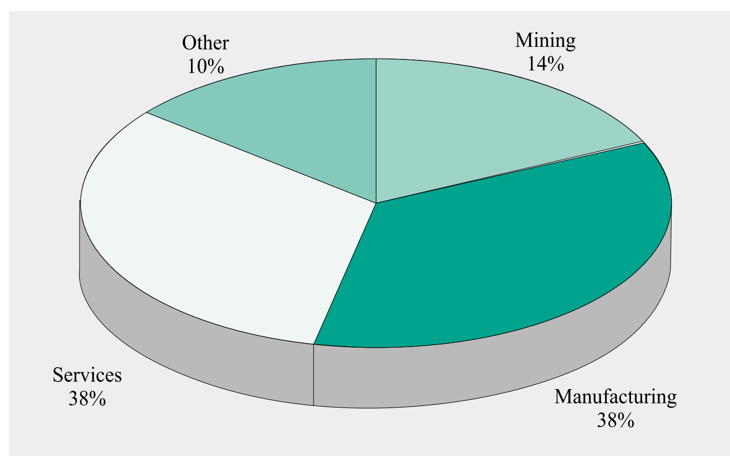


Source: UNCTAD, FDI/TNC database and annex table B.6.

- East and South-East Asia has been the most dynamic host region for world FDI since the late 1980s (Bora, 1996a and 1996b).

- The orientation of Australia's trade has changed dramatically away from Europe and towards East and South-East Asia (Anderson, 1995), and the newly industrializing economies of Asia accounted for 23 per cent of Australia's exports in 1995. Japan accounted for another 24 per cent. Altogether, East and South-East Asia accounts for more than half of Australia's exports.

Figure II.9. Sectoral distribution of Australia's FDI outward stock, 1995



Source: UNCTAD, FDI/TNC database.

Foreign direct investment often follows exports as a mechanism to enhance market access (UNCTAD, 1996a). Yet, although East and South-East Asia's markets have opened gradually over the past twenty years, Australian investors seem to be turning away from that region. More puzzling still, recent surveys have found that Australian investors still rank East and South-East Asia high as an investment location in the short- to medium-term (Australia, Bureau of Industry Economics, 1995).

Several possible reasons for this paradox have been advanced. One is that Australian investors have not been aware of the developments and opportunities in the Asia-Pacific region and are risk averse (Australia, East Asian Analytical Unit, 1994). Another is that policies in East and South-East Asia have also discouraged investment by restricting local equity, imposing sectoral restrictions and lacking assurances against expropriation and compensation (Australia, East Asian Analytical Unit, 1994; Australia, Bureau of Industry Economics, 1995). But while investment regimes in South and South-East Asia may not be as open as those in developed countries, they are not discriminatory, in the sense that preferences were granted to non-Australian investors (APEC, 1995a and 1995b). Hence, none of these reasons explains Australia's low FDI in East and South-East Asia.

A more plausible explanation may be the structure of Australia's industrial base. Most Australian firms in manufacturing that are not affiliates of foreign-based TNCs are of small or medium size. Australia's small and medium-sized enterprises have not yet reached a stage of development that would allow them to internationalize significantly via FDI. In addition, they may be discouraged from investing abroad as this appears to be associated with reducing domestic employment. Furthermore, the parent firms of foreign affiliates in Australia historically have sometimes discouraged their affiliates' investments abroad, especially in Asia; instead, parent firms' investments in Asia have been channelled through their existing Asian affiliates.

Another factor that requires closer investigation is the industrial structure of Australia's FDI outflows to East and South-East Asia compared with its factor-content of trade. Preliminary investigations have found that the decline in the share of FDI going to the ASEAN region was almost entirely in the manufacturing sector (Australia, Bureau of Industry Economics, 1995): in 1981, ASEAN members held 68 per cent of Australia's outward FDI stock in manufacturing, a share that collapsed to under 5 per cent by 1987.[6] The composition of exports to the region is also changing: primary products now account for less than 30 per cent, a share that has been constantly declining over the years (from nearly 40 per cent in 1989). The decline in FDI and increase in exports, however, should be considered within the context of increasing exports aided by tariff cuts. The direction and composition of FDI outflows are also influenced by large investments in one or two countries as the level of Australian outward FDI is relatively low. Yet, the decline in the share of Australian FDI may simply reflect a mismatch between the factors that make East and South-East Asia attractive as a host for FDI and the "ownership" advantages possessed by Australian firms when they seek to invest abroad. For example, a significant portion of FDI into East and South-East Asia has been in labour-intensive manufacturing industries. Australian TNCs, however, do not have many "ownership" advantages in this area; hence they have not been active investors in these industries in the region. In general, compared to the services sector, the manufacturing sector in Australia was not globally competitive until the late 1980s. The services sector is relatively competitive, but many industries in this sector in Asia were not opened to foreign investment until recently. Supply factors are the key to understanding changes in FDI structure. There is some evidence that Australian FDI into Asia's manufacturing sector is increasing, but there is little indication that the region will soon regain its importance as a destination for Australia's investments.

B. Developing countries

1. Least developed countries

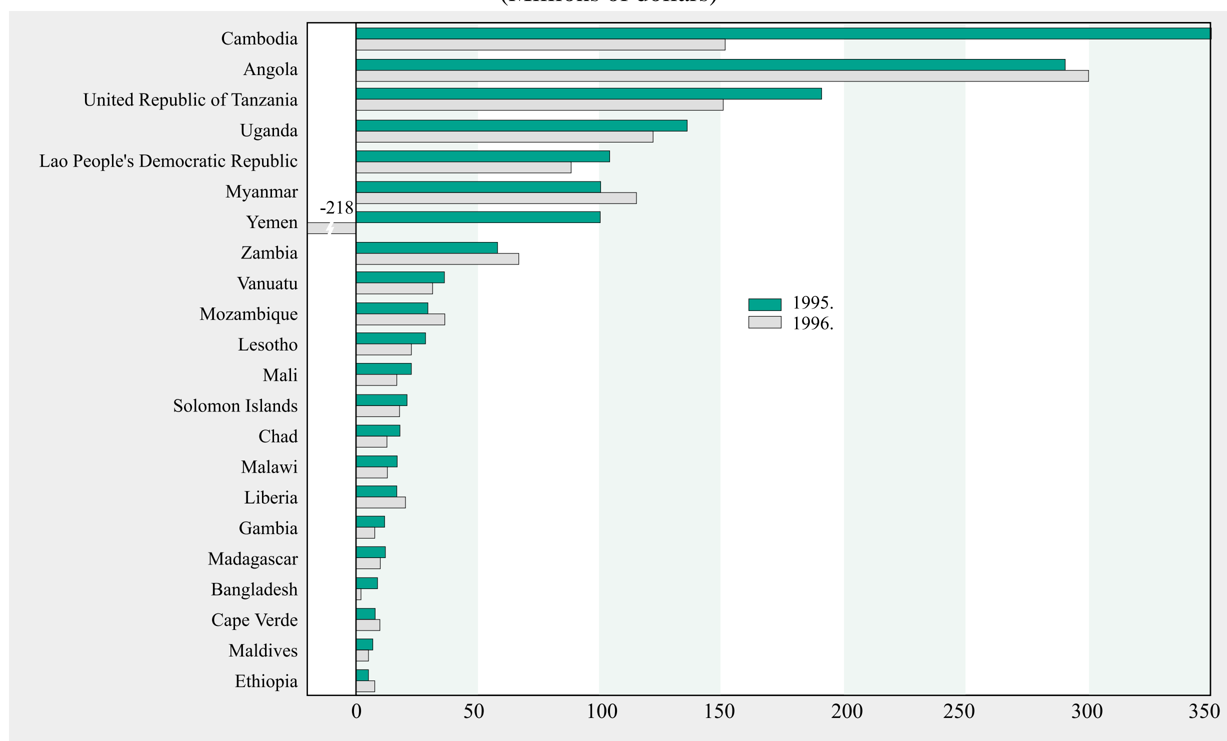
(a) Trends

The 48 least developed countries (LDCs) (32 of them in sub-Saharan Africa)[7] have captured very little of the increase in FDI flows into developing countries during the 1990s. Although their annual average FDI inflows almost tripled between the periods 1986-1990 and 1991-1996, their share of developing-country inflows declined from 2.1 per cent to 1.8 per cent. In comparison, the value of goods imported by LDCs rose by 27 per cent between the periods 1986-1990 and 1991-1995 and their share of developing-country imports fell from 3.4 to 2.3 per cent. Typically, LDCs suffer from a variety of drawbacks that discourage FDI, not all of them readily amenable to policy reforms: the small size of their domestic market (in terms of both population size and per capita incomes),[8] poor infrastructural facilities, adverse climatic conditions, remote geographical or land-locked positions (in some cases) and political instability (see also UNCTAD, 1995b).

In 1996, flows to LDCs rose by 56 per cent. Cambodia, Angola and the United Republic of Tanzania topped the LDC league in terms of absolute amounts (figure II.10). Vanuatu, Angola and Liberia had the highest ratios of FDI inflows to gross fixed capital formation (figure II.11); as these data indicate, FDI inflows are of great importance for some LDCs, much greater than for many countries. Within the LDC group, FDI flows vary widely across regional groupings or individual

Figure II.10. FDI flows into the top 20 LDCs, 1995 and 1996

(Millions of dollars)



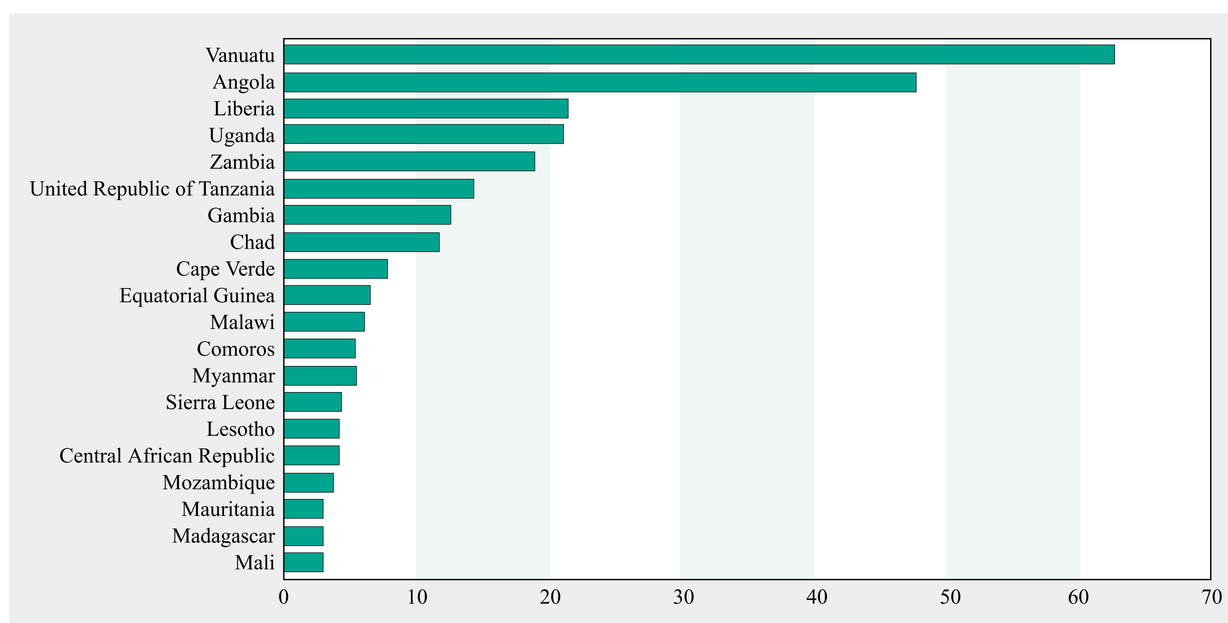
Source: UNCTAD, FDI/TNC database and annex table B.1.

countries, as well as from year to year, with disinvestments or large repatriations of earnings in one year followed by positive investment flows the next. African LDCs are the main recipients of FDI flows in absolute terms, but their share in total LDC inflows of 91 per cent during the period 1986-1990 declined, on average, to 50 per cent during the period 1991-1996. In contrast, the eleven LDCs in South, East and South-East Asia and the Pacific have seen the absolute levels and their share of LDC inflows increase from 8 per cent on average during the period 1986-1990 to 22 per cent during 1991-1996.[9] Cambodia, with $350 million in 1996, was the star performer among them (box II.2). While all South, East and South-East Asian LDCs, without exception, have captured growing amounts of FDI inflows between the two periods mentioned above, only some two-thirds of the African LDCs have succeeded in attracting more FDI.

The disparity between African and Asian LDCs reflects, in part, the importance for the latter group of intra-regional FDI as a source of investment. In Myanmar, for example, developing Asia accounted for 39 per cent of cumulative FDI inflows during 1990 and 1994. The corresponding figure for Bangladesh was 83 per cent.[10] Asian LDCs' share of intra-Asian FDI, mainly from China, the Republic of Korea, Malaysia and Thailand, averaged 6 per cent during the period 1991-1995, with a peak value of 9 per cent in 1992 due to strong outward flows from Thailand. For example, between October 1988 and end-September 1996 some 204 projects were approved by Myanmar, with Singapore emerging as the leading source of FDI, followed by the United Kingdom, France and Malaysia (EIU, 1996a). With some United States TNCs, such as Pepsi Cola, and European TNCs, such as Carlsberg (Denmark) and Heineken (the Netherlands) pulling out of Myanmar in 1996,[11] the share of Asian investments is likely to increase

Figure II.11. FDI inflows as a percentage of gross fixed capital formation in the top 20 LDCs, 1995

(Percentage)



Source: UNCTAD, FDI/TNC database and annex table B.5.

[a] Gross fixed capital formation data are not available for Cambodia, Kiribati, Lao People's Democratic Republic, Maldives and Samoa.

Box II.2. Cambodia

Cambodia has attracted larger FDI flows than any other least developed country in 1996 (see figure II.10). In Cambodia FDI is a relatively recent phenomenon that has emerged on a significant scale only after the conclusion of the United Nations peace-keeping operation in 1993. Upon taking office after the United Nations supervised elections, the Royal Government of Cambodia moved quickly to put in place an appropriate legal framework and to create the necessary institutions to promote FDI.

The Law on Investments adopted by the National Assembly in August 1994 created the Council for the Development of Cambodia (CDC) and the Cambodian Investment Board, which operates as an integral part of the CDC, and serves as a one-stop agency responsible for processing applications and granting incentives to eligible investors. The major investment incentives listed in the law include: eight-year exemption from corporate income tax; 9 per cent rate of corporate income tax; 5 year loss carry-forward; exemption from import duties; repatriation of profits free of tax; and the distribution of dividends free of tax.

Because the sub-decree implementing the Law on Investments has not yet been adopted (it is expected to take effect in mid-1997), the application of the law has not followed a fixed pattern. The CDC has developed a matrix for calculating eligibility for the tax holiday incentive based on the following factors: capitalization, location, technology transfer, training, exports, value added, employment of women, total jobs created, and the employment of the handicapped and veterans. However, some observers are now arguing that the financial incentives are too generous, too much of a burden on public revenue, and in any case larger than what is required to make Cambodia a competitive investment environment.

The rise in FDI inflows since the inception of CDC has been impressive, especially considering that Cambodia is a least developed country. From August 1994 to end-1996, CDC approved 405 projects representing about $4 billion of proposed fixed capital investment and additional employment of about 145,000. These figures represent investors' stated plans, rather than actual out-turns: the recorded flow of direct investment to Cambodia over this period is significantly lower (see annex table B.1). Data available so far for 1997 indicate that investors' plans remain buoyant: the dollar value of projects approved during the first four months of 1997 was more than twice that of the comparable period a year earlier.

Like almost all least developed countries, Cambodia's internal market is small and characterized by the low purchasing power of consumers. Investment in Cambodia therefore tends to be oriented towards production for markets abroad, making use of Cambodian raw materials and inexpensive Cambodian labour. When ranked by the number of proposed jobs created, the most important and most rapidly growing sectoral destination for investment is garment manufacture. Investors have also shown interest in rubber and palm oil, wood processing and food processing. Although its projected impact on employment is relatively small, investment in the tourist sector accounted for a relatively large part of the total projected dollar value of fixed capital investment.

Because it tends to be oriented towards production for export, direct investment has been, and will continue to be, influenced by trade policies. Cambodia has obtained most-favoured-nation status with most developed countries — most recently with the United States — and this is influencing direct investment, especially in the garment sector. Cambodia has also secured its participation in GSP schemes — again most recently with the United States — and this can be expected to shape direct investment in the period ahead. Finally, if and when Cambodia joins ASEAN, the country will participate in the ASEAN Free Trade Area and the planned ASEAN Investment Area. This can be expected to stimulate a further increase in investment flows from other ASEAN member states.

further. From August 1994 to the end of March 1996, more than a half of the investment in Cambodia came from Malaysia and Singapore, with other economies (such as Canada, China, the United Kingdom, Taiwan Province of China and Thailand) accounting for most of the rest.[12] The "flying geese" model of industrial restructuring (UNCTAD, 1995a and 1996c), observable in the newly industrializing economies of the region, has benefited many neighbouring South, East and South-East Asian LDCs, by stimulating FDI into low-cost, labour-intensive activities in which these LDCs have a locational advantage.

A similar industrial restructuring that would give rise to large and persistent flows of intra-regional investment is, however, not observed in Africa at this stage, although southern African LDCs could, potentially, benefit from such a process in the context of FDI from South Africa (see below). Potentially, the North African countries could also begin to move low value added labour-intensive production to their neighbours in the south, most of which are LDCs, as part of their own industrial restructuring efforts.

The implication is that the opportunities available to Asian LDCs to integrate themselves into the investment plans of TNCs from the newly industrializing economies of the same region, as the latter upgrade their industrial structures, are not available yet to African LDCs, because such restructuring is not presently taking place in Africa on a significant scale.

(b) Prospects

Least developed countries are trying hard to attract more investment. Several have stepped up their efforts to expand the size of markets by cooperating with neighbouring countries, through such channels as preferential trade areas and speedy customs clearance. COMESA (Common Market for Eastern and Southern Africa), a common market fostering economic growth through investment, production and trade among 20 member States, is one example of such regional integration efforts. The CFA Franc Zone of UEMOA (West African Economic and Monetary Union), of which Guinea-Bissau became a member as of January 1997,[13] is another example. Other regional cooperation initiatives have been undertaken by the countries through which the Mekong river flows (Cambodia, China, Lao People's Democratic Republic, Myanmar, Thailand and Viet Nam), three of which are LDCs. Together, they have planned several projects involving foreign private investors for improving infrastructural facilities in transportation, telecommunications and power generation for the whole region. For instance, some of the hydroelectric dams on the Mekong river and a fibre-optics telecommunication loop for the region have attracted considerable foreign-investor interest.[14] Finally, if and when Cambodia, Lao People's Democratic Republic and Myanmar become members of ASEAN, these countries can benefit from the common investment regime being created for that area, as well as any common investment promotion activities in the future.

Furthermore, several LDCs, particularly in sub-Saharan Africa, have stepped up their efforts to attract FDI through wide-ranging reforms for greater liberalization, notably by eliminating foreign exchange restrictions applicable to foreign investors; the privatization of state enterprises; the establishment of "one-stop" shops; and policies to improve the overall macroeconomic environment, together with the adoption of stable exchange rates. These efforts have been complemented, on the international side, by the conclusion of 137 bilateral investment treaties as of 1 January 1997, of which 25 are between countries within the same region; however, the density of these treaties is lower for LDCs than for the three developing-country regions as well as Central and Eastern Europe. For Asian LDCs, liberalization policies have already contributed to sizeable increases in FDI inflows, illustrated by the recent FDI performance of Bangladesh.

Privatization is a strong catalyst for drawing in foreign investors to business opportunities in LDCs, particularly in the development of infrastructure. Examples of recent privatizations are numerous. In a move to encourage foreign participation in infrastructure development, 60 per cent of the stake in the Société des Télécommunications of Guinea was sold to Telekom Malaysia in 1996 (EIU, 1996b). Agreements have also been signed between Guinea and Unified Industries (United States) to build, own and operate electricity generation facilities for six years (EIU, 1996c). The partial privatization of Tanzania Breweries in 1993 enabled a South African brewery to acquire a 50 per cent stake and a five-year management contract in the former. [15] Engen, a South African oil company, was encouraged in October 1996 to build an oil terminal in Dar-es-Salaam with the option to bid for a network of retail fuel stations.[16] And Uganda's decision in 1996 to allow the sale of some major state-owned enterprises (up to 51 per cent of the equity) to a group of local and foreign investors marks a further step in the privatization process of that country (EIU, 1996d).

With the easing or the end of prolonged conflicts in some African LDCs (e.g., Angola and Mozambique), liberalization and the opening up of state-owned mining enterprises to foreign investors, together with improved world mineral prices since 1994, signs of an FDI revival are beginning to appear. Several major mining projects with foreign participation are planned or are already under way: oil and diamonds in Angola, gold in Mali and the United Republic of Tanzania, bauxite in Guinea and copper in Zambia (UNCTAD, 1995b). And as more welcoming FDI regimes are set up and the domestic economic situation improves, foreign investors are seeking investment opportunities outside mining, such as in fishing, cut flowers, fruits and vegetables, light manufacturing and tourism. For example, Lesotho's proximity with South Africa, the largest market in the region, has prompted TNCs to invest in asparagus processing in the former (EIU, 1996e). In turn, South Africa has invested in Lesotho's cellular telephone development (EIU, 1996e) and in December 1996 Peugeot (France) announced plans to produce components of a car model designed for African markets in Madagascar. South African investors have also expressed interest in Mozambique, in projects such as power links, an aluminium smelter and tourism development.

One obstacle to attracting FDI to LDCs has been the lack of information on investment opportunities in most of those countries. Only 2 per cent of over 200 investment guides -- an important medium for disseminating information on a country's investment environment and business opportunities -- published by the top six international accounting firms cover LDCs.[17] And only 6 of the 48 LDCs provide comprehensive guides to foreign investors.[18] In today's highly competitive FDI market, a low level of awareness of the investment opportunities available, lack of information on investment conditions and legal frameworks and lack of readily available information on contact points in the countries themselves can hamper inward FDI.

2. Africa

(a) Trends

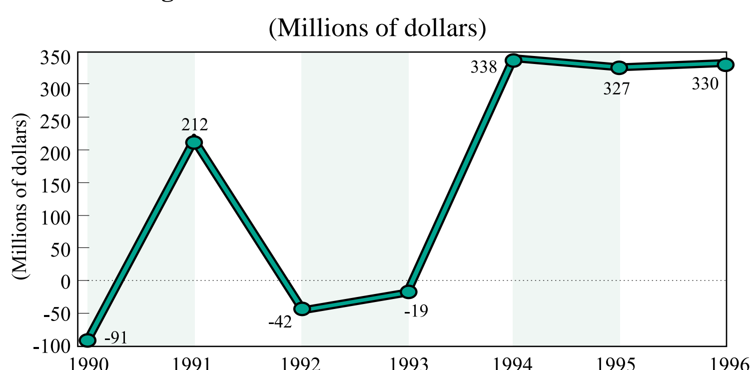
Foreign-direct-investment inflows into Africa increased 5.3 per cent,[19] to almost $5, billion in 1996. (Investment trends for South Africa are discussed in box II.3.) Nigeria, Egypt and Morocco topped the African league of the largest recipients in 1996 (figure II.12). But in relation to gross fixed domestic capital formation, Nigeria, Angola and Seychelles head this league (figure II.13). Africa's share of developing-country inflows was 3.8 per cent in 1996, the lowest share since the early 1980s. On average, Africa's share of developing-country inflows has more than halved, from 11 per cent during 1986-1990 to 5 per cent during 1991-1996. This suggests that Africa has not participated in the surge of FDI flows to developing countries.

Box II.3. South Africa: the "wait-and-see" phase is over

After a period of disinvestments (negative FDI inflows), FDI flows to South Africa reached over $300 million both in 1994 and 1995 (box figure). A good part of that investment is concentrated in the Gauteng province around Johannesburg, where 80 per cent of all foreign affiliates and more than 75 per cent of all persons employed by foreign affiliates are located (IRRC, 1996, p. 4).

Box figure. South Africa: FDI inflows 1990-1996

(Millions of dollars)



Source: UNCTAD, based on annex table B.1.

[a] Estimates.

United States' firms have made by far the largest investment commitments in South Africa since the April 1994 election. These commitments, valued at 8 billion Rand, are more than twice the level of commitments by German TNCs (3.2 billion Rand), the next most important investors. In terms of employment, United States affiliates account for 60,000 of the 500,000 employees currently employed by all foreign affiliates in South Africa (IRRC, 1996, p. 2). Other important sources of investment are the United Kingdom, Switzerland, France, as well as the Republic of Korea and Malaysia.

The growth of FDI from Asia is an important new phenomenon. Investors from the Republic of Korea plan major investments in the motor and auto-components industry,[a] while Malaysian TNCs are concentrating on services (hotels, property and telecommunications) and petroleum. In 1996, Malaysia's Petronas announced plans to spend $436 million to purchase a controlling stake in Engen, a large South African oil refinery.[b] Telekom Malaysia has formed a consortium with SBC International (United States) which acquired a 30 per cent stake (for about $1.3 billion) in the privatized South African Telkom in 1997.[c]

Food and beverages, motors and automobile components, electronics and information technologies, some services and property were the most important recipients of FDI into South Africa between May 1994 and May 1996. Food and beverages, as well as clothing, hotels and leisure, are areas of strong interest to United States TNCs. German TNCs concentrate particularly on the manufacturing sector, with a focus on motors and automobile components, while United Kingdom TNCs invest in a variety of industries, including banking and other financial services, chemicals, beverages, publishing and motor components (Business Map, 1996, p. 11). Between May 1994 and May 1996, 74 per cent of all TNCs entering South Africa invested in the services sector, 24 per cent invested in manufacturing, and only 2 per cent invested in mining (IRRC, 1996).

By establishing investment facilities in South Africa, TNCs also aim to supply the regional and world markets. In particular, some automobile TNCs started to integrate their South African affiliates into their international production networks, and export part of their output back to the home country or to other countries. This puts pressure on other foreign affiliates to integrate their TNC networks as well, in order to enhance their ability to access world markets and become more efficient. For instance, BMW announced in 1995 that it would step up its investment commitments by 1 billion Rand, to make its South African affiliate a full-fledged member of BMW's global manufacturing and distribution network.[d]

/...

(Box II.3, cont'd.)

The reversal of the trend in FDI inflows into South Africa (from disinvestments to positive investments) suggests that the "wait-and-see" approach by TNCs to South Africa has come to an end.

- An increasing number of parent firms is buying back their South African affiliates, which they had sold during the period of sanctions (between the end of the 1980s and May 1994). This is particularly the case for TNCs based in the United States. Indeed, the number of United States' parent firms with investments or employees in South Africa rose steadily during the 1990s: from 104 in 1991 to 281 in May 1997 (IRRC, 1997). Between May 1994 and May 1997, more than 120 United States-based TNCs entered the country (IRRC, 1997).
- The number of firms investing in South Africa is growing rapidly. According to some reports (IRRC, 1996, p. 2), on average, nearly four United States' firms per month have been investing in South Africa between May 1994 and May 1996, slowing down slightly in the following 12 months up to May 1997 when only 30 United States' companies entered South Africa (IRRC, 1997). As of May 1996, 350 subsidiaries of TNCs based in Germany had invested in South Africa -- 20 TNCs more than as of May 1994 (Business Map, 1996, p. 11).
- Firms that have already invested in South Africa are planning to expand their investments. A recent survey of 31 affiliates in South Africa of TNCs based in France found that 76 per cent of them (compared with 60 per cent in 1995) plan to extend their investment in the next three years (Moniteur du Commerce International, 1996, p. 39).

In addition, the Rand's depreciation (since the beginning of 1996) has made purchases of South African assets cheaper for foreign firms.[e] This has contributed to the growth of merger-and-acquisition purchases of local firms by foreign companies. The number of such purchases has risen sharply -- from 9 in 1991 to 59 in 1996; the ensuing increase in foreign investment (including portfolio equity investment) inflows has risen from 46 million Rand in 1991 to an estimated 4,130 million Rand in 1996.[f]

Some foreign investors, however, remain cautious, as reflected in their preference for various forms of non-equity investment. A recent survey of German-based small and medium-sized TNCs found that most preferred joint ventures with local partners that do not entail capital commitments, their contribution being "in kind", in the form of technology (Blank, 1996, p. 264). Much of the involvement in South Africa by United States-based TNCs takes place through franchising, with capital raised by the local partner rather than brought in by the parent firm (Business Map, 1996, p.11). Another sign of investor caution is that acquisitions, rather than greenfield investments, form the lion's share of investment flows to South Africa from the major source countries,[g] although, where opportunities exist, TNCs quite often prefer mergers and acquisitions as an entry strategy.

Foreign-investor concerns centre on the political situation, social problems (e.g., high crime rates) and the difficulty of market entry (given that a good part of South Africa's economy is controlled by a few industrial conglomerates).[h] The reduction of these impediments, in conjunction with a strengthening of South Africa's existing locational advantages (e.g., a good business infrastructure, a large and potentially significant domestic market and reasonable rates of return on investment), as well as the expectation that South Africa will become an economic hub in the region, are likely to encourage FDI flows into that country over the next years. Despite these concerns, the sharp increase in FDI flows in 1994 and 1995 suggests that foreign investors' confidence in South Africa as an investment location has revived, and that the "wait-and-see" phase is now over.

[a] Roy Cokayne, "Daewoo plans R 1 bn vehicle plant for SA", *The Mercury*, 15 March 1996.
[b] James Kynge, "Petronas takes in global panorama", *Financial Times*, 25 October 1996.
[c] Roger Mathews and Mark Ashurst, "S Africa sells 30% of Telkom in $1.25 bn deal", *Financial Times*, 27-28 March 1997.
[d] Roy Cokayne, "BMW injection shows confidence in SA", *The Mercury*, 24 January 1996.
[e] "Sliding Rand helped gain direct foreign investment", *Daily News*, 9 October 1996.
[f] Data provided by Ernst & Young. Due to definitional differences, the merger-and-acquisition figures reported here do not correspond to FDI inflows reported elsewhere in this box. The figure for 1996 is preliminary.
[g] "Exchange curbs keep investors on wrong side of SA border", *Sunday Times*, 5 May 1996.
[h] Some attempts have been made to reduce the size of these conglomerates through demonopolization and rationalization.

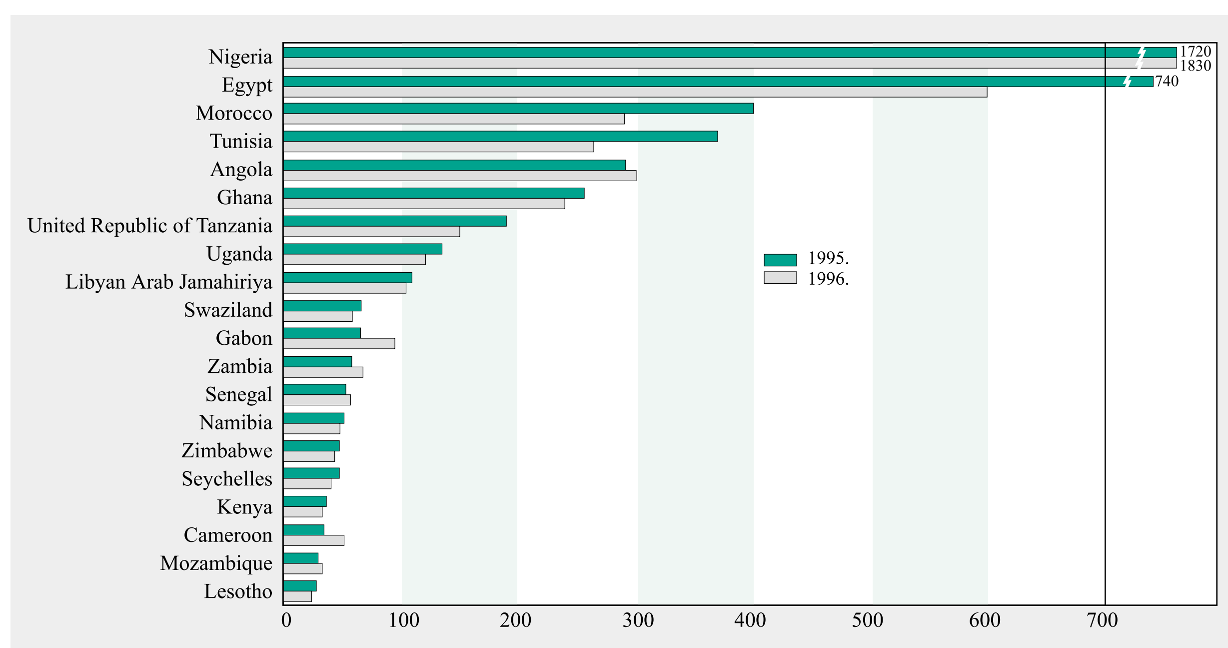
But these figures have to be put into perspective:

- The decline in the region's share in developing-country inflows is not limited to Africa. Latin America and the Caribbean also experienced a declining share (from 39 per cent in 1986 to 30 per cent in 1996). Apart from difficult business conditions in a number of African countries, this steep decline is partly a result of the rise of China. If China is excluded from the data, Africa's share in developing-country inflows changes from 3.8 per cent to 5.7 per cent in 1996 (and that of Latin America and the Caribbean from 30 per cent to 45 per cent).

- The absolute level of FDI flows into Africa is increasing, from an annual average of $800 million during 1975-1980 to an annual average of $3.9 billion during 1990-1996. Although rising from a small level, FDI inflows into Africa grew by fivefold between the periods 1975-1980 and 1990-1996, compared with 4.7 times for Latin America and sevenfold for developed countries as a whole. Asia, however, has performed much better, mainly because the countries of that region have the benefit of substantial interregional investment flows, and both Asia and Latin America have shown a particularly dynamic FDI performance in the most recent years.

- Considering that market size is an important determinant of FDI inflows, it is noteworthy that, as a percentage of GDP, Africa's FDI stock in 1995 was 13 per cent, compared to about 13 per cent for Western Europe, 14 per cent for Asia, and 18 per cent for Latin America and the Caribbean. If only sub-Saharan Africa is considered, the share is as much as 17 per cent. Considering that market size in African countries is relatively small and that

Figure II.12. FDI flows into the top 20 countries in Africa, 1995 and 1996
(Millions of dollars)



Source: UNCTAD, FDI/TNC database and annex table B.1.

the level of development of Africa is lower, the difference between the performance of Africa and that of other regions using this indicator is not that unexpected.

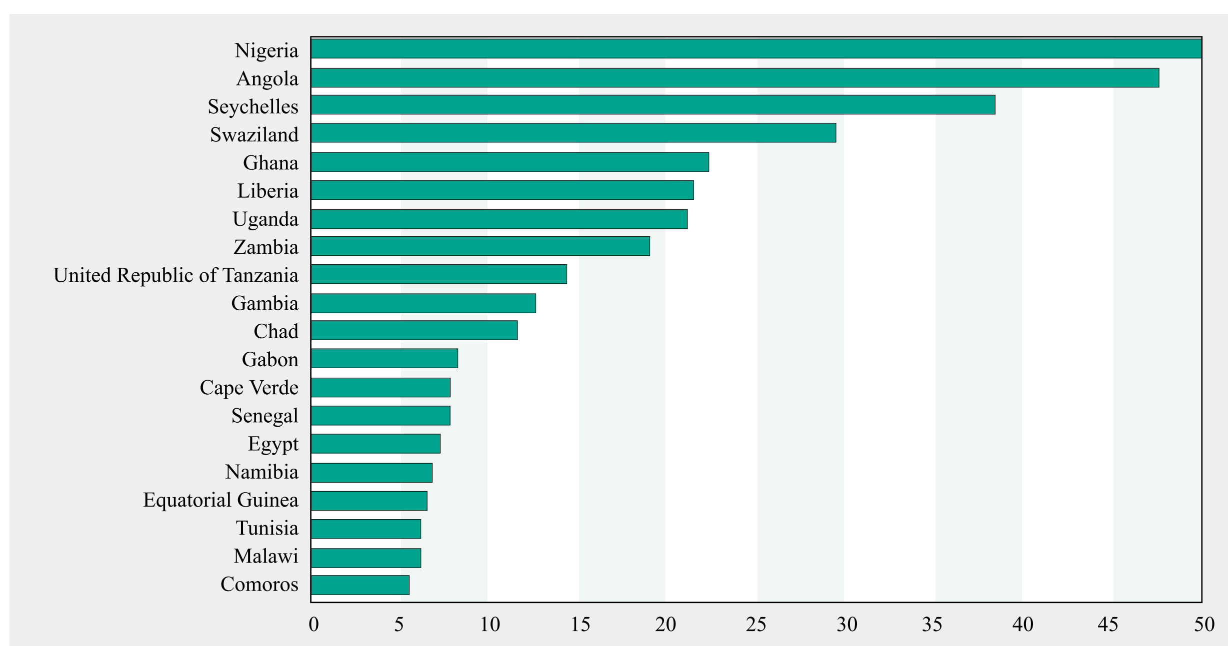
- While FDI flows into Africa account for only a small share of flows into developing countries as a whole, the relative importance of the FDI inflows that the continent receives is quite high: in relation to gross fixed capital formation during 1990-1995, FDI flows accounted for 5.4 per cent, in comparison with nearly 5.5 per cent for Asia, 8.4 per cent for Latin America and the Caribbean and 5.9 per cent for Western Europe. There are a number of countries in Africa which, by this measure, received more FDI than major developing countries in Asia and Latin America.

- While flows continue to be concentrated in a few host countries (Nigeria and Egypt accounted for over a half of FDI into Africa during the first half of the 1990s), other countries are beginning to receive sizeable inflows (box II.4).

- While FDI in the primary sector in Africa is, relatively speaking, far more important than in other continents, the secondary and tertiary sectors together now account for perhaps as much as two-thirds of all FDI in Africa. It is a picture that is also reflected in the principal oil exporting countries: in Nigeria, for example, the primary sector accounted for about 33 per cent of the total FDI stock, with manufacturing contributing 48 per cent and services 19 per cent in 1992. The respective figures for Egypt in 1995 were 4 per cent, 47 per cent and 48 per cent; and for Algeria in the same year, 5 per cent, 25 per cent and 70 per cent (UNCTAD, 1997a).

- To the extent that data for United States' affiliates in Africa can be generalized, the rate of return on FDI in Africa has been considerably higher -- and consistently so -

Figure II.13. FDI inflows as a percentage of gross fixed capital formation in the top 20 countries in Africa, 1995
(Percentage)



Source: UNCTAD, FDI/TNC database and annex table B.5.

- than that in Latin America, and higher than the average for both developed and developing countries (UNCTAD, 1995b).

- Perhaps most interestingly, a number of firms from Africa are themselves beginning to become TNCs, i.e., they are emerging as outward investors. Although African TNCs remain relatively rare and small in size (with an outward FDI stock of $26 billion in 1996, including South Africa), this shows that there *are* firms in Africa that can be competitive internationally, not only through trade but also through production in foreign markets. Firms from South Africa lead, followed by those from Nigeria. Together they accounted for two-thirds of FDI from the region in the 1990s (UNCTAD, 1997a).

Box II.4. Morocco, a rising star

During the 1990s, broad macroeconomic reforms have created a favourable investment climate in Morocco. The privatization programme and the liberalization of the FDI regime have also contributed to making the country attractive to foreign investors. As a result, FDI inflows to Morocco increased almost fivefold, from an average of $83 million during 1985-1990 to an average of $419 million during 1991-1996, with $400 million in inflows in 1996 alone.

Prospects for sustained inflows are promising. Recent announcements of large investment projects included a $900 million investment by Daewoo (Republic of Korea), ACCOR's plans to construct 19 hotel units, ABB-CMS' planned investment of $1.6 billion and SGS Thomson's plan to invest $400 million in micro-electronics.

Morocco is now the third largest recipient of FDI in Africa — and it is at the forefront of changing the image of Africa.

Source: UNCTAD, based on information provided by the Ministry of Finance and Foreign Investment of Morocco.

This suggests that the picture is mixed. And, of course, these figures are aggregates and mask a wide range of performances. But this is precisely the point: one needs to take a differentiated look at Africa, examining each country -- and perhaps even each industry -- on its own merit to see whether investment opportunities exist. And, of course, these figures do not say anything about the desire of African countries to attract more FDI -- or, indeed, about the potential for more FDI in Africa.

Within Africa, the host subregional or country pattern has not changed significantly during the past decade (annex table B.1):

- The share of North Africa in Africa's total inflows has declined from an average of 44 per cent during 1986-1990 to an average of 38 per cent during 1991-1996.

- The corresponding share of sub-Saharan Africa has risen slightly,[20] from 56 per cent to 62 per cent between the two periods.

- The share of oil exporting African economies in Africa's total inflows has increased marginally, from 71 per cent during 1986-1990 to 73 per cent during 1991-1996.

- The share of Africa's FDI inflows accounted for by the least developed countries in that region has remained almost the same: an average of 18 per cent during 1986-1990 and an average of 17 per cent during 1991-1996 (see the earlier discussion).

- Investment flows into Africa have become less concentrated. The five largest recipients during 1991-1996 -- Nigeria, Egypt, Morocco, Tunisia and Angola -- accounted for 78 per cent of all investment inflows to that region. But the corresponding share during 1981-1985 of the top five recipients -- Egypt, Nigeria, Tunisia, Cameroon and Angola -- was 93 per cent.

Geographical proximity, historical ties and recent trade agreements between North African countries and the European Union continue to render Western Europe the principal source of investment flows to Africa.[21] Two countries, France and the United Kingdom, together accounted for 88 per cent of Western European investment to Africa during the first half of the 1990s. The United States accounted for 15 per cent of all investment flows into Africa originating from the developed countries. A new development is that developing countries, mainly in Asia, are also becoming a growing source of investment for Africa (box II.5), although North African countries receive considerable investment from West Asia, mostly in finance.[22]

Most FDI flows in some North African countries, such as Algeria and the Libyan Arab Jamahiriya, go into the hydrocarbon industry. New oil discoveries in Algeria, coupled with a gas pipeline completed in 1996 that has already started to pump gas to Portugal and Spain via Morocco, are prompting the arrival of more petroleum investment. Privatization and high and sustained growth rates in Egypt, Morocco and Tunisia have attracted rising FDI in industries as diverse as hotels, cars, electronics and infrastructure. BMW (Germany) has announced plans to open its first assembly plant in Egypt in 1997.[23] Egypt is also attracting considerable investment in infrastructure, including telecommunications and airports, mostly through build-operate-transfer projects.

(b) Prospects

Several factors hold out the prospect of improvements in FDI performance in some parts of Africa. These factors are:

- *Favourable growth performance.* Africa's economic recovery, which started in 1994, was strong in 1996, with domestic output rising by 4.4 per cent, the biggest increase since 1988. This performance compares favourably with the 2.7 per cent GDP increase in 1995, and represents a turnaround in the per-capita income growth rate (UN-ECA, 1997). Still, per-capita income levels remain low.

- *FDI (and trade) liberalization.* In an effort to improve their investment regimes, several countries in Africa have removed ownership restrictions,[24] reduced taxation rates and abolished price controls. They have also encouraged private-sector initiatives. As of 1 January 1997, some 45 African developing nations had concluded at least one bilateral investment treaty and, in total, had signed 267 BITs, of which 17 were with countries in the continent.

- *Privatization.* Sub-Saharan African countries continued to sell off state-owned enterprises, including some in infrastructure, to foreign investors. They raised $544 million in 1995,

Box II.5. Asian FDI in Africa

Transnational corporations from developing economies in South, East and South-East Asia (which already play a substantial role in intra-Asian FDI flows) are beginning to discover Africa (box table).

Box table. Major Asian FDI flows to Africa,[a] 1990-1996

(Millions of dollars)

	1990	1991	1992	1993	1994	1995	1996
China	..	1.3	7.7	12.8	27.4	17.7	..
Republic of Korea	..	..	29.0	30.7	113.5	40.7	..
Malaysia	-	1.2	4.8	4.8	34.0	36.1	46.1
Pakistan	5.0	4.2	8.1	7.0	5.5	..	..
Taiwan Province of China	13.0	4.5	16.9	0.4	18.7	28.8	20.9

Source: UNCTAD, FDI/TNC database.

[a] Including South Africa.

Examples are numerous. Daewoo (Republic of Korea) plans a multi-billion dollar expansion of its investments in Morocco.[a] Hyundai (Republic of Korea) began building a new assembly plant in Botswana in 1996 to make vehicles for the African market. The JR Group (Hong Kong) is planning to expand into the Seychelles' tourism industry and to set up an offshore bank there (EIU, 1996f). Telekom Malaysia purchased a 30 per cent stake in Ghana Telecom. In addition, agreements were signed in 1996 between firms from Malaysia and Ghana in industries as diverse as hotels, banking, real estate and palm-oil development, aimed at attracting FDI in joint ventures or in wholly foreign-owned projects in the latter country. Furthermore, in order to facilitate business exchanges, Ghana and Malaysia accorded each other most-favoured-nation status, and Ghana waived visa requirements for Malaysians.[b] PRC Trading of Huang Gu (China) established a brewery in Accra in 1996,[c] and another Chinese firm has expressed interest in processing cocoa in Ghana for export to Asia. Finally, there are a number of important investments by Asian firms in South Africa (see box II.3). All of these examples indicate a growing interest of Asian developing economies in investment opportunities in Africa.

[a] "Bilan du monde", *Le Monde*, Edition 1997, p. 87.
[b] K. Hardi, "Rawlings looks East for growth", *Africa Business,* February 1996, pp. 28-29.
[c] Asmah George, "Chinese to brew beer in Accra", *African Business,* April 1996, p. 29.

compared with $74 million in 1990 (table II.4). Mozambique and Zambia, for example, have large-scale privatization programmes. Government efforts to nurture private business have been backed with more prudent macroeconomic management.[25] Some privatizations involving foreign investors have led to the upgrading of capital, know-how and technology. Consequently, some loss-making state-owned firms were transformed into profitable and dynamic enterprises.

- *Regional integration agreements.* The convergence of economic policies in many African economies is improving prospects for enhanced regional cooperation. Governments are harmonizing their investment codes and customs duties (on imported components), with a view towards attracting TNCs that aim at serving the regional market. Formal regional integration or cooperation agreements also increase the size of domestic markets and allow firms both from the member countries and from outside to achieve economies of scale in production.

- *Links with other regions*. The most significant developments are the free-trade agreements between North African countries and the European Union, the Lomé Convention and its possible extension to South Africa, and the African Growth and Opportunity Act introduced in the United States Congress in April 1997.[26] While the customs-union agreement between North African countries and the European Union allows for enlarged trade and FDI flows through facilitated market access and lower tariff rates, the Lomé Convention (signed between the 70 African, Caribbean and Pacific States, on the one hand, and the European Union, on the other) permits manufactured goods and most agricultural exports to gain duty-free access to the European Union.

Overall, prospects for an improved FDI performance during the second half of the 1990s appear favourable. Oil and mining companies, for example, have announced investment plans for Africa in 1997 totalling some $5 billion.[27] Prospects for investments in manufacturing and services are also improving. Even if there should be a further decline in Africa's share in world FDI flows, the importance of FDI for the continents might increase. In fact, during the period of a declining share, FDI stock as a percentage of GDP doubled from 6 per cent in 1985 to 13 per cent in 1995. More generally, it is the growth rate of FDI that matters, rather than the share of the region in world FDI flows. Naturally, Africa's prospects in this respect (and especially those of the continent's least developed countries) would improve if a broader basis for sustained economic growth could be created -- a task in which the international community has an important role to play, especially through official development assistance.

(c) South African transnational corporations and the economic development of southern Africa

Since the beginning of the 1990s, economic liberalization and regional integration in the southern African region have been on the rise. Within the Southern African Development Community (SADC) (box II.6), a group of countries with the strongest economic links with South Africa, hopes have been high that post-apartheid South Africa could emerge as a "growth pole" for the region, contributing positively via trade and FDI to the development of its neighbours. There have even been expectations that South Africa would initiate a regional restructuring process similar to the one which centred on Japan in East and South-East Asia. This section analyses the particular conditions

Table II.4. Privatization revenues in sub-Saharan Africa, 1988-1995

(Millions of dollars)

Country	1988	1989	1990	1991	1992	1993	1994	1995	Total
Côte d'Ivoire	..	..	..	10	6	5	14	120	154
Ghana	..	1	10	3	15	28	476	87	619
Mozambique	..	1	4	5	9	6	2	26	52
Nigeria	..	33	16	35	114	541	24	..	764
South Africa	..	632	..	5	..	..	..	..	637
Uganda	..	..	..	..	12	19	24	47	101
Zambia	..	..	..	..	..	..	..	69	69
Zimbabwe	..	..	..	..	..	..	232	75	307
Other	10	16	45	2	35	49	22	121	299
Total	10	683	74	60	191	648	792	544	3002

Source: World Bank, 1997a.

Note: There may be some discrepancy between the sum of the countries and what is reported as a total, due to rounding.

for two possible scenarios:
South Africa as the regional growth pole; and South Africa as the "leading goose" for the southern African region.

i. Growth pole

To become a regional growth pole, South Africa would need to contribute to the development of the neighbouring economies, mainly through trade and FDI.[28] With a GDP of more than $125 billion in 1996, South Africa's economy is by far the largest in the region. Due to South Africa's political and economic isolation during the apartheid era, trade with its neighbours remained modest. However, since South Africa's 1994 elections, its trade with neighbouring countries has expended rapidly. This growth has been largely accounted for by increases in South Africa's imports of primary and intermediate goods and the expansion of its manufactured exports. However, this has been achieved at the cost of rising trade deficits incurred by many of South Africa's neighbours.

In principle, direct investment by South African TNCs could play a crucial role in the development of neighbouring countries, by serving as an "engine of growth" (UNCTC, 1992b), in particular in the following ways:

- *Provision of capital and contributing to capital formation in the host economy.* Already before the elections in 1994, South African FDI in southern Africa increased significantly (table II.5). Traditionally, most of these investments have been by mining companies, often accompanied by investments from financial institutions that seek to provide financial services to them (Business Map, 1996, p. 13). More recently, South African TNCs have been investing also in food processing, retailing and other services in countries in the region. Privatization programmes in these countries are also attracting investment from South Africa. South African Breweries, for example, purchased a major stake in Tanzanian Breweries when it was partially privatized in 1993 (annex table A.10).

Box. II.6. The Southern African Development Community

The Southern African Development Community (SADC), the successor of the Southern African Development Coordination Conference, comprises Angola, Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe. SADC was established in August 1992, with South Africa (1994) and Mauritius (1995) joining later. The SADC treaty foresees, among other things, deeper economic cooperation and integration, on the basis of equality and mutual benefit through cross-border investment and trade as well as freer movement of factors of production; it thus goes farther than previous regional initiatives that just sought to coordinate rather than integrate the economies of member states. In August 1996, member states initialled the SADC trade protocol. It foresees the creation of a free-trade area within 8 years after the protocol is ratified by member states as part of the strategy change of SADC away from regional project coordination towards the liberalization of trade in services, goods and capital. At the SADC summit in September 1997, member states will discuss an internal tariff-reduction schedule. Botswana, Lesotho, Namibia, South Africa and Swaziland have already established free trade among them, as they also represent the Southern African Custom Union (SACU), which originates from a 1910 Custom Union Agreement between South Africa and several then British High Commission territories. In this connection, the question of dual membership in SADC and other regional organizations, such as SACU or COMESA (Common Market for Eastern and Southern Africa), is not yet fully resolved.

Table II.5. South African FDI[a] stock in selected SADC countries, 1991-1994

(Millions of Rand)

Country	1991	1992	1993	1994
Botswana	76	169	198	232
Lesotho	11	20	32	43
Malawi	10	5	7	8
Mozambique	4	4	4	3
Namibia	45	82	94	96
Swaziland	89	72	85	605
Zambia	4	2	5	7
Zimbabwe	85	61	72	65
Total SADC	324	415	497	1 059
Memorandum:				
Other Africa	1 454	2 194	2 281	2 693
Total Africa	1 778	2 609	2 778	3 762

Source: UNCTAD, based on data provided by the South African Reserve Bank.

[a] The threshold in the definition of FDI used here is different from the one used by the International Monetary Fund (see definitions and sources in the annex). Up to 1994, the South African Reserve Bank defined FDI on the basis of a threshold of 25 per cent. This means that the FDI used here are, in comparison to IMF data, an underestimation.

- *Transfer of technology and contribution to human resource development.* Little hard evidence is available that South African TNCs are contributing to economic development in the SADC countries through the transfer of technology. Although there are a number of firms in SADC countries with modern production processes, the generally low level of technological capability and sophistication of manufacturing in most of these countries makes it difficult for many local firms to absorb such transfers (Lall *et al.*, 1996). There is also a paucity of hard evidence available on the contribution to human resource development (which usually takes place through vocational training of unskilled and semi-skilled workers) in South African affiliates in SADC member States as well as in the form of improvements in management capabilities, technical know-how and entrepreneurial abilities through formal and informal channels of learning.

- *Providing opportunities for additional export revenues.* Few data are available on the contribution of South Africa's TNCs to the export revenues of host countries in the region. But the more firms invest there to produce goods that are exported back to South Africa, the more positive should be the effect on the bilateral trade balances of those countries.

To sum up, South Africa's potential as a regional growth pole through trade and FDI is by no means exhausted. However, the feasibility and success of a growth-pole strategy depends crucially on two factors. The first is free access to the South African market for exports produced in neighbouring economies. Since 1995, when South Africa started with a process of progressive import-tariff reductions in accordance with its WTO obligations, the country has taken some decisive steps in this direction. Average import protection in manufacturing is due to be reduced to 8 per cent in the year 2000, from 19 per cent in 1994. But, despite significant reductions in many industries, some goods will still be subject to relatively high protection in the year 2000. For instance, clothing (excluding footwear) will still have a nominal rate of tariff protection of more than 45 per cent until 2000, despite a planned 44 per cent reduction (Industrial Development Corporation, 1996, p.6).[29]

The second condition is faster demand growth in South Africa, which has risen rather modestly since 1994 (with GDP growth rates not exceeding 4 per cent; Vayenas, 1997). At present, prospects hinge largely on the results of the Growth, Employment and Redistribution (GEAR) programme, which is the main instrument of the Government of South Africa for stimulating the domestic economy.

ii. Building the nest?

The question for the future is whether South African firms can go beyond their traditional role in neighbouring economies and help them develop new industries, notably in manufacturing. Much may depend on whether South African TNCs establish an intra-regional division of labour, in the framework of which they upgrade production at home to more capital- and technology-intensive activities. These issues are at the centre of the debate on whether the southern African region can learn from the model of regional economic integration pioneered in South-East Asia where several groups of countries followed each other through stages of industrial development, driven by the dynamics of a changing intra-regional division of labour.[30] This process is often referred to as the "flying geese" model (originated by Kaname Akamatsu and further developed by, e.g., Kiyoshi Kojima and Terutomo Ozawa), with Japan generally labelled as the "lead goose". The "lead goose", in the course of its own development process, constantly develops new industries and passes on to the next-tier countries those in which it has lost competitive advantages.[31]

Recent trade liberalization measures have created additional pressures. Economic restructuring in South Africa is expected to have a substantial impact on several South African manufacturing industries. The overall outcome is expected to be a "relative shift in employment away from labour-intensive sectors" (Bell and Cattaneo, 1996, p. 23).

The need for restructuring is underlined by the findings of surveys of productivity in South Africa's manufacturing industries (Nordås, 1996). These suggest that South Africa's present trade regime has not helped the creation of globally competitive firms outside mining and energy. It is very likely that some industries will decline once exposed to global competition. South African policy makers have identified several industries (including aluminium, forestry, stainless and carbon steel) that could offset the negative effects of contraction in other industries (Maia, 1997). High unemployment makes the creation of new industries or the upgrading of existing ones all the more imperative. Trade liberalization also increases the need for restructuring in neighbouring economies.

However, it is not evident that restructuring will take place along the lines of relocating production through FDI from South Africa to other SADC members with lower labour costs only. This would tackle only some of the problems of low productivity and weak competitiveness. These are often due to deficiencies such as outdated management and organizational structures that cannot be solved simply by relocating production processes to areas with lower wage costs.[32] Also, an untapped reservoir of labour in South Africa suggests that the potential for labour-intensive production in that country has not yet been exhausted. In this connection, it is important to note that intra-regional restructuring does not refer solely to the relocation of production processes; partnerships and alliances with firms in neighbouring countries, for instance, as regard research-and-development activities, as well as cross-border subcontracting linkages, can increase the competitiveness of South African firms without necessarily implying a reduction in employment in South Africa.

Still, it seems quite probable that at least some South African firms will attempt to improve their efficiency by combining their firm-specific assets with the locational advantages of other countries. But how far is such interactive restructuring likely to go, and how closely will it follow the "flying geese" model of East and South-East Asia?

Some answers can be found by comparing the situation in southern Africa with the conditions that accompanied the TNC-assisted interactive restructuring process in Asia (UNCTAD, 1995a, pp. 260-261). The six conditions are: different levels of development; ability to restructure; sufficient demand and markets; market verification of restructured industries through internationally competitive exports; enabling framework for the transmission of TNC assets; and a favourable investment climate.

Of these conditions, only the first is met by the southern Africa region at present. Several indicators suggest that the region possesses complementary economic structures that could enable TNCs to take advantage of differences in comparative advantages in order to match their own tangible and intangible assets with those of individual host countries.

Although GDP per capita in a few countries in the region is on a par with that of South Africa (table II.6),[33] its level of development is significantly higher than that of most of them. This was also true of Japan *vis-à-vis* the Asian economies when the "flying geese" model took shape. Variations in GDP per capita in southern Africa are matched by differences in labour costs (table II.7), suggesting a comparative advantage in labour-intensive production processes for those countries in the region which already have a sufficiently developed industrial base. These cost advantages are enhanced by considerable disparities between labour laws, which, from an employer's perspective, seem more restrictive in South Africa than in neighbouring countries.[34] On the other hand, average figures for wages and GDP tend to mask the significant social and regional disparities within South Africa. Thus, wages for black workers are still far lower than the average (Standing *et al.*, 1996), and production is highly concentrated in the Gauteng-Province around Johannesburg, leaving some regions in the country at a lower level of development than others. However, South Africa's relatively rich endowment of human capital is conducive to the development of new industries, which could gradually replace those that are based primarily on an abundant supply of cheap labour.

Table II.6. Intra-regional disparities in GDP per capita levels in SADC (1994) and in East and South-East Asia (1970)

(Dollars and percentage)

SADC	GDP per capita 1994	GDP per capita levels in 1994 as share of South African GDP per capita in 1994	East and South-East Asia	GDP per capita 1970	GDP per capita levels in 1970 as share of Japanese GDP per capita in 1970
South Africa	2 554	100.0	Japan	7 307	100.0
Mauritius	2 846	111.4	Hong Kong	4 502	61.6
Botswana	2 731	106.9	Singapore	3 017	41.3
Namibia	1 577	61.7	Taiwan Province of China	2 188	29.9
Swaziland	1 158	45.3	Malaysia	2 154	29.5
Zimbabwe	636	24.9	Korea, Republic of	1 680	23.0
Zambia	410	16.0	Thailand	1 526	20.9
Lesotho	338	13.2	Philippines	1 403	19.2
Kenya	328	12.8	Indonesia	715	9.8
Malawi	178	6.9	China	696	9.5
Burundi	156	6.1			
United Republic of Tanzania	102	4.0			

Source: UNCTAD, based on Summers and Heston (1991), and data retrieved from Web site http://www.nber.org/pwt56.html.

As to the other conditions, good progress has been made in creating an enabling framework for FDI, as well as in implementing economic liberalization policies. However, most of the conditions necessary for the initiation of intra-regional restructuring are still far from being in place:

Table II.7. Annual average wages[a] and share of manufacturing in GDP in SADC countries, 1994
(Dollars and percentage)

Country	Annual average wages (Dollars)	Share of manufacturing in GDP (Per cent)
Botswana	4 354	3.9
Lesotho	1 838	13.1[b]
Malawi	878	20.4
Mauritius	..	20.8
Namibia	..	8.9
South Africa	9 348	22.8
Swaziland	3 895	29.0
United Republic of Tanzania	205	4.8
Zambia	1 660	22.0
Zimbabwe	2 239	30.4

Source: UNIDO, 1996.

a Includes supplements.
b 1990.

- *Ability to restructure*. While there is a need for industrial restructuring in South Africa and in other SADC member states, the ability to undertake it seems at present far more limited than in East and South-East Asia. Firstly, unlike Japan, South Africa faces high levels of unemployment. Any significant relocation of production processes -- should it occur -- is therefore likely to induce far more political resistance in South Africa than it did in Japan, though it must be taken into account that not all employment-creating investment in neighbouring countries necessarily leads to employment reduction in South Africa, but rather -- as happened in East and South-East Asia -- it can also contribute to an upgrading of domestic employment. The high rate of unemployment also dampens prospects for fast wage increases, an important incentive for interactive regional restructuring assisted by TNCs. Second, at present it remains unclear whether South Africa possesses capabilities similar to those of Japan in creating new, dynamic, world-competitive industries. While Japan's share of world exports was almost 9 per cent as long ago as 1970, South Africa's was only 0.3 per cent of world exports in 1994.[35] The fact that foreign investors in South Africa ranked the lack of a well-educated work force as a major investment impediment seems to point in the same direction (Blank, 1996, pp. 265-266). Finally, lower levels of education limit the ability of most countries in the region to implement a restructuring process, to increase productivity and to absorb TNC assets (e.g., new technologies) (table II.8).

- *Demand and markets*. At present it is unclear whether extraregional and intra-regional demand will develop dynamically enough to sustain a regional restructuring process. In Asia, demand from the United States for goods produced in intra-Asian production networks drove the expansion of manufacturing production. In sub-Saharan Africa, extraregional demand so far focuses on primary commodities. But some recent developments could alter this situation. South Africa has become a partial member of the Lomé Convention between the European Union and the African, Caribbean and Pacific (ACP) States, receiving preferential tariffs for goods produced in South Africa that use inputs from ACP countries. In addition, the United States is considering an Africa package supporting United States' investment in Africa and helping countries to gain better trade access to United States' markets through substantial trade concessions (even in areas such as textiles).[36] However, any regional interactive restructuring process in neighbouring countries will depend

on stronger demand from South Africa for goods other than raw materials.[37] According to a recent study (International Trade Centre, 1997, p. 8), the main export opportunities South Africa offers neighbouring countries lie in low-processed food products and in some manufactured goods, in particular textiles.[38] Though South Africa is becoming an increasingly important trading partner for many sub-Saharan economies, overseas demand will also remain important to stimulate the traditional production of unprocessed, low value-added primary commodities.

- *Market verification of restructuring through exposure to international competition*. Any industry that has emerged from a restructuring process has to prove itself in competition with foreign competitors. Outward liberalization is important in this respect. Recent trade liberalization initiatives on the national, as well as regional, level points in this direction, though there is still much scope for further action. These measures could be buttressed by domestic initiatives to strengthen firms' competitiveness, such as the South African cluster strategy.

- *Enabling framework for the transmission of TNC assets*. The transmission of such TNC assets as capital, technology and management know-how requires a set of increasingly liberal policies at national and regional levels. In sub-Saharan Africa, despite a general trend towards more liberalization, there is still room for improving the enabling framework. In particular, foreign-exchange controls are often cited as significant obstacles to cross-border investment.[39] Also, bilateral investment agreements within the region are rare.[40] However, this was not much different in Asia in the early stages of the restructuring process.

- *A favourable investment climate*. The lack of a comparatively favourable investment climate seems to be one of the most important impediments retarding a TNC-assisted regional integration process as reflected, for instance, in very low figures for domestic investment in recent years. Most countries in the region need to foster political stability, improve the efficiency of public administration, upgrade existing infrastructure and ease social problems, particularly poverty. These problems are not easy to tackle in the short run. However, innovative approaches have been developed to overcome at least some of these by joint action (box II.7).

Table II.8. Enrolment ratios in selected SADC countries (1993) as compared to selected South-East Asian economies (1970)
(Percentage)

SADC	1st level	2nd level	3rd level	East and South-East Asia	1st level	2nd level	3rd level
Angola	88	14	0.7	Japan [a]	99	92	24.6
Botswana	115	57	3.7	Korea, Republic of	103	42	16
Lesotho	48	26	2.3	Malaysia	87	34	4
Malawi [b]	80	4	0.9	Thailand	83	17	13
Mozambique	60	7	0.4	Taiwan Province of China	98 [c]	66 [c]	18
South Africa [d]	117	82	15.9				

Source: UNESCO, 1995 and 1996.

[a] 1975.
[b] 1992.
[c] 1976-1978.
[d] 1994.

iii. Conclusions

While there is a potential for South Africa to become a regional growth pole, it is unlikely to initiate vigorous TNC-assisted interactive regional restructuring processes in the near future. This is also reflected in the natural resource-seeking, rather than efficiency-seeking, character of most FDI flows from South Africa to neighbouring countries. At present, the "geese" do not seem to be ready for take-off. Rather, they are still in the "nest-building" stage.[41] National efforts are paramount in this respect. But they could benefit substantially from regional cooperation and international support. South Africa could lead the way by further reducing the remaining barriers to outward FDI to her SADC partners.

Box II.7. The Maputo development corridor

Since the opening up of the port of Maputo in 1996, the Governments of South Africa and Mozambique have developed a number of activities to spur economic development in the region between Johannesburg and Maputo (including the South African provinces of Mpumalanga and Kwazulu/Natal), including the establishment of a joint investment promotion company and the upgrading of railway links and other infrastructure facilities. The private sector responded to these new developments: according to the Development Bank of Southern Africa, investment commitments by South African (as well as other) firms have reached $2 billion. Most of these commitments are in mining, chemicals and agro-processing industries. Many investors are attracted by the location of Maputo, the nearest port to South Africa's industrial heartland around Johannesburg. They are also attracted by the prospects of cheap energy supplies, which may come in the near future from planned hydropower plants in the north of Mozambique. The infrastructure facilities in the corridor, including the Maputo port and the railways between Maputo and Johannesburg, are to be privatized and thus may offer additional investment opportunities for foreign companies in the corridor. The project might serve as a successful example for further joint initiatives to attract foreign investors. Further development corridors of the same type in other parts of South Africa are planned as part of the "spatial development initiative" of the Government of South Africa that focuses on the development of certain regions. [a]

[a] Jourdan and Gordhan, 1996.

3. Latin America and the Caribbean

(a) Trends

In the period of volatility in portfolio investments in Latin America and the Caribbean in 1995, FDI inflows into the region registered small increases overall, despite substantial ones into individual countries. By contrast, in 1996, FDI flows to the region increased significantly, by 52 per cent, to nearly $39 billion, a record level. The region accounted for 30 per cent of all FDI inflows received by developing countries. Investment flows are also becoming more diversified in terms of recipient countries than they were in the beginning of the 1990s. In 1996, eight countries received average inflows of over $1 billion, compared with only two countries in 1990. Particularly significant have been investments in mining (Chile and Peru), petroleum (Colombia, Ecuador and Venezuela), manufacturing (Argentina, Brazil and Mexico), and in export-oriented activities in Mexico's *maquiladoras* and in some Central American and Caribbean countries. Transnational corporations, especially in automobiles, are integrating Latin America more extensively into their global strategies.

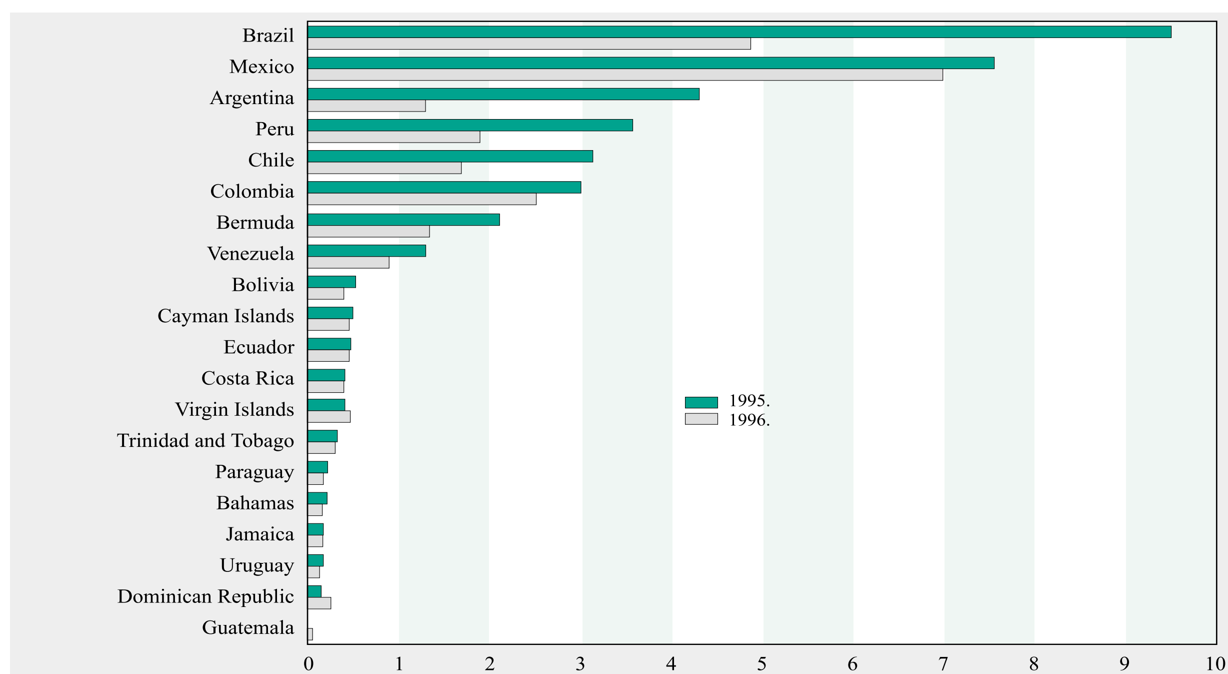
With nearly $10 billion, Brazil was the largest recipient of FDI inflows, easily topping Mexico (nearly $8 billion). This represents a dramatic reversal: in 1992, when Mexico received over $4 billion and Argentina nearly $3 billion, Brazil received only $2 billion. Brazil's impressive FDI performance

in 1996 may be an indication of things to come. Inflows for the first four months of 1997 were over $4 billion — two and a half times that of the same period in 1996.[42] A survey by the Government found that FDI funds worth some $221 billion are ready to enter Brazil between 1996 and 2000.[43] At the same time, the re-activation of Brazil's privatization programme, in which foreign-investor participation is expected to be substantial, could generate more than $12 billion worth of FDI between the same years. The automobile industry has proven to be particularly attractive. Several large TNCs have made investments or announced plans to do so.

After a slump in 1994 and 1995, FDI inflows into Argentina showed the second largest increase of all countries in Latin America in 1996 (after Brazil), to about $4.3 billion, placing that country again high in the league of Latin American recipients (figure II.14). (In relation to gross domestic capital formation, however, Argentina is in seventeenth place; see figure II.15.) The main factors were privatization schemes that encouraged the participation of foreign enterprises and foreign banks, membership of MERCOSUR -- in particular the benefits of a regulatory framework for the automobile and auto-parts industries and provision of preferential financing means -- and recent liberalizations in mining legislation (Chudnovsky, Lopez and Porta, 1997). As in Brazil, this increase may be the beginning of a period of sustained inflows. In particular, the automobiles, food and beverages, mining, oil and petrochemicals, construction and telecommunications industries are expected to receive up to $23 billion in FDI until the year 2000.[44]

During the first half of the 1990s, FDI flows to Mexico were concentrated in services, especially in the case of privatization programmes. Having reached a record FDI level of $11 billion in 1994, Mexico's inflows declined in 1995, but increased somewhat in 1996. Mexico's prospects for more FDI flows are good, especially in the automobile industry. For example, Volkswagen (Germany) had announced investments of $500 million for the period 1995-1996. The change in Mexico's policy on

Figure II.14. FDI flows into the top 20 countries in Latin America and the Caribbean, 1995-1996
(Billions of dollars)



Source: UNCTAD, FDI/TNC database and annex table B.1.

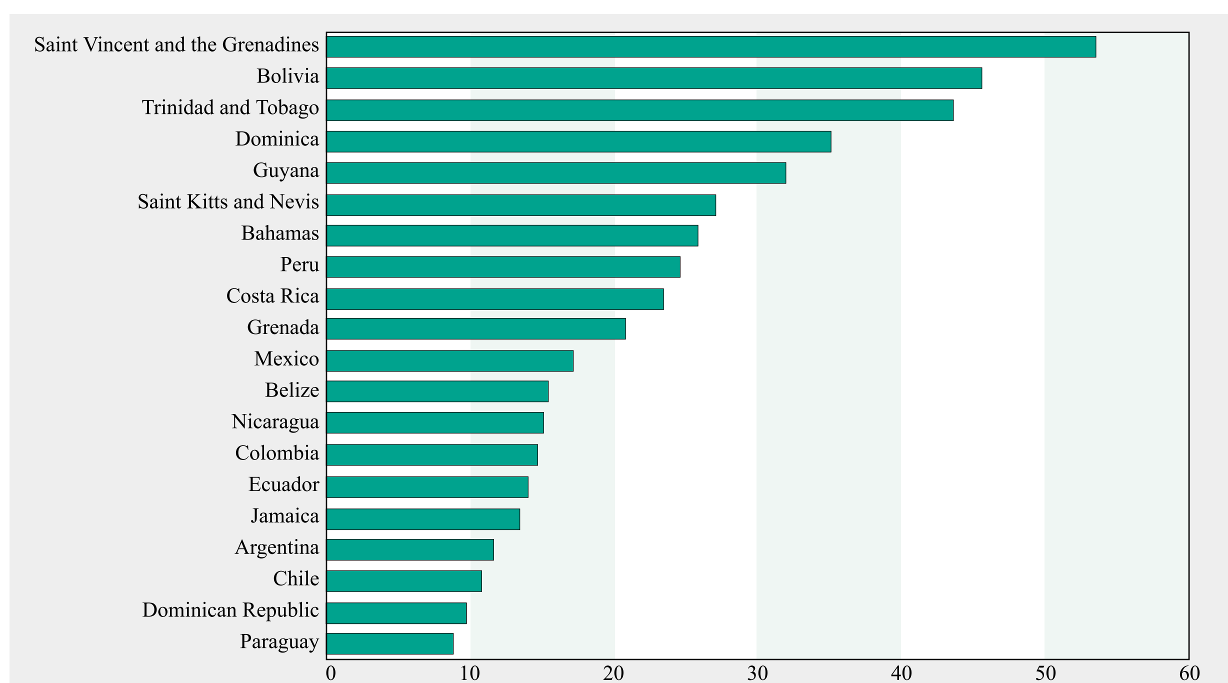
petrochemical privatization may pull in investment, even though the Government decided to retain 51 per cent of the capital of existing petrochemical plants. (But it also authorized, in 1997, the establishment of new firms in that industry in which the private sector could have participation up to 100 per cent.)

During the first half of the 1990s, FDI flows to the region had been influenced heavily by privatization programmes implemented by various countries. In 1996, privatizations accounted for almost a quarter of all FDI inflows, compared to a half in 1993. Investment flows to Latin America are now increasingly in the form of greenfield investments. Even in privatized firms, sequential FDI flows aimed at modernizing the existing facilities take the form of greenfield investments. Latin American privatizations, however, are far from being completed. While, according to some estimates, about $60 billion worth of state-owned assets have been sold, a further $70 billion worth of such assets are likely candidates for privatization (Dermota, 1996, p. 52). Therefore, there is still considerable potential for privatization-associated FDI.

The main trends among sources of FDI for Latin America and the Caribbean are:

- The United States remains the foremost foreign investor in the region. Cumulative FDI flows from the United States during the period 1990-1995 reached nearly $66 billion and accounted for about 58 per cent of Latin America's total cumulative investments.[45] According to the United States Department of Commerce, United-States TNCs are now investing more heavily in Brazil than in any other foreign country,[46] and will continue to account for the majority of that country's inward FDI.

Figure II.15. FDI inflows as a percentage of gross fixed capital formation in the top 20 countries in Latin America and the Caribbean, 1995
(Percentage)



Source: UNCTAD, FDI/TNC database and annex table B.5.

- Canada's FDI is concentrated largely in mining in virtually every country in Latin America and the Caribbean. Exploration budgets for Latin America of Canadian mining companies increased from 16 per cent of their total budgets in 1992, to 42 per cent in 1995.[47] One company, Falconbridge, has moved its headquarters from Canada to Santiago, Chile.

- European FDI flows to Latin America and the Caribbean increased by 39 per cent in 1995, to nearly $6 billion -- a historic high (IRELA and IADB, 1996). The members of MERCOSUR received more than a half of European Union FDI flows to that region (IRELA and IADB, 1996). The main destinations were Brazil ($2 billion), Argentina ($1 billion) and Mexico ($880 million). Germany and Spain are the largest European investors in that region. Most European FDI is concentrated in natural resources and services, with energy and telecommunications being the primary recipients in the context of privatization plans. Almost a half of Europe's FDI to Latin America came through privatizations schemes, with Spain, Italy and France being the most active investors through such schemes. However, in 1995 and 1996, European investment has become more prevalent in the manufacturing sector, especially through large investments by German, French and Italian automobile TNCs in MERCOSUR. The Framework Agreement of 15 December 1995 between the European Union and MERCOSUR is likely to encourage further European FDI in that region.

- Japan's share of Latin America's FDI inflows remains low (about 13 per cent in 1995). Japanese FDI in Latin America is concentrated mostly in finance and insurance (34 per cent) and transport (32 per cent). The region remains the second largest target for Japanese outward investment to developing countries. Some 70 per cent of Japanese investment in Latin America is in tax havens (the Cayman Islands and the Virgin Islands) and another one-fifth is in Brazil and Mexico.

- Intra-regional investment has increased substantially in recent years. During the 1990s, intra-regional FDI was about $7 billion. Chile was in first place, with nearly $5 billion as of March 1997, followed by Brazil ($935 million) and Argentina (with $899 million). The main destinations are Argentina and Peru (receiving nearly $4 billion and about $1 billion, respectively, from Chile), followed by Venezuela (receiving $601 million from Colombia).

- Investment flows from Asian developing economies (in particular, China, India, Hong Kong, Malaysia and Singapore) continued to leave their mark in the region, particularly for trade-supporting purposes and in the manufacturing of consumer goods (electronics, bicycles and textiles). Investments by Asian TNCs are mostly market-seeking, spurred by the region's recent integration efforts (MERCOSUR).

*   *   *

Several recent surveys and forecasts suggest that FDI flows to Latin America and the Caribbean are likely to increase considerably during 1997. According to a survey of the *Fortune* 1000 companies by the Bank of Boston, 80 per cent of the executives surveyed are more confident of Latin America's business prospects than they were five years ago.[48] Foreign investors placed Mexico and Brazil in first and second place, respectively, and Chile in third place. The Institute of International Finance estimated that FDI flows to Latin America and the Caribbean will increase in 1997, with Brazil receiving the bulk of inflows ($13 billion), followed by Mexico ($8 billion), Colombia ($3 billion) and Chile (1.5 billion).[49]

(b) A regulatory shift

Over the past few years, Latin American and Caribbean countries have undertaken a number of changes regarding their treatment of FDI. In particular, they:

- have significantly modified their national investment regimes, liberalizing the conditions under which foreign investors operate;
- have entered into numerous BITs with developed countries and, increasingly, among themselves;
- have implemented new regional — or, specifically, subregional — arrangements to deal with FDI;
- are now considering negotiating a hemispheric-wide investment agreement, within the context of the Free Trade Area of the Americas (FTAA) initiative, involving the entire Western hemisphere.

The revival and recent dynamism of economic integration has been accompanied by an expansion of intra-regional investment flows which, in turn, has encouraged the negotiation of investment arrangements among the countries of the region, either bilaterally or in the context of the various existing trade and economic integration agreements.

The driving forces behind these various initiatives are twofold:

- the comprehensive economic reforms implemented by most, if not all, countries of the region since the mid-1980s; and
- the reactivation of regional economic integration.

The policy reforms led to a substantial shift in economic theory and practice throughout the region as countries decided to replace their traditional, inward-oriented policies by a development strategy meant to enhance their participation in the world economy. This new strategy required a new approach to FDI. Up to the mid-1980s, what permeated FDI regimes was the idea of control: countries established controls for the entry of TNCs, controls for their operations after they were established, controls on the remittance of profits and other dividends, controls for the transfer of technology, exchange controls and so on. Latin American and Caribbean countries sought to control what they perceived were the negative effects of FDI; this "controlling" philosophy was, of course, fully consistent with the economic model in place in most countries at that time.

The opening of the region's economies in the late 1980s and early 1990s also brought a liberalization of investment regimes. Just as the protected economies of the past required a restrictive investment framework, the trade-liberalizing economies of the present are seen to demand open investment policies. Policy coherence is meant to maximize the positive effects of the overall development strategy of any particular country. The changes effected by Latin American and Caribbean countries regarding their national investment regimes are characterized as follows:

- The *de facto,* if not *de jure,* granting of national treatment to foreign investors. The previous policies tended to discriminate against foreign investors by denying them certain privileges to which only nationally owned firms were entitled, i.e., access to local financial markets.
- The elimination or significant reduction of controls on profit and capital remittances. Before, it was common to request from foreign investors that they send only a percentage of their profits abroad.

- The opening of entire industries that were previously closed to foreign investors, e.g., public utilities, banking and petroleum.

- The establishment by many governments of investment-promotion agencies -- sometimes in conjunction with the private sector -- to stimulate investment by foreign and national investors in their respective countries.

These changes are the foundations on which Latin American and Caribbean countries have built their network of bilateral and regional investment arrangements. These arrangements are intended to encourage investment from the participating countries and, increasingly, to protect their own investments, i.e., indigenous investment originated in the Latin American and Caribbean countries. In looking at agreements negotiated among the Latin American and Caribbean countries, as well as those negotiated by them with the United States and Canada (i.e., the investment agreements concluded in the Americas), the following characteristics stand out.

First, the number of agreements: as of 1 January 1997, there were 53 BITs between the countries of the Americas, 50 of which were negotiated in the 1990s. Thirty-seven of these BITs were negotiated between Latin American and Caribbean countries; only nine BITs have been concluded by the United States with other countries of the region, and seven have been negotiated by Canada. In addition to BITs, there are eight investment arrangements negotiated in the context of the existing trade and integration agreements, five of which are of a subregional nature: the NAFTA and the Group of 3 (Colombia, Mexico and Venezuela) chapters on investment, two protocols on investment concluded by the MERCOSUR countries,[50] and a decision on investment taken by the Andean Group.[51] The remaining three arrangements are chapters in the bilateral free trade agreements negotiated by Bolivia and Mexico, Costa Rica and Mexico and Chile and Canada; although bilateral in nature, these three agreements are not BITs as they cover a broader range of issues than do BITs.

Second, the various investment arrangements share important common features. A broad consensus has emerged in the Americas on issues that seemed controversial not long ago. Common approaches have been adopted in investment agreements in such areas as scope of application, treatment of investment, transfers, expropriation and dispute-settlement. More specifically:

- The investment instruments have a broader scope of application than traditional agreements as the definition of investment has been expanded to cover new forms of transactions, such as intellectual property rights, and are being applied to a more diverse group of investors, including natural persons. In addition, most treaties and agreements, such as the NAFTA chapter on investment and the two MERCOSUR Protocols, include standard provisions, such as “fair and equitable” treatment.

- The agreements also provide for national treatment and most-favoured-nation treatment for foreign investments once they have been admitted by the host country. The arrangements normally state that each party shall grant treatment “no less favourable” than that accorded to investments of its own nationals or companies, or those of third states. The arrangements also contain exceptions to national and most-favoured-nation treatment, of which the most common are related to privileges granted to certain investments in the context of economic integration schemes.

- The investment arrangements require the host country to guarantee the free transfer of funds related to investments. Almost all treaties define in great detail which types of payments should be included in the transfer clause. These generally refer to

returns (profits, interest, dividends, and other current incomes); repayment of loans; and proceeds of a total or partial liquidation of an investment. Most treaties also stipulate that transfers should be effected in a convertible currency. It is normally stated that transfers shall be made at the normal exchange rate applicable on the date of the transfer, and without delay. There are some exceptions or limitations on transfers, due for instance to balance-of-payments problems.

- The agreements prohibit the expropriation of investments except in specified conditions. They typically require that expropriations be made only for a public purpose, in accordance with due process of law, and on payment of compensation, which should be "prompt, adequate and effective". All BITs provide for disputes between states concerning the interpretation or application of the treaty to be submitted, at the request of either party, to *ad hoc* arbitration tribunals. Arbitration, however, has to be preceded by consultations, and disputes shall, whenever possible, be settled amicably through consultations or diplomatic channels.

- All investment treaties and agreements include separate provisions dealing with disputes between a contracting party and an investor, and contemplate arbitration as a means of dispute-settlement. This constitutes a major departure from traditional practice in Latin American countries, which have followed the Calvo doctrine. This holds that disputes between a foreign investor and a host country should be handled by the courts, and according to the law, of the host country. Thus foreign investors were limited to bringing claims against the host state in a domestic court or having their home countries assume their claims against the host state (diplomatic protection). The agreements normally refer to specific institutional arbitration mechanisms, including the ICSID Convention (or the ICSID Additional Facility Rules, in cases in which either the host or home state of the foreign investor is not an ICSID contracting party).

As well as many common features, the arrangements concluded by countries in the Americas also contain differences. The most important are related to the entry and establishment of investments and investors. Two approaches have been adopted in the agreements concluded among countries of the region. Newer instruments, such as the Colonia Protocol, and the chapters on investment in the NAFTA and other free-trade agreements, as well as the BITs signed by the United States and Canada, call for national treatment and most-favoured-nation treatment of both the pre-establishment phase (entry) and the post-establishment phase, and prohibit performance requirements as a condition for establishment. In the other bilateral and regional investment agreements, the national treatment and the most-favoured-nation standards are only applied at the post-establishment phase.

In addition to the existing investment agreements, three of the countries of the Americas (the United States, Canada and Mexico) are participating in the OECD negotiations on a Multilateral Agreement on Investment. The countries of the Americas have also been discussing the elements of a hemispheric-wide agreement on investment and have set up, in the context of the FTAA, a working group dealing specifically with this issue. This working group has been meeting since late 1995, and has already identified the main elements that may be included in such a hemispheric agreement.

4. South, East and South-East Asia

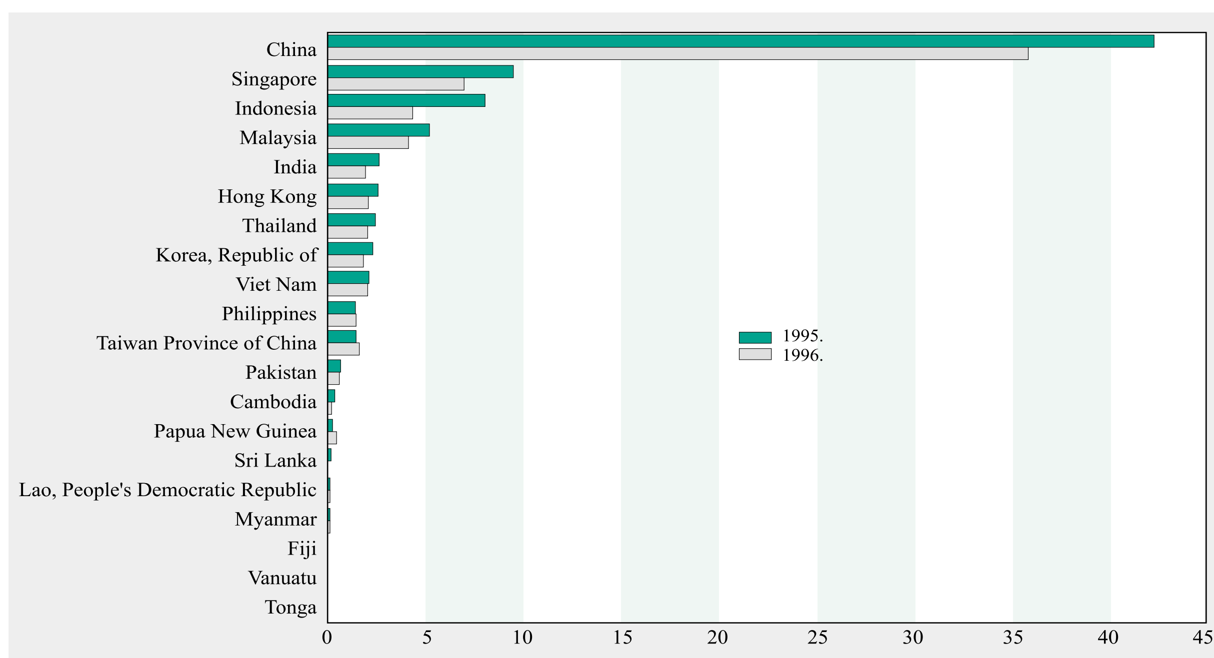
(a) Trends

Inflows of FDI into South, East and South-East Asia rose 25 per cent in 1996, to a record $81 billion. That represented about two-thirds of all developing-country FDI inflows. The increase shows foreign investors remain confident about the region's long-term prospects, despite a slowing in its export growth and, to a lesser extent, GDP growth.

China, with $42 billion in 1996, was once again the largest FDI recipient among developing countries, and the second largest in the world. China accounted for over two fifths of the $16 billion increase of FDI inflows into the region (figure II.16). Inflows into China set a new record, partly because of the rush of foreign investors to establish and implement FDI projects before the enactment of policies that would abolish some of the preferential treatment for foreign investors (on 1 April 1996, with an extension of six months for certain types of projects). Another factor has been the Government's recent efforts to promote FDI to mid-west provinces that offer such locational advantages as rich natural resources and low-cost labour and land. Foreign investors have shown a growing interest in these provinces, where inflows increased by over 35 per cent, compared with 18 per cent for the country as a whole in 1996. In addition, a successful "soft landing" and continuing macroeconomic reforms;[52] further liberalization of the FDI regime for some industries (particularly those that had been opened only partially and on a trial basis in the past); and the continued consolidation and expansion of investments by large TNCs; have all contributed to China's successful FDI performance.

Investments into the newly industrializing economies of Hong Kong, Republic of Korea, Singapore and Taiwan Province of China in 1996 increased by about 27 per cent over the previous year. Singapore was the star performer, maintaining its lead as the second largest recipient in the

Figure II.16. FDI flows into the top 20 countries in South, East and South-East Asia and the Pacific, 1995-1996
(Billions of dollars)



Source: UNCTAD, FDI/TNC database and annex table B.1.

region. Combined inflows to the other three newly industrializing economies, at $6 billion in 1996, were below Singapore's $9 billion. Electronics was the leading recipient industry for the Republic of Korea, Singapore and Taiwan Province of China, and services were the biggest recipient for Hong Kong. For decades, Hong Kong has been one of the most important international business centres in the region; however, there has been some concern whether that position can be maintained after its return to China. Results of recent surveys have shown that foreign investors have confidence in the future of Hong Kong, China as a regional business centre (box II.8).

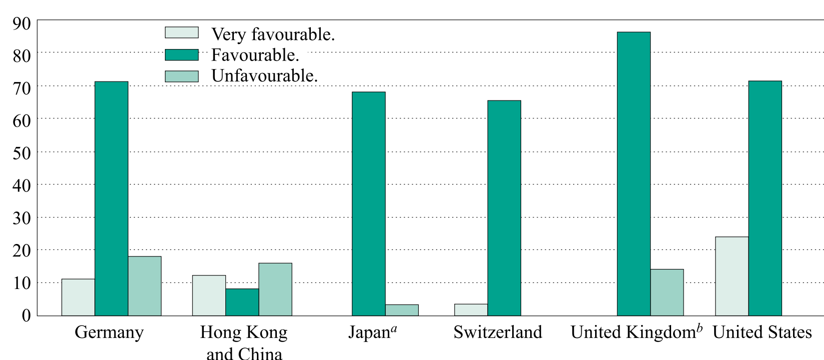
Box II.8. Foreign investors' confidence in Hong Kong, China, after reversion

Hong Kong, China has emerged as a major regional trade, financial and business-services centre. With annual average outflows estimated at over $20 billion during 1993-1996, Hong Kong, China is the world's fifth largest FDI source economy.[a] It is also a major recipient of FDI, attracting an average annual flow of about $2 billion in the 1990s. According to Hong Kong's Industry Department, Hong Kong's manufacturing FDI stock has quadrupled between 1984 and 1995. Accumulated investment from China during 1985-1995 is estimated to have exceeded $10 billion (Zhan, 1995). The United States, the United Kingdom and Japan have also obtained sizeable stakes in Hong Kong.

Hong Kong became a "Special Administrative Region" of China on 1 July 1997. According to the scenario of "one country, two systems", within one sovereign State, the territory will retain its own economic, financial and social systems. Hong Kong, China is to remain autonomous for another 50 years in all areas except defence and foreign affairs. How is foreign investors' confidence going to be affected now that Hong Kong's sovereignty has reverted to China?

During the second half of 1996, the chambers of commerce of Germany, Japan, Switzerland, the United Kingdom and the United States conducted surveys of their respective foreign affiliates in Hong Kong (box figure).[b] These surveys found that 83 per cent of companies surveyed expected Hong Kong, China's business environment in the next five years to remain favourable. About 45 per cent of the companies plan to expand their presence in Hong Kong, China through additional investment. The vast majority of the respondents (80 per cent of the German firms) aim at launching strategies to penetrate China's market via Hong Kong, China to take advantage of the territory's considerable experience of doing business in China and its excellent business infrastructure.

Box figure. Hong Kong, China investment climate assessments for the second half of the 1990s



Source: UNCTAD, based on Delegate of German Industry and Commerce: Hong Kong, South China, Viet Nam and German Association of Hong Kong (1996); Hong Kong Companies Registry (1996); "Japanese firms adopted cautions attitude", *Nihon Keizai Shimbun*, 17 October 1996; Swiss Business Council of Hong Kong (1996) and American Chamber of Commerce in Hong Kong (1996).

[a] "Favourable" includes unchanged assessments.

[b] "Favourable" includes "very favourable".

/...

(Box II.8, cont'd)

Similar findings emerged from a survey by the Hong Kong Trade Development Council in 1995. Over 92 per cent of the 2,500 local and foreign trade and manufacturing companies surveyed said they would keep their regional headquarters in Hong Kong, China after 1997, while most of the remaining firms said they would move to China. Nearly all of the respondents expected to stay in Hong Kong, China well beyond 1997.

The steady increase in the establishment of regional headquarters and regional representative offices set up by TNCs in Hong Kong, China also demonstrates business confidence. According to the Hong Kong Companies Registry (1996), the number of foreign regional representations in Hong Kong reached 2,307 as of late 1996, an increase of 12 per cent over 1995 (box table). The most significant increase -- 600 per cent between 1993 and 1996 -- was recorded by companies from Taiwan Province of China. During the same period, 106 new United States companies registered in the territory (American Chamber of Commerce in Hong Kong, 1996). An increasing number of Japanese trading houses are moving their textile-business headquarters to Hong Kong, China.

Box table. TNC regional representations in Hong Kong, 1996

Item	United States	Japan	United Kingdom	China	Rest of the world	Total
Regional headquarters	188	122	90	85	331	816
Regional representative offices	226	338	123	128	676	1491
Total	414	460	213	213	1007	2307

Source: UNCTAD, based on data provided by the Hong Kong Industry Department.

Nevertheless, the general sense of optimism is tempered with cautious pragmatism. For example, 52 per cent of the Swiss companies in Hong Kong, China have drawn up contingency plans in case Hong Kong, China's evolution does not live up to expectations. Some firms have also adopted a "wait-and-see" approach to short-term plans during Hong Kong's transition, but believe that business will be back to normal by 1998.

Overall, the surveys of foreign investors have found that Hong Kong, China's geographical proximity and trade and investment links with China, low taxation and free trade policy and the financial, communications and transport infrastructure are enduring attractions for FDI. The political climate was ranked eleventh place in a list of seventeen factors likely to affect investment decisions according to the *1996 Survey of External Investment in Hong Kong's Manufacturing*, and seventh in a list of sixteen factors according to the *1996 Survey of Regional Representation by Overseas Companies in Hong Kong*. Cost considerations, which have been a concern for companies doing business in Hong Kong, China, overshadowed by political uncertainty, could re-emerge in the medium-term as the factor most detracting from Hong Kong, China's business environment. Recent increases in commercial property rentals are expected to be followed by increases in residential rentals and labour costs.

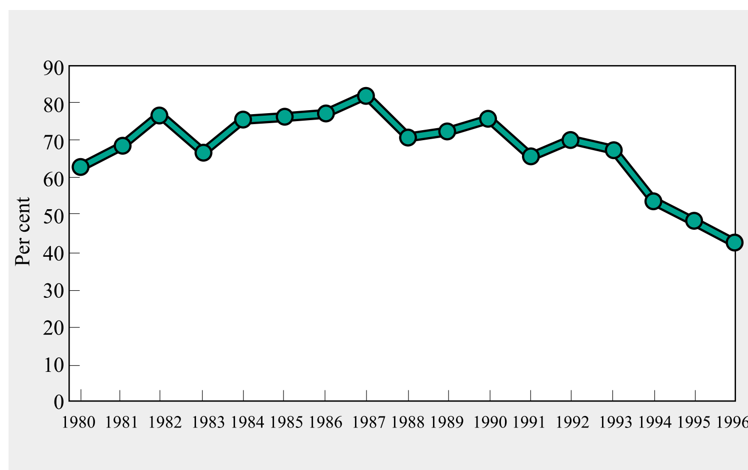
Should China remain on a stable course of development with continued reform and liberalization, then Hong Kong, China stands a good chance of sustaining its favourable investment environment. In the meantime, Hong Kong, China's continued prosperity after 1997 contributes to China's economic development. However, Hong Kong, China is being used less and less as a gateway for FDI into China and also less and less as a "window" for China onto the outside world, reflecting China's openness and the increasing role of some coastal cities such as Guangzhou, Shanghai and Xiamen, as well as the preference of both foreign and Chinese firms to have direct transactions to save costs and time.

[a] It should be noted that about 30 per cent of this investment is indirect FDI, i.e., investment by foreign affiliates in Hong Kong, China, and more than half of it is directed towards China (UNCTAD, 1997b).

[b] According to Hong Kong's Industry Department, investment from these five countries accounted for 61 per cent of the total FDI stock in Hong Kong, China. Investment from China accounted for another 20 per cent.

Flows into four ASEAN member countries (Indonesia, Malaysia, the Philippines and Thailand) increased by 43 per cent in 1996, to an estimated $17 billion. This was attributed to the significant growth experienced in Indonesia, Malaysia and Thailand, while flows into the Philippines fell below the 1995 level. Despite absolute increases in FDI over the past six years, ASEAN economies as a whole (i.e., including Brunei Darussalam and Viet Nam) have experienced sharp decreases in their share of inflows to South, East and South-East Asia, from 61 per cent during 1990-1991 to over 30 per cent during 1994-1996 (figure II.17). One reason is that ASEAN countries have faced domestic capacity constraints and infrastructure bottlenecks, while other economies in the region are now offering low labour costs and attractive incentives to foreign investors. Similar circumstances also helped to propel the earlier FDI take-offs of the ASEAN economies. ASEAN is now responding by proposing an ASEAN Investment Area to enhance its attractiveness to foreign investors. While the ASEAN Investment Area is still at the design stage, the types of activities planned -- ranging from coordination of legal and regulatory measures for further investment liberalization to information exchange, training, promotion, facilitation and network activities -- will widen the scope for investment in the member States.

Figure II.17. Share of ASEAN[a] in total flows into South, East and South-East Asia, 1980-1996
(Percentage)



Source: UNCTAD, FDI/TNC database.

[a] Includes Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam.

Viet Nam experienced a dramatic decrease of FDI contractual commitments during the first eleven months of 1996 but, at the end of that year, two large projects pushed the year's FDI commitments to a record-breaking $9 billion, a 29 per cent increase over the previous year.[53] The increase in actual investments, however, was much smaller -- 8 per cent compared with 169 per cent in 1995.

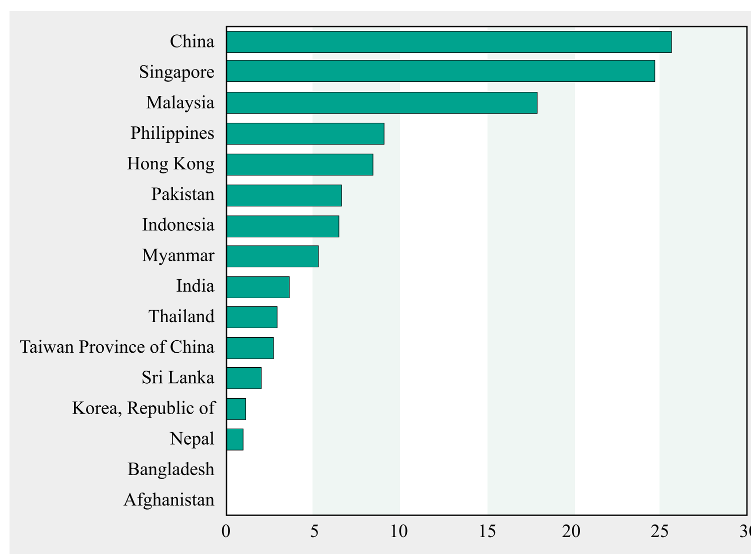
Investment flows to South Asia rose to about $3.5 billion in 1996, mostly reflecting a remarkable increase of about 34 per cent in flows to India. After a 47 per cent increase in 1995, inflows to India reached an estimated $2.6 billion in 1996. For the first time in recent years, FDI overtook portfolio investment, which accounted for the largest share of private capital inflows into that country.[54] The Government of India has stepped up its efforts to attract FDI, including investments from overseas Indians, in an effort to raise annual inflows to $10 billion. Recently, India has become an attractive FDI location for Asian newly industrializing economies. Indeed, the pace of investment from the Republic of Korea in India is outstripping even that of the United States and the United Kingdom, traditionally India's biggest trade and investment partners.[55] Firms from the Republic of Korea plans to invest $4 billion in India in the next two years.[56] FDI flows to the rest of the economies in South Asia remain low, but are growing.

Flows into the Pacific economies were an estimated $375 million in 1996, a decline from their 1995 peak of $590 million. Papua New Guinea continued to be the largest host economy in the Pacific.

Ranking the countries of the region by the ratio of FDI flows to gross domestic capital formation in 1995 reveals that FDI has played a significant role (about a quarter) in China, Singapore and Malaysia (figure II.18). For most of the other economies in that region, however, the ratio is less than 10 per cent. Fiji, Papua New Guinea and Vanuatu, however, enjoyed particularly high ratios of FDI flows to gross domestic capital formation. Malaysia has the highest ratio of inward FDI stock to GDP, followed by Singapore, Indonesia, Hong Kong and China (figure II.19). The shares of FDI inflows in gross fixed capital formation and FDI stock in GDP for the entire region in 1995 were 9 per cent (8 per cent in 1994) and 15 per cent (14 per cent in 1994), respectively. While there is a general recognition that FDI has contributed to South, East and South-East Asia's growth and development, the question has also been raised whether the large current account deficit in some economies can be attributed to the fast growth of FDI inflows (discussed below).

Figure II.18. FDI inflows as a percentage of gross fixed capital formation in South, East and South-East Asia, 1995

(Percentage)

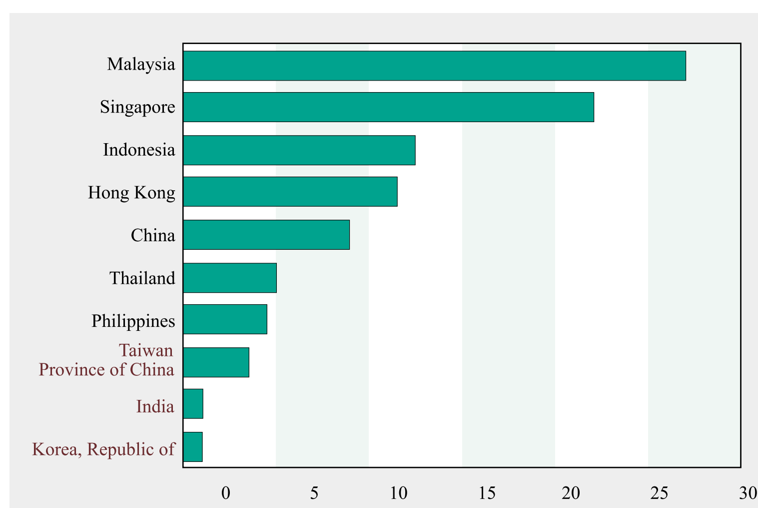


Source: UNCTAD, FDI/TNC database.

Intra-regional investment remains the principal FDI source for the region, despite the remarkable growth of FDI by TNCs from developed countries. For the major Asian developing economies, the FDI stock attributed to other Asian developing economies, at nearly 40 per cent, is still larger than that from either Europe, Japan or the United States (UNCTAD, 1997b, p. xiv). The "flying-geese" process of regional industrial restructuring remains the driving force behind intra-regional flows, with more and more countries taking part. To keep moving up the value-added chain of production and stay competitive, the newly industrializing economies are competing to become regional business centres, trying to attract FDI in services and high-technology industries, while the four ASEAN countries and China have adopted a more selective approach to FDI, targeting

Figure II.19. Inward FDI stock as a percentage of GDP in selected host economies, 1995

(Percentage)

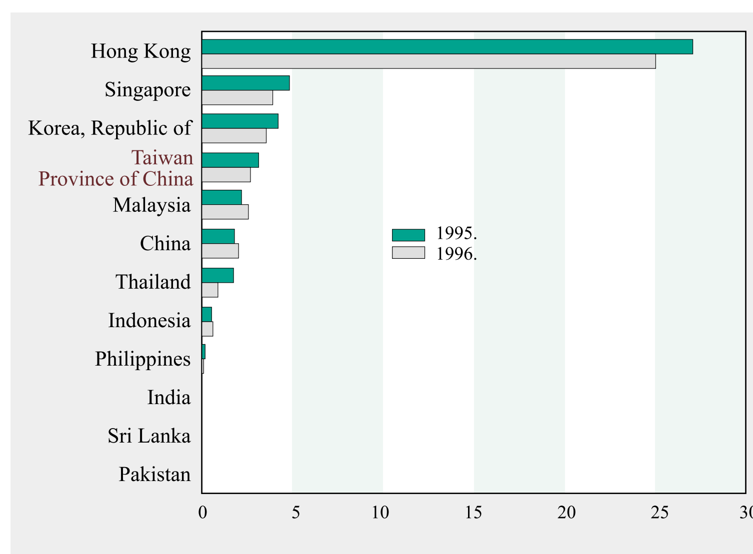


Source: UNCTAD, FDI/TNC database and annex table B.6.

"qualitative investments" for upgrading their industrial bases. In the meantime, the rising costs of land and labour have increased the speed at which firms based in the newly industrializing economies are moving labour-intensive activities to other parts of the region, including LDCs (see above).

Figure II.20. FDI outflows from South, East and South-East Asia, 1995 and 1996

(Billions of dollars)



Source: UNCTAD, FDI/TNC database and annex table B.2.

Investment outflows from the region rose by 10 per cent in 1996, to $46 billion, with Hong Kong topping the league of outward investors (figure II.20). The region accounted for 89 per cent of FDI outflows from all developing countries in 1996, and four fifths of the FDI stock held by these countries as of that year. One important feature of the region's FDI is its recent great leap outward, leading to a greater geographical diversity. Outside the region, North America, Australia and Latin America remain the most important FDI destinations. Asian TNCs are also expanding rapidly into the European Union (box II.9). More recently they have begun to invest in Central and Eastern Europe, taking advantage of privatization programmes, rising local demand for consumer goods and proximity to the European Union market. In the meanwhile, some Asian TNCs, particularly from Malaysia, China and the newly industrializing economies are also moving into Africa (see section on Africa).[57] Investment from developing Asia to South Africa accounted for over 20 per cent of the total inflows of that country during 1994-1996.

Developing Asia's outward FDI exhibits a distinct pattern, reflecting differing stages of development of the home economies. Firms from the newly industrializing economies, mainly the Republic of Korea and, to a lesser extent, Taiwan Province of China, are setting up global production facilities in capital- and technology-intensive industries. These economies, which possess advanced skills, research and industrial bases and large indigenous firms, are investing extensively in electronics, automobiles, petrochemicals and oil refineries. Firms from Singapore and Hong Kong tend to invest more in high value-added services, ranging from trade and finance to tourism, as well as in some manufacturing niches. The four ASEAN countries are developing indigenous specialized capabilities in component manufacturing, resource-based activities (e.g., wood, rubber and petrochemicals) and labour-intensive activities (e.g., textiles). Investments from China and India, both countries with diversified industrial bases, are also broad-based. Many Asian investors have been involved extensively in real estate development and infrastructure building.

The extent to which Asian developing economies are becoming more transnationalized is reflected in the rising ratio of FDI outflows to gross domestic fixed capital formation (annex table B.5). Although the average ratio for all Asian developing countries is still low by the standards of the industrialized countries, it is considerably higher than the average for the developing world as a whole. Among the major home economies in the region, except for Hong Kong (most of whose outward investment went to mainland China), Singapore recorded the highest degree of international investment activity in 1991-

Box. II.9. Investment from developing Asia into the European Union is on the rise

Investment outflows from South, East, and South-East Asian developing economies into Europe increased from an annual average of $100 million during 1989-1991 to an annual average of $ 5 billion during the early 1990s. While North America remains their main investment location outside Asia, manufacturing and services investments in the European Union have gathered momentum.

Still, the European Union accounted for only 4 per cent of Asia's outward FDI stock in the early 1990s. Although low, that share reflects the fact that Asian firms are only just beginning to penetrate the European market. Many firms from the Asian newly industrializing economies increasingly see a need for a physical presence in the European Union in order to serve this large and rich market. Other firms from these economies are seeking access to advanced technology, skills or research-and-development facilities.

Outward investment by Asia's newly industrializing economies in Europe is divided about equally between manufacturing and services. Manufacturing FDI is biased heavily towards the electronics industry, which accounted for three-quarters of the combined manufacturing projects of the newly industrializing economies. Textiles, clothing, leather and footwear, as well as chemicals and the production of toys, follow by a wide margin. The distribution of projects within the services sector is much less concentrated than in manufacturing. Investment in trade-supporting services figures most prominently, but FDI in financial services is only slightly less important. Asia's newly industrializing economies have also invested in other services, such as sea transport, hotels and telecommunications.

Investments in both manufacturing and services projects are primarily located in the United Kingdom and Germany, followed by France and the Netherlands. The same ranking of host countries prevails with regards to electronics. The major host countries in the European Union have attracted a similar number of FDI projects from Asia's newly industrializing economies, both in manufacturing and services. The only exception is France, where manufacturing projects (all but one in electronics) account for two-thirds of the total number of projects. The United Kingdom hosts Asian FDI projects in all major service industries. In the services sector of Germany, the focus of investors from the Asian newly industrializing economies has been clearly on trade and, to a lesser extent, on finance and sea transport.

Partly driven by growing exports, Asian FDI in Europe is on the rise. Still, it is at an early stage and needs to be nurtured, especially since most Asian firms have little or no experience of investing in Europe. Governments have a role to play. Asian governments, in addition to gradual liberalization, could give a helping hand to their outward investors, including through training and orientation programmes, provision of information, promotion of partnerships and contacts, and rendering financial support.

Governments of European Union countries could liberalize further FDI frameworks and remove any remaining impediments to foreign investors. Governments of member countries and the European Commission could also make greater efforts to assist prospective Asian investors in establishing themselves in Europe.

Source: based on UNCTAD, 1997b.

1995, followed by Malaysia and Taiwan Province of China (estimates based on annex table B.5). China, the Republic of Korea and Thailand are catching up rapidly. In fact, the ratio of FDI outflows to gross fixed capital formation (during 1991-1995) was 9.5 per cent for Singapore and 6.9 per cent for Malaysia; this compares with 5.6 per cent for all developed countries, 7.9 per cent for the European Union and 6.6 per cent for the United States.

The trend in the transnationalization of firms from the region is likely to continue. For example, the big six chaebols of the Republic of Korea (Daewoo, Hyundai, LG, Samsung, Sangyong and Sunkyong) have planned to invest $80 billion abroad between 1996-2005 (EIU, 1996g). At the same time, the region will most likely maintain its lead in attracting FDI, thanks to the projected sustained dynamism of the region's economy.

(b) Does foreign direct investment create balance-of-payments problems?

In the past decade, a number of East and South-East Asian countries experienced remarkable economic growth, which was partly export-led and associated with an upsurge of FDI during that period. A feature of this performance is that, despite rapid export growth, large and persistent current account deficits were registered in some countries, such as Malaysia and Thailand. These deficits were mainly financed by heavy inflows of private capital, of which FDI constituted a significant portion. The weakening of global industrial production -- which started in 1995 and which was particularly severe in the electronic industries -- was a major factor contributing to the general decline in the pace of export expansion and the deterioration in the current account position of the region as a whole. In the event, the export slowdown turned out to be short-lived but it, nevertheless, focused attention on the continuing current account deficits experienced by some countries and raised questions about the role of FDI in this regard. This section examines this issue, focusing on the balance-of-payments (BOP) impact of inward FDI. There is no implication that FDI can or should be judged solely on the basis of its BOP impact. This should be viewed in the broader context of the general macroeconomic setting and in relation to the role of TNCs as regards other national objectives, such as growth and development.[58]

The current account balance is one of the principal indicators that economic authorities follow closely.[59] At certain stages of the development process, large current account deficits need not be a cause for alarm. Such deficits are normal at the initial stage of industrialization or when there are major structural changes brought about by the diversification, deepening or upgrading of the industrial base which involve heavy imports of capital and intermediate goods. Nor is it surprising that large FDI inflows are at times associated with large current account deficits, as such inflows are normally used to finance new projects or the expansion or modernization of existing production facilities. These almost inevitably require the importation of new and advanced machinery. Nevertheless, the persistence of large deficits raises a number of concerns and entails the risk of a sudden shift in investors' confidence, leading to reversals in capital inflows, particularly of portfolio capital.

In assessing the sustainability of persistent current account imbalances, the ratio of the deficit to GDP has to be considered in relation to the structural features of the economy, the macroeconomic policy stance and the political situation.[60] Among the structural features are high levels of gross domestic investment used to expand productive capacity, to promote future economic growth and to enhance a country's ability to generate future trade surpluses with which to meet external obligations. Investment and savings rates could also serve as measures of creditworthiness and as indicators of the growth potential that international lenders and portfolio investors find attractive. Another consideration is the importance of the export sector in the economy as measured by the ratio of exports to GDP. As exports are a source of foreign exchange, a large export sector indicates a capacity to service and, ultimately, to reduce external indebtedness. The manner in which the current account deficit is financed as well as the level and composition of external liabilities have an impact on a country's ability to absorb external shocks. In the case of foreign debt, the country bears most of the burden arising from such shocks, whereas equity financing, such as through FDI, allows asset price adjustments so that foreign investors share part of the negative impact. As to the volatility of capital flows, this varies according to the type of instrument, with, for example, short-term debt

and portfolio investment being potentially more volatile than FDI. A satisfactory international reserve position can also serve as a safety net in times of payments difficulties.

The impact of FDI on the BOP of a country varies, depending on the purpose of the investment, the nature of the activity and the age of the project. In general, trading transactions of market-seeking foreign affiliates are likely to entail more imports than exports, particularly in the initial stage when a substantial proportion of machinery and inputs is likely to be imported.[61] By contrast, resource-based or efficiency-seeking affiliates will generally record higher exports than imports. The trading consequences of strategic asset-seeking investment are likely to be ambiguous, depending on the type of investment (Dunning, 1993). Different value-added activities require different proportions of tradable inputs and outputs. For example, studies on selected Asian countries show that industries producing apparel and electrical machinery have much higher export propensities than the chemical industry.[62] This finding could also reflect the production orientation of these industries, whether import substituting or export oriented, as well as differences in comparative advantage. At the firm or project level, the type of linkages created and the age of a project are important determinants of the BOP impact; new projects normally require heavy imports of machinery and equipment as well as intermediate inputs but, as the project matures, import requirements per unit of output may be expected to decline as local sourcing tends to increase over time.[63] Payments of direct investment income are also likely to increase over time as they are a function of the stock of inward FDI; such payments necessarily begin only after new investments become productive and/or profitable. Outflows also result from the payment of royalties, which can be quite substantial, and, where it occurs, from transfer pricing (Vaitsos, 1973). Factors specific to a host country, such as the importance of TNCs in the economy, the country's stage of development, its size and its resource endowments influence the extent and nature of external transactions of TNCs. Thus, the effects of FDI on the BOP are bound to be country specific and sensitive to the type of investment, the industry mix and the maturity structure of investment.

There are various approaches to estimating the impact of TNC activities on the BOP of host countries.[64] One approach, used in the discussion below, is to identify the transactions associated with their activities that are reflected in the current and financial accounts of the BOP either as credit(+) or debit(-) entries.[65] These are referred to as direct effects. The trading activities of TNCs generally produce the largest BOP impact. Exports of goods and related freight and insurance services are credits in the current account, whereas imports are debits. Of particular interest are payments of direct investment income(-) consisting of dividends, distributed branch profits and interest on intra-company loans as well as payments of royalties and licence fees used in FDI operations(-). The most immediate impact on the BOP of FDI may be reflected in the financial account under the item direct investment in a country (+), comprising equity capital and intercompany claims and liabilities. Borrowing from offshore capital markets to finance TNC activities(+) and interest paid on such loans(-) also have immediate and longer term impacts on the BOP. The sum of all these items would constitute the actual direct BOP effect of TNC activities. If positive, this would normally involve a foreign exchange inflow; if negative, an outflow.

The operations of TNCs also have indirect BOP effects. These arise mainly from the contribution of FDI to gross domestic capital formation, which (through the interaction of the multiplier and accelerator effects) is generally growth enhancing. Higher economic growth, in turn, influences other macroeconomic variables (e.g., exports, imports and savings) which are reflected directly or indirectly in the BOP. Large capital inflows or outflows resulting from TNC activities can also affect the exchange rate and hence the price and volume of traded goods. Transnational corporations may also induce domestic firms to produce goods for which there is demand abroad, thus raising exports; or they may use inputs of local suppliers, the production of which requires

imported goods, thus raising imports (UNCTC, 1981). These are just some examples of how FDI affects the BOP indirectly. The indirect effects could be significant, but are difficult to quantify and the validity of estimates depends on the realism of simplifying assumptions.

Another problem is that the BOP effect of FDI cannot be measured exactly without knowing what would have happened if the FDI had not occurred (Dunning, 1993). It is the "net effect" that counts, measured by the difference between the actual external transactions associated with TNC activities and those that would have occurred in their absence. Any such assessment is bound to be conjectural, and its validity depends on the conduct of macroeconomic policy and various behavioural assumptions. Another approach that is widely used is regression analysis relating FDI with important BOP and other macroeconomic variables. In this case, the choice of explanatory variables would necessarily be selective. Despite measurement problems and other limitations, a number of empirical studies examine the effect of FDI on the BOP by applying these different approaches mentioned. Most of the literature deals with the BOP impact of outward investment, but there are also some important studies on inward FDI (see box II.10).

This section examines the BOP impact of inward FDI on four Asian economies -- China, Malaysia, Singapore and Thailand -- in which FDI has played an important role, particularly since the mid-1980s. They represent countries at various stages of development, with different market sizes and resource endowments. Singapore has generally had, and continues to have, a healthy BOP position. Malaysia and Thailand, while experiencing rapid export growth, due largely to FDI in export-oriented industries, registered large and persistent current account deficits in the 1990s. China's current account balance in the past decade has, on average, been positive.

Table II.9 presents quantitative estimates of transactions by foreign affiliates that would be captured in the BOP of these countries. There are serious data constraints on trade and financial flows related specifically to foreign affiliates in a host country. For some countries, inward FDI was the only variable for which complete time-series data are available. Sometimes, existing trade data provide only partial coverage of TNC activities. In view of these data limitations, only imperfect insights into the repercussions of TNC activities on the BOP can be gleaned. Nevertheless, the analysis and comparison of country experiences can give an indication of which factors were responsible for differences in the impact on the individual country's BOP.

i. Singapore

Of the four countries, Singapore is the most economically advanced, and is characterized by a high degree of industrial sophistication and technological capability. Foreign direct investment has been vital to the economic development of the country. During the period 1991-1995, FDI accounted for about a quarter of gross fixed capital formation. The manufacturing sector is heavily dominated by foreign affiliates whose share in total exports was 87 per cent in 1994. Since 1988, the current account has registered a healthy and rising surplus, averaging over $13 billion a year in 1994-1996. This surplus combined with high capital inflows has allowed international reserves and outward investment to increase steadily. The surplus is a reflexion of a very high domestic savings rate relative to the investment rate -- 49 per cent and 35 per cent, respectively, in 1995.

Singapore's statistics do not distinguish payments of direct investment income from those of other investment income. There are no figures on imports of TNCs so that the net trade effect cannot be determined. There is, however, reason to believe that the net contribution of FDI to the BOP is positive. Studies have shown that TNCs have significantly higher export propensities than domestic firms.[66] The

Box II.10. Empirical findings on the BOP effects of inward FDI

Sanjaya Lall and Paul Streeten (1977) conducted empirical studies to quantify the BOP and income effects of FDI in the manufacturing sector of six developing countries (Colombia, India, the Islamic Republic of Iran, Jamaica, Kenya and Malaysia). The studies covered a sample of 159 firms, of which 147 had foreign equity participation. Except for Kenya, the overall direct effects of the activities of sample firms on the BOP of host countries were found to be negative. As a percentage of sample firms' sales, the negative effects ranged from 12 per cent in India to 55 per cent in the Islamic Republic of Iran. The surprisingly positive direct effect for Kenya, amounting to 3 per cent of sales, can be explained by the large exports of some firms surveyed which were probably not representative of all foreign firms in the country. Regardless of the industry or source of control, a large majority of sample firms had negative direct effects. On average, foreign-controlled firms had more adverse direct effects than locally controlled firms. These results can be attributed largely to the nature of import-substituting industrialization at that time. Government policies clearly induced FDI into industries that were neither very competitive nor export oriented. Moreover, the bulk of FDI in manufacturing was heavily dependent on imports.

Lall and Streeten recognized that a comprehensive evaluation of the BOP effects of FDI must compare the actual situation with what would have happened had FDI not occurred, and calculate the direct and indirect effects under each situation. The approach used was to calculate social income effects of FDI in a cost-benefit framework. Three alternatives to FDI were considered, the first of which was importing the entire output produced by foreign firms. The net income effects were negative in about 40 per cent of sample firms, though this had no relation to "foreignness". The main determinant of variations in the income effects was the extent of protection granted to the firms. The second — the financial replacement alternative — compared the actual cost of servicing FDI (through profits, interest and royalty payments) with the social cost of alternative sources, such as local capital or foreign borrowing. The finding was that the purely financial contribution of FDI appeared to be negligible or negative, implying that it would have been cheaper to use alternative sources. The third alternative was the most likely local replacement. By means of a composite index of technology and entrepreneurship ability, each sample firm was assigned a certain degree of local replacement. The results showed that some 30 per cent of firms with foreign equity appeared to be totally replaceable by local firms, 50 per cent were partially replaceable, and the rest totally irreplaceable. However, the study emphasized that the calculations might have overlooked some other relevant factors.

The United Nations Centre on Transnational Corporations (1981) conducted a study on the direct effects of TNCs on the BOP of Mexico, based on the 1977 trade of all foreign affiliates in Mexico identified as having international trade transactions. Assumptions were made as to the foreign-affiliate share of other BOP items for which TNC transactions were not separately identified. The study showed a current account deficit of $758 million for foreign affiliates, representing 47 per cent of the country's current account deficit in 1977. The overall BOP deficit arising from activities of foreign affiliates, including FDI-related capital flows, amounted to $521 million. A disaggregation by industry showed discernible differences in the export and import orientation of TNCs. The largest importers were in pharmaceuticals, machinery and automobiles, accounting for 65 per cent of total imports of foreign affiliates, largely surpassing their share of exports of 34 per cent. In contrast, heavy industries had the highest share of exports (47 per cent), compared with a 30 per cent share of imports. These trade patterns are reflected in their respective share in the trade deficit: 92 per cent for the former and 4 per cent for the latter. Non-durable consumer goods accounted for the remaining 4 per cent.

The studies mentioned above were undertaken several years ago. Conditions and policy orientation have since changed, which could raise doubts as to the studies' relevance to current analysis. A recent study (Fry, 1996) examined the effects of FDI inflows on a group of six Asian economies (Indonesia, Republic of Korea, Malaysia, Philippines, Singapore and Thailand). Through regression equations, the five channels through which FDI influences the economy and hence the BOP were examined, namely, savings, investment, exports, imports and economic growth. Positive effects were found on the first four variables, with a lagged response for exports. The impact on economic growth was felt indirectly through the effects on investment and exports. The result of a dynamic simulation showed that FDI raised investment initially and worsened the current account balance. However, in the steady state (i.e., constant ratio of FDI to GDP over time) savings increased even more than investment because of the growth resulting from current and previous FDI, thus leading to an improvement in the current account balance in the long run.

Table II.9. Balance-of-payments transactions of foreign affiliates in selected Asian countries, 1990-1995[a]

(Millions of dollars)

Country	1990	1991	1992	1993	1994	1995
China						
Trade, net	...	...	-9 015	-16 596	-18 221	-16 050
Exports	...	12 000	17 356	25 237	34 713	46 890
Imports	...	...	-26 371	-41 833	-52 934	-62 940
Direct investment income[b]	- 46	- 10	- 22	- 231	- 400	-9 953
Subtotal: current account	...	...	-9 037	-16 827	-18 621	-26 003
FDI in country	3 487	4 366	11 156	27 515	33 787	35 849
Total transactions of affiliates	...	...	2 119	10 688	15 166	9 846
Memo item: Country						
Current account balance	11 997	13 272	6 401	-11 609	6 908	1 618
Malaysia[c]						
Trade, net	787	-1 302	349	-166	-2 028	...
Exports	15 462	18 284	22 316	26 177	34 483	...
Imports, c.i.f.	-14 675	-19 586	-21 967	-26 343	-36 511	...
Royalties	- 176	- 216	- 275	- 273	- 273	...
Direct investment income	-1 926	-2 275	-2 939	-3 222	-3 846	-5 350
Subtotal: current account	-1 315	-3 793	-2 865	-3 661	-6 147	...
FDI in country	2 332	3 998	5 183	5 006	4 348	4 700
Total transactions of affiliates	1 017	205	2 318	1 345	-1 799	...
Memo item: Country						
Current account balance	- 870	-4 183	-2 167	-2 809	-4 147	-6 800
Singapore						
Trade, net	...	...	...	...	...	...
Exports, manufacturing	22 504	22 620	24 331	...	...	...
Imports	...	...	...	...	...	...
Direct investment income	...	...	...	...	...	...
Subtotal: current account	...	...	...	...	...	...
FDI in country	5 575	4 887	2 204	4 686	5 480	6 912
Total transactions of affiliates	...	...	...	...	...	...
Memo item: Country						
Current account balance	3 097	4 884	5 615	4 205	11 284	15 093
Thailand						
Trade, net	...	...	...	...	...	...
Exports	...	...	...	...	...	...
Imports	...	...	...	...	...	...
Royalties and license fees[d]	- 170	- 206	- 281	- 427	- 452	- 630
Direct investment income	- 312	- 56	...	...	...	...
Subtotal: current account	...	...	...	...	...	...
FDI in country	2 444	2 014	2 114	1 730	1 322	2 003
Total transactions of affiliates	...	...	...	...	...	...
Memo item: Country						
Current account balance	-7 281	-7 571	-6 303	-6 364	-8 085	-13 554

Sources: UNCTAD, based on IMF, 1996b; and other international and national sources.

a Positive figures are credits; negative figures are debits.

b Profits and dividend payments were not recorded before 1995.

c Trade data for 1990-1992 are based on Phang (forthcoming), whereas 1993-1994 data are extrapolations using the growth in trade of foreign affiliates (limited companies only); 1994 royalties assumed to be the same as 1993.

d Total paid, includes non-TNCs.

presence of many local firms that supply and service foreign affiliates in Singapore implies that domestically-sourced inputs and value added are likely to be significant. Data on United States' non-bank foreign affiliates suggest that TNCs from the United States contribute positively to the merchandise trade balance of Singapore. In 1993, United States imports of goods shipped by these affiliates from Singapore amounted to $9 billion, or more than double the exports of goods shipped from the United States to these affiliates in Singapore of $4 billion.[67] However, United States foreign affiliates represented less than 12 per cent of Singapore's total merchandise exports and less than one-fifth of its stock of foreign direct equity investment in that year, so that it is difficult to make generalizations on the overall trade contribution of TNCs only on the basis of United States data. It should be noted that the overall trade balance (including trade-related services) of Singapore has been in deficit in the 1990s and the major contribution to the current account surplus derives from other services. Singapore has a highly developed traded services sector and already has a strong position in the region as a financial and offshore banking centre. These are areas in which foreign affiliates are quite active. In the electronic industries, which are dominant in Singapore, constant upgrading and diversification have failed to prevent a declining trend in the importance of manufacturing. This trend coincides with an expansion of the country's role as a regional procurement and operational headquarters, as well as a research-and-development centre. The stock of FDI in the services sector now exceeds by a large margin those in the primary and secondary sectors. While there are no data on the TNC contribution to the substantial surplus in the service account, this is likely to be significant. (The services sector is, in general, less import-intensive then, but probably as export-intensive as the manufacturing sector (UNCTC, 1989).) Inward FDI flows have been sustained at a fairly high level in the 1990s, but remittances of profits have also been rising.

The benefits of FDI to the BOP and to the economy as a whole result from deliberate government policy. Creating an attractive business environment for TNCs has been a principal concern (of the Government). Therefore, the Government has invested substantially to provide adequate infrastructure, education and training, R&D and public services. FDI policies have been directed at supporting priority sectors and achieving sustained and diversified growth.

ii. Malaysia

Malaysia is one of the fastest growing countries of the region, with growth averaging about 9 per cent a year between 1990 to 1996. The structural transformation of the economy over the past two decades has placed it at the forefront of the second-tier of newly industrializing economies. Transnational corporations have played an important role in this transformation and in the spectacular expansion of manufacturing exports. These accounted for 80 per cent of total exports in 1995, compared with 21 per cent in 1980. Malaysia has been one of the largest recipients of FDI among developing countries. The big surge in FDI with a decisive export orientation occurred in the late 1980s and has been sustained throughout the 1990s. Malaysia has a high savings rate but the investment rate is even higher. This is reflected in the current account, which registered rising deficits throughout the 1990s, reaching a peak of $6.8 billion or 7.7 per cent of GDP in 1995. The deficit declined in 1996 with an easing of overheating pressures in response to weakening export demand, which led to slower import growth.

Manufacturing is dominated by a few industries, notably the electrical and electronic industries, making the economy vulnerable to changes in world demand for the products involved. In 1995, exports of electrical machinery, appliances and parts amounted to almost 66 per cent of exports of manufactures or 52 per cent of total exports. This industry, in which foreign affiliates are prominent, is characterized by high import intensity, limited technology transfers and backward linkages. Value added is relatively low and has even declined over the years, from 28 per cent of

gross output in 1981 to 22 per cent in 1992. A survey of 18 of the largest foreign affiliates in the industry carried out in 1995 showed that the value of imported materials and components accounted for 78 per cent of their total inputs (Ariff and Yew, 1996); this is much higher than the average for all manufacturing industries. The global electrical and electronics industry is highly competitive and requires specialized inputs that meet precise quality standards. These inputs may not easily be available locally. Building a network of local suppliers takes time, although already there are encouraging signs of foreign affiliates forging backward linkages.[68] Evidence points to local technological capabilities influencing the extent of local procurement. There are indications of technological deepening and upgrading, and of serious efforts to diversify beyond the electrical/ electronic industries. There may also be possibilities for the country, with its rich natural resources, to develop resource-based industries; this could be beneficial to the BOP as relatively fewer imported inputs would be required and higher domestic value added per unit of output.[69] This suggests an area where more FDI can be attracted, but the pace of all these changes appears slow, as does technological absorption. A principal constraint is the shortage of skilled labour and there are other deficiencies in transport, telecommunications and energy, which the Government is attempting to remedy. The economy is almost close to full employment and has lost its comparative advantage in low-skilled labour-intensive type activities, which characterize a substantial part of TNC activities in the country. With a labour shortage, and based on what has been achieved so far, the country may need to shift to higher value-added activities, which would require substantial investment in R&D and a strengthening of the human resource base.

The contribution of TNCs to the trade balance in 1990-1994 was on the whole negative. With profit remittances and other direct investment income payments averaging $2.8 billion per year, foreign affiliates had large current account deficits during the period, generally surpassing the deficits registered for the country as a whole. This implies that, in contrast, local firms and other entities had contributed positively to the current account. Because of heavy inflows of FDI, the overall direct effect of TNC activities on the balance of payments was positive. However, remittances of profits show a steadily rising trend. That is not unexpected, given the heavy inflows of FDI since the late 1980s, which added substantially to the FDI stock. Profit remittances may soon exceed inward FDI flows, which have not grown much in recent years. An extrapolation of available data suggests that the total direct effect has probably been negative in the past few years. International reserves dropped in 1994 and 1995, although an increase was registered in 1996. After some time lag, the impact of FDI on the BOP may turn positive. There is, moreover, scope for improving such gains by reducing import dependence and moving towards more profitable value-added activities. Foreign direct investment has contributed to a major structural transformation in Malaysia, but now a major challenge for the country is how to create the conditions which would encourage FDI that would upgrade and diversify the country's industrial base.

iii. Thailand

Like Malaysia, Thailand benefited from the currency appreciation and higher labour cost in Japan and other Asian newly industrializing economies, which led to a sharp rise in FDI inflows in the late 1980s. The expansion of largely export-oriented FDI fuelled strong export growth and triggered an investment boom. Economic growth has been rapid, averaging 8 per cent per year between 1990 to 1996. However, Thailand was among the countries in the region most affected by the 1996 export slowdown. For the first time in almost a decade, GDP growth fell below 7 per cent.

In the 1990s, Thailand registered a widening of the current account deficit, which reached around 8 per cent of GDP in 1995 and 1996. This was, of course, a manifestation of the large savings-investment gap. The savings rate of 34 per cent in 1990-1995, high in relation to the average of around 25 per cent for developing countries as a whole,[70] was surpassed by the gross domestic

investment rate of over 41 per cent. The large current account deficits were only partly financed by FDI. Most of the financing was through external borrowing, particularly bank loans. In recent years, these have shown a shift in maturity structure, with a rising share of short-term debt, that is creating concern.

Data limitations again prevent a definite assessment of the BOP effects of FDI. Investment inflows averaged $2 billion a year in 1990-1995.[71] Royalty payments and licence fees have been increasing as well as investment income, of which profit remittances are a significant part. Indications are that FDI has played an important role in the large trade deficit, which constitutes the bulk of the current account deficit. An analysis of the impact of FDI flows, using a dynamic simulation exercise for the period 1987-1991 of a simple macroeconomic model of Thailand, confirmed the expansionary effect of FDI on exports, private investment and GDP growth (Jansen, 1995). However, FDI also led to an adjustment process in which imports and investment income payments rose sharply, resulting in enlarging the current account deficit by more than the increase in FDI. A decomposition analysis of the sharp increase in the import to GDP ratio from 25 per cent in 1985 to 40 per cent in 1991 showed that this was largely due to a rise in import dependency, which was related to the growing role of FDI. Foreign investment projects imported 90 per cent of all machinery and equipment and over 50 per cent of raw materials. The trend towards intra-regional networks of FDI and trade may have further strengthened this dependence. In 1995, the ratio of total merchandise imports to GDP increased even further to over 42 per cent. However, import dependency that is related to FDI, especially that involving imports for processing, is likely to be cyclically sensitive. Hence, imports will probably decrease as capacities in affected industries become less fully utilized. Moreover, considering that over 43 per cent of total imports in 1990-1995 were capital goods, the current BOP constraint resulting from such imports has to be weighed against future growth in income and savings.

The heavy reliance on imported inputs, coupled with low value added, limit the realization of potential foreign exchange gains from FDI. Although backward linkages exist in resource-based and lower-end manufacturing, few local linkages have been generated for more technologically sophisticated industries because of the inability of local support industries to provide quality inputs and services. Thailand needs to upgrade and diversify its industrial base, not only to increase value added, but because it is already losing its competitive edge in low value-added labour-intensive industries, which have accounted for much of the FDI in the past decade. Higher technology industries are slowly coming onstream. But there appear to be bottlenecks due to the shortage of skilled labour and inadequate resources devoted to research and development. In view of the long-term nature of these activities, upgrading may take time. In the near future, it is expected that the current account deficit will narrow, as an improvement in the savings rate is accompanied by lower investment and import rates, due to surplus capacity in many basic industries.

iv. China

China has been the largest developing country recipient of FDI since 1992. During 1993-1996, it accounted for 36 per cent of FDI flows to developing countries, with average annual FDI amounting to almost $35 billion.[72] China constitutes an attractive location not only because of its size, but because of its economic growth. This averaged more than 10 per cent a year during 1990-1996. But market access has not been the only motive for FDI; relatively low labour costs have made China an important export platform for TNCs engaged in labour-intensive industries.

China generally enjoyed current account surpluses in the 1990s.[73] However, the figures need to be revised downwards, as the reporting of dividends and profit remittances only started in 1995. The

total direct impact of the BOP transactions of foreign affiliates has been positive (even allowing for adjustments in payments of direct investment income), but this has largely been due to heavy inflows of FDI. The net trade effect of TNC activities has been negative and substantial. A decomposition of 1994-1996 trade data into processing and non-processing shows large deficits, averaging $22.5 billion a year in non-processing trade of foreign affiliates, a substantial portion of which consisted of imports of investment goods (table II.10). In contrast, processing trade registered a rising net surplus, reaching $11.6 billion in 1996. This reflects a marked decline for foreign affiliates in the import intensity of processed exports (as measured by the ratio of imports for processing to exports after processing) from 92 per cent in 1994 to 78 per cent in 1996. However, this still compares unfavourably with the 1996 ratio for local firms of 66 per cent, implying higher local value added for the latter. This suggests an area where further improvement in the BOP contribution of FDI could take place, provided that local suppliers are competitive and are up to international standards. It is expected that the deficit on invisibles would widen because of rising direct investment income payments. This, combined with heavy investment requirements, leads to a forecast of current account deficits for China in the coming years. But FDI inflows are likely to remain high, which should be sufficient to finance the deficit (EIU,1996h).

* * *

The impact of FDI-related activities on the balance of payments is bound to be country specific and sensitive to the type of investment, the industry mix and the age structure of investment. Results of a dynamic simulation of a macroeconomic model of six Asian countries showed that FDI raised investment initially and worsened the current account balance (Fry, 1996). However, in the steady state (i.e., constant ratio of FDI to GDP over time), savings increased even more than investment because of the growth resulting from current and previous FDI leading to an improvement in the current account balance in the long run. Factors specific to a host country, such as the importance of TNCs in the economy, the country's stage of development, its size and its resource endowments, influence the extent and nature of external transactions of TNCs. As the overall BOP effect of FDI comprises direct and indirect effects, the validity of estimates depends on the adequacy of the data and the realism of the assumptions associated with indirect effects. The counterfactual situation is also virtually impossible to determine, and thus efforts to evaluate the BOP effects of TNC activities can at best allow only partial conclusions.

Table II.10. Value of international transactions of foreign affiliates in China, 1994-1996[a]

(Billions of dollars)

	1994[b]			1995			1996		
Firms	Exports	Imports	Trade balance	Exports	Imports	Trade balance	Exports	Imports	Trade balance
Foreign affiliates	34.8	53.0	- 18.2	46.9	62.9	- 16.1	61.5	75.6	- 14.1
Processing trade	30.6	28.1	2.5	42.1	37.1	5.0	53.1	41.5	11.6
Non-processing trade	4.2	24.9	- 20.7	4.8	25.9	- 21.1	8.4	34.1	- 25.7
All firms	121.0	115.0	6.0	148.8	132.1	16.7	151.1	138.8	12.2
Processing trade	57.0	47.0	10.0	73.7	58.4	15.4	84.4	62.3	22.1
Non-processing trade	64.0	68.0	- 4.0	75.1	73.7	1.3	66.7	76.5	- 9.8

Source: UNCTAD, based on International Trade Centre; UNCTAD/WTO calculations, based on ITC's *ChinaTraders* database, provided by the Statistics Department, Customs General Administration, China.

[a] Foreign affiliates include fully foreign-owned, equity joint ventures and contractual joint ventures. Components may not add up to totals due to rounding.

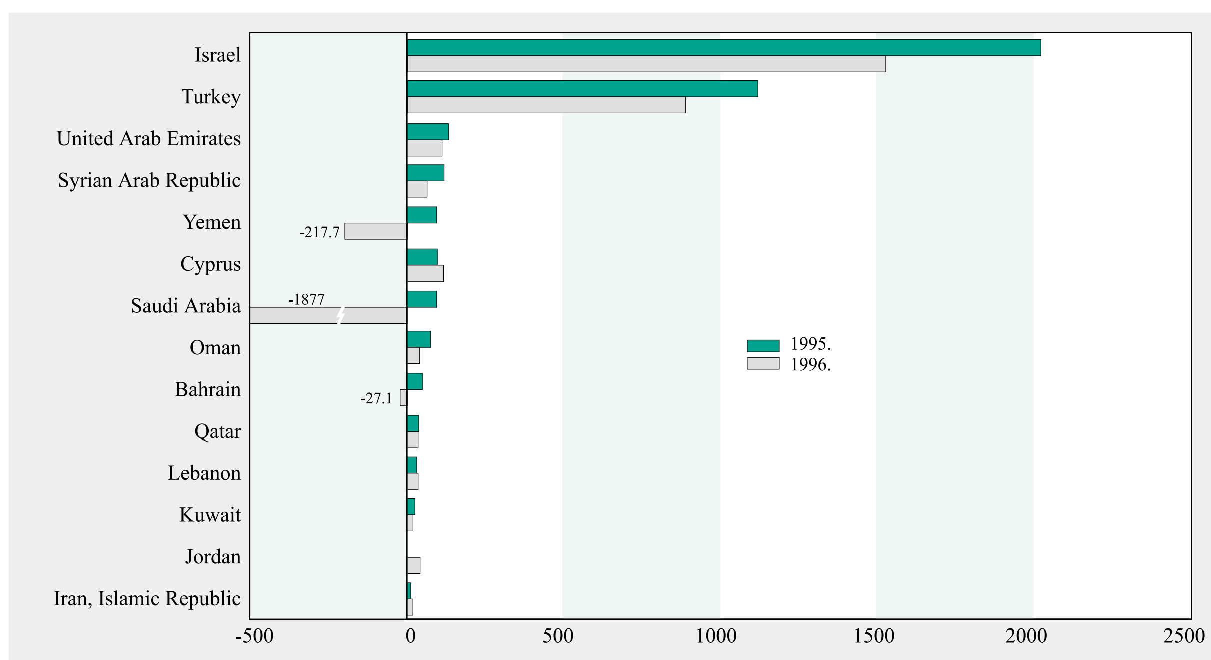
[b] Differences in trade data from table II.9 may be due to rounding.

Beyond that, it is clear that FDI cannot be judged solely on the basis of its BOP impact. Whatever the impact, it should be viewed in relation to TNCs' contributions to other objectives, such as growth and development. Moreover, an evaluation of the effects of TNC operations on the BOP needs to be placed in the context of a country's overall macroeconomic performance. At some stages in the development process, for example, the presence of large current account deficits need not cause alarm. The persistence of large deficits, of course, can raise the concern of economic authorities. But, in assessing their sustainability, the level of deficits must be considered in relation to the structural features of a country's economy; its macroeconomic policy stance; and the political situation; which all influence a country's ability to meet future payments obligations and absorb external shocks. Nonetheless, the importance of government policies that facilitate and encourage foreign affiliates to build forward and backward linkages and to raise domestic value added needs to be emphasized. Such policies not only help improve the BOP but, above all, contribute to the strengthening of domestic enterprises and, therefore, to growth and development.

5. West Asia

After a slowdown of FDI flows to developing West Asia (annex table B.1) in 1994 and large disinvestments in 1995,[74] particularly in Saudi Arabia and Yemen, investment flows attained a level of nearly $2 billion in 1996. Flows to West Asia in that year accounted for 1.5 per cent of all FDI flows to developing countries. (Including Israel, flows to West Asia accounted for 1 per cent of global FDI flows in 1996.) The nearly $3 billion increase in FDI inflows in 1996 reflected mainly increases in Saudi Arabia, Syrian Arab Republic, Turkey and Yemen. Some three-fifths of the countries in the region have received higher inflows in 1996 than in 1995 (figure II.21). Turkey alone received $1.1 billion in 1996, an increase of 26 per cent over 1995.

Figure II.21. FDI flows into West Asia, 1995-1996
(Millions of dollars)

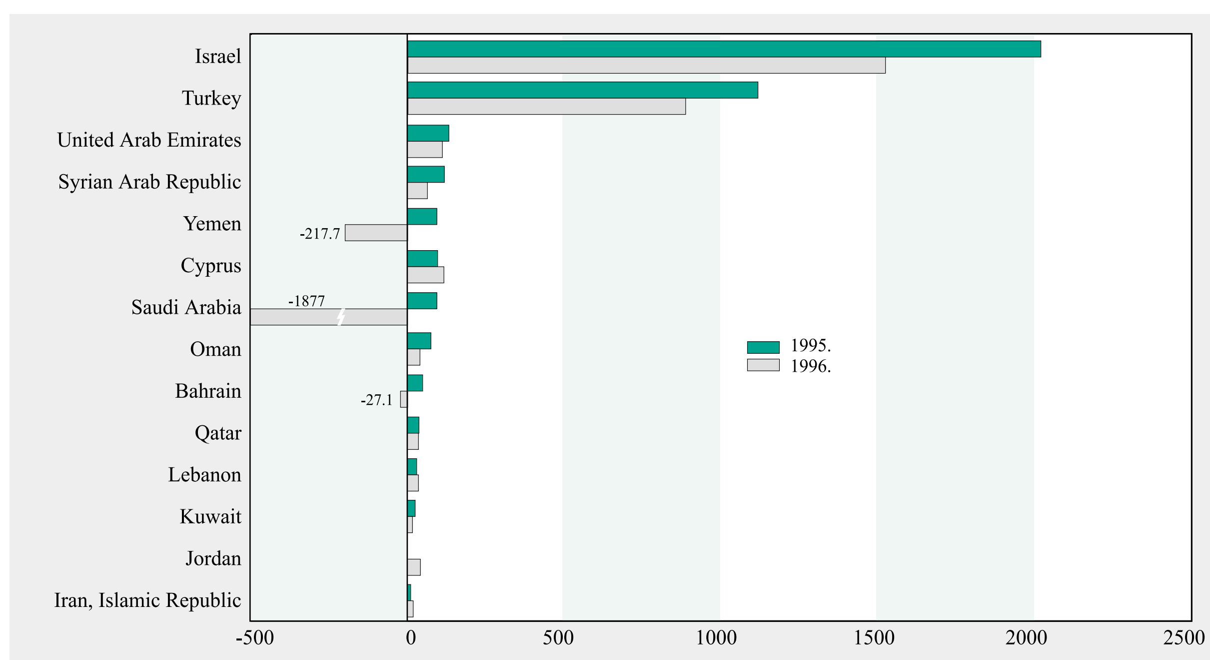


Source: UNCTAD, FDI/TNC database and annex table B.1.

Investment flows to West Asia have been declining over time. West Asia's share of developing-country inflows fell from 30 per cent during the period 1981-1985 to 2 per cent during the period 1991-1996. This reflected mainly decreases in FDI flows to the eight oil exporting countries,[75] whose share of total developing-country inflows declined markedly -- from 29 per cent to 0.3 per cent -- between the same periods. However, the share of developing-country inflows accounted for by the six non-oil exporting economies has increased only marginally,[76] from 1.2 per cent to 1.7 per cent, between the above-mentioned periods. This poor performance of West Asia as a host to FDI is also reflected in the low ratio of FDI to gross fixed capital formation, which averaged 1.2 per cent during the period 1991-1995, whilst in Africa (another region receiving little FDI) the corresponding share was 6 per cent (figure II.22).

The past ten years (1986-1996) have been characterized by significant year-to-year fluctuations in investment flows to West Asia. Saudi Arabia and, to a lesser extent, Yemen are responsible for most of these fluctuations. Investment in oil exploration and other natural resources in these economies tends to be "lumpy", because large FDI inflows may occur in one year, but not in following years. In Yemen, for example, large investment inflows in oil exploration took place between 1991 and 1993 (e.g., by Canadian Occidental Petroleum Ltd. (Canada) in partnership with Pecten Yemen and Consolidated Contractors International Co. (Lebanon)[77]), but these inflows dropped to minuscule levels thereafter and even turned negative in some years, because of net disinvestments. If Saudi Arabia and Yemen are omitted, a more stable FDI trend emerges over the 1990s. Furthermore, 1996 (and not 1993) emerges as the peak year for investment inflows in the past decade. In other words, the volatility of inflows into two West Asian economies -- albeit major ones -- masks recent improvements in the FDI performance of other countries in the same region.

Figure II.22. FDI inflows as a percentage of gross fixed capital formation in West Asia, 1995
(Percentage)



Source: UNCTAD, FDI/TNC database and annex table B.5.

West Asian countries are beginning to make stronger efforts to create a business-friendly environment. However, countries that are members of the Gulf Co-operation Council (GCC)[78] are relatively less open to non-GCC investors.[79] For example, in Oman, effective from January 1997, the new corporation tax code penalizes companies with foreign-equity stakes by requiring them to pay tax rates of 25 to 50 per cent on profits (depending on the level of foreign ownership), while wholly owned Omani firms pay tax rates ranging between 5 to 7.5 per cent (EIU, 1996i). However, the preferential FDI treatment given to GCC members is not reflected in the pattern of bilateral investment treaties. As of 1 January 1997, only 7 of the 152 treaties concluded by these countries for the promotion and protection of FDI were intra-regional bilateral arrangements. France, Germany and the United Kingdom together accounted for some three-fifths of the treaties signed by West Asian countries with developed countries (UNCTAD, 1997c).

Most FDI outflows from West Asia originate mainly from Kuwait and Saudi Arabia and are directed to GCC members. Though small, annual average intra-regional flows have tripled between the periods 1980-1985 and 1991-1994, attaining $640 million in the latter period (UNCTAD, 1997c).

While the petroleum industry of the oil exporting countries receives most FDI inflows, in the non- oil exporting economies FDI flows go mainly to the secondary and tertiary sectors. Activities to expand the oil and gas industry and plans for large investments mainly in Oman, Qatar and the United Arab Emirates to supply gas to Asian markets, encourages petroleum FDI into these countries.[80] Saudi Arabia's application in 1997 to join the WTO, if successful, could enable its petrochemical industry to gain better access to international markets, as well as boost its non-oil exports through enhanced investment and trade liberalization.[81] FDI flows to non-oil producing economies, such as Jordan, Lebanon and Turkey are increasingly going into manufacturing. In the case of Turkey, manufacturing FDI, rising since 1988, has been encouraged by the 1989 customs union agreement with the European Union. The privatization of large state-owned firms, notably the planned sale of a 30 per cent stake in Turk Telekom in 1997, could lead to more FDI in services. Flows to Cyprus are concentrated in tourism and financial services.

C. Central and Eastern Europe

1. Trends

In 1996, FDI flows into Central and Eastern Europe fell to $12 billion from $14 billion in the previous year (annex table B.1). Nonetheless, inflows during 1995-1996 were more than twice as high as the annual average inflow (of nearly $6 billion) during 1992-1994. Large declines were registered by Hungary (nearly $3 billion), the Czech Republic (over $1 billion) and the Russian Federation ($200 million). Among the largest recipients in that region (figure II.23), only Poland saw a substantial increase in inflows in 1996, to $5.2 billion.[82] The region's inward FDI stock in 1996, at $46 billion, was less than that of Indonesia ($59 billion).

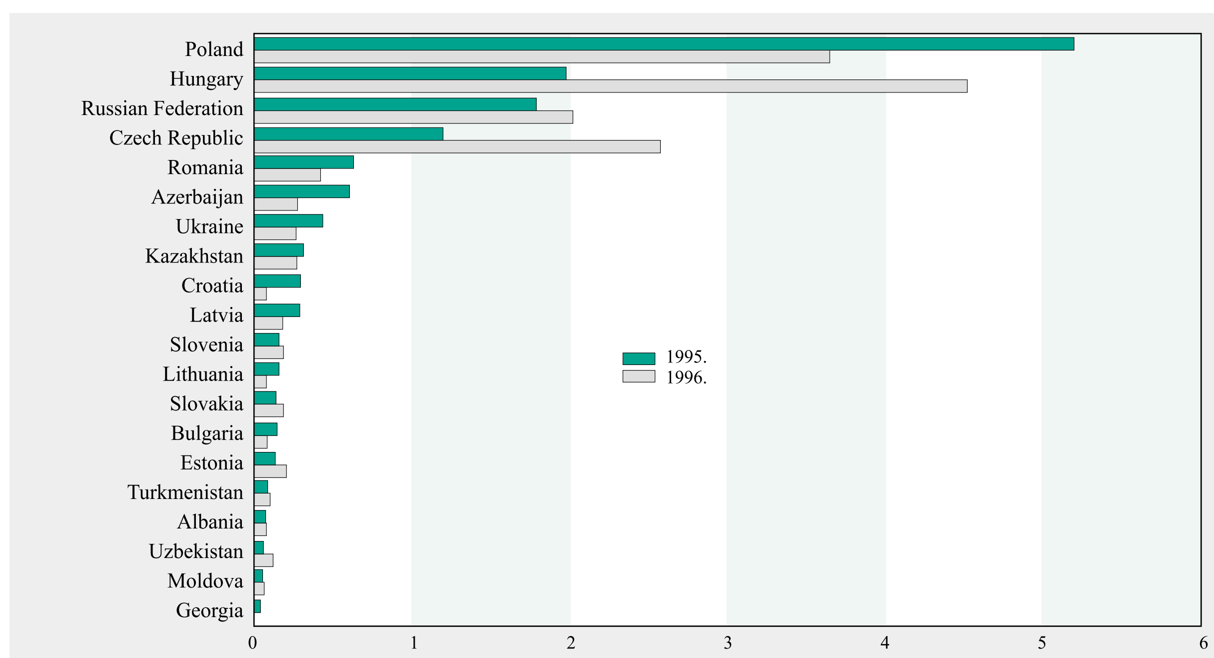
The reduced flows into Central and Eastern Europe reflect, in part, declines in privatization-related investments. In Hungary, for example, FDI flows worth $600 million in 1996 (or 29 per cent of its inflows) were received in connection with privatizations, compared with about $3 billion in 1995 (or 66 per cent of inflows in that year).[83] The decline in FDI inflows also reflects problems related to transition to a market economy. Without a stable market economy in place, some foreign investors may have overestimated the region's potential to absorb FDI and temporarily shelved plans for expansion.

Nonetheless, prospects for privatization-related investment in the region are still good, especially in those countries that are only now embarking on large-scale privatization schemes, such as Bulgaria (in 1997-1998) and Romania (in 1997). Even in countries in which privatization is quite advanced, such as the Czech Republic, there are still good prospects for sequential FDI, although the extent to which such FDI takes place varies from privatization project to privatization project. There are also signs that investments that are unconnected with privatization schemes, and are geared to both domestic and regional markets, are increasing, propelled by closer trade links with the European Union.[84] Efficiency-seeking investments are also on the rise, as TNCs, especially automobile manufacturers, are taking advantage of the availability of skilled low-cost labour in several countries in the region.[85]

Investment flows to the region remain concentrated in the Czech Republic, Hungary, Poland and the Russian Federation. The first three countries alone accounted for 68 per cent of the region's inflows (and 73 per cent of its inward stock) in 1996. (It should be noted, however, that these countries together also accounted for 30 per cent of the region's GDP in 1995.) Western European TNCs still dominate the FDI source picture, followed closely by TNCs from the United States and the Asian newly industrializing economies, in particular the Republic of Korea (UN-ECE, 1996a). Japanese TNCs remain on the sideline.

A small but growing share of inflows is accounted for by intra-regional investments, particularly within the Commonwealth of Independent States.[86] With Central and Eastern European countries recovering slowly from the transitional depression, many companies based there are beginning to rebuild their export networks in other countries in the region, banking on their connections and knowledge of markets and a level of local brand awareness that remains high.

Figure II.23. FDI flows into the top 20 countries in Central and Eastern Europe, 1995-1996[a]
(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

[a] Includes economies in Central Asia and former Yugoslavia.

Trade within the region by the Czech Republic, Hungary, Poland and Slovakia rose by 40 per cent in 1995, and trade between the Czech Republic and Poland has more than doubled since 1995 (UN-ECE, 1996b). Several Central and Eastern European companies are also investing in the region (box II.11), including through mergers and acquisitions and joint ventures. For example, Slovakia's VSZ a.s. merged with Trinecke Zelezarny a.s. from the Czech Republic, to form a steel-making company, and the Russian gas company Gazprom acquired Hungary's General Banking & Trust Co.[87]

The growing importance of intra-regional FDI is also reflected in the fact that 16 per cent of the BITs concluded by Central and Eastern European countries are with other countries of the region, most of them settled in 1996. Romania leads, together with Poland, in BITs concluded with other transitional economies, followed by the Czech Republic, Hungary and Ukraine (see annex table B.10).

Box II.11. Hungary's nascent outward investors

In 1996, Hungary experienced record FDI outflows of $58 million. In the first quarter of 1997, more than $50 million FDI outflows were approved.[a] Last year, the National Bank of Hungary registered 385 licences and approved another 74 licences for outward investment. Hungarian firms initiated new investments in 44 countries in 1996, mostly in Romania, followed by the United States and Slovakia. The favoured locations for Hungarian FDI were Slovakia, Romania and Austria. In Romania, Hungary was the twentieth largest foreign investor, contributing $23 million in cumulative inflows out of an estimated total of $2.2 billion between 1989 and 1996.

Oil and Gas Ltd. (MOL), Hungary's largest company and its second biggest exporter, has become that country's most active outward investor. In Croatia, Oil and Gas Ltd. is negotiating the acquisition (for DM 92.8 million) of a 12.5 per cent stake in the Adriatic Sea-Hungary pipeline. The company has also expanded its network of petroleum distribution in neighbouring countries and has participated in oil exploration and drilling in the Commonwealth of Independent States, as well as in other oil-endowed countries in other regions. Hungarian pharmaceutical producer Richter Gedeon has established, together with a Russian partner, a packaging factory in the Russian Federation. In Romania, pharmaceutical producer Pharmavit has been the most successful Hungarian investor.[b] Zalakerámia, a ceramic tile manufacturer, acquired a producer in Croatia and, recently, the majority stake in the Cesaron factory in Romania.[c]

Growth of Hungary's outward FDI is based on several factors:

- Most major Hungarian enterprises have been privatized and have, by now, consolidated their activities and strengthened their financial position. Some are listed on the local stock exchange, enabling them to raise capital, including for outward investment.
- The small size of Hungary's economy leaves many enterprises with international expansion as the only avenue for becoming competitive internationally.
- Hungarian enterprises may be in a particularly advantageous position when investing in other transitional economies because of their knowledge of these markets. Often, particularly in the case of smaller investors, cultural and personal links play an important role in investment decisions. This is reflected by the importance of Central and Eastern Europe in the Hungarian outward FDI picture. That region accounted for about a quarter of Hungary's FDI abroad in 1996 (box table).

/...

(Box II.11, cont'd)

Box table. Hungary's FDI abroad, 1996

(Millions of dollars and percentage)

Host country	Number of licences	Share of total (Per cent)	Value of FDI (Million dollars)	Share of total (Per cent)
Central and Eastern Europe	217	58	14.0	24
Poland	23	6	0.4	1
Romania	106	28	4.9	8
Russia	22	6	1.8	3
Slovakia	37	10	5.1	9
Ukraine	29	8	1.8	3
Western Europe	98	25	10.0	17
Austria	37	10	3.3	6
Germany	36	9	2.0	3
Netherlands	4	1	2.0	3
United Kingdom	21	5	2.7	5
United States	46	12	2.8	5
Other	24	6	31.4	54
Total	385	100	58.2	100

Source: National Bank of Hungary, unpublished data.

The available data suggest that Hungarian FDI in Central and Eastern European countries is concentrated in manufacturing, whereas the country's FDI in Western countries appears to be more geared towards establishing a trading presence.

Hungary's investment abroad has been facilitated by the liberalization of its FDI regime in compliance with the country's OECD membership. In 1996, the regulation of capital outflows was simplified. A two-step procedure for authorization for outward FDI, involving both the Ministry of Industry and Trade and the Ministry of Finance, was replaced by a one-stop reporting and registration obligation with the National Bank of Hungary. Only portfolio investments and special cases not fulfilling all provisions of the new law (e.g., where the host country is not an OECD member country and no bilateral investment treaty exists) now require prior authorization by the National Bank of Hungary.

The Government is also considering measures to promote further outward FDI, such as establishment of a promotion fund, preferential credit lines and investment guarantees. The promotion fund would operate as a joint stock investment company, co-investing with Hungarian private enterprises that invest abroad and selling its stake in the fund to those enterprises after a period of time. The Hungarian Export Credit Guarantee Corporation (MEHIB) has developed a political risk insurance scheme for Hungarian outward investors. Investment locations are ranked on the basis of four risk categories that are revised twice a year. A fifth category applies to countries on an ad hoc basis.

[a] See *Világgazdaság*, "Növekszik a magyar tőkekivitel" ("Hungarian capital exports increase"), vol. 29, no. 46, 5 June 1997, pp. 1 and 3.

[b] See *Magyar Hirlap*, "Egyre több magyar cég lépi át a határokat" ("There are more and more Hungarian firms investing abroad"), 8 February 1997, pp. 1 and 10.

[c] See Tamás G. Korányi, "Bukarestben vett gyárat a Zalakerámia" ("Zalakerámia has bought factory in Bucharest"), *Napi Gazdaság*, vol. 6, no. 209, 4 June 1997.

2. Foreign direct investment and competition

By increasing competition in local markets, FDI has had a major influence on market structures in several countries of Central and Eastern Europe. There are many examples of FDI liberalization contributing to a healthier competitive market. Foreign direct investment, particularly in small and medium-sized enterprises, has helped to de-monopolize markets and stimulate competitive behaviour. Foreign-investor participation in the restructuring and privatization of large state-owned enterprises has helped to overcome the "legacy of monopolization" (Fingleton *et al.*, 1997). Foreign affiliates typically have better marketing capabilities, a superior market performance and are also engaged more actively in exporting than are purely domestic firms (UNCTAD, 1995a).[88] Competition introduced by such firms, either in the form of products and services unavailable previously or of higher quality, is forcing local producers and service providers to try and enhance their own performance (OECD, 1996c; see also Hooley *et al.*, 1996). This is particularly visible in consumer-related services and manufacturing industries that were neglected under the centrally planned system (box II.12).

The rush of TNCs to establish a local presence in the region has resulted, in many industries, in too many companies fighting for too few consumers. That has further improved consumer welfare through quality improvements and price decreases and a consumer orientation of goods and services hitherto unknown in the countries of the region. This has been further accentuated by growing competition from local manufacturers who are taking advantage of the new business opportunities and are winning customers back from foreign companies (and brands) by improving quality and offering less expensive products.

Box II.12. TNCs in consumer and service industries in Central and Eastern Europe

Services industries and consumer-oriented manufacturing were mostly neglected under the centrally-planned economic systems in Central and Eastern Europe. After the market-opening, prior unavailable products and services were introduced through trade and investment. For example, retailing companies such as Globi (Belgium), Robert/Auchan (France), Savia/Tesco (United Kingdom), Seham/Ahold & Allkauf (Germany), Marks & Spencer (United Kingdom), Ikea (Netherlands) and Metro (Switzerland) expanded their networks of supermarkets and hypermarkets to the Baltics, the Czech Republic, Hungary, Poland and Slovakia.[a] In the tobacco industry, companies such as B.A.T. (United Kingdom), Phillip Morris (United States), R. J. Reynolds Tobacco Co. (United States), Reemtsma (Germany) and Rothmans International (United Kingdom) invested more than $3 billion to buy cigarette factories in the region. Similarily, the world's largest hotel groups (Trust House Forte Plc (United Kingdom), Holiday Corporation (United Sates), Intercontinental (Japan) and Sheraton (ITT Corp., United States)), and the world's biggest music companies (Bertelsmann Music Group (Germany), EMI (United Kingdom), Polygram (Netherlands), Sony (Japan) and Time Warner (United States)) moved swiftly into Central and Eastern Europe. And, as Western consumer-related companies moved into the region, the global advertising agencies that promote and market their products followed closely behind (including Bates, Saatchi &Saatchi, BBDO, Grey, McKann Erickson, Young & Rubicom and FCB). Perhaps more important, several insurance companies established a presence after restrictions on foreign involvement were lifted -- among others, Nationale Nederlanden (Netherlands), Sedgwick (United Kingdom), Marsh & McLennan (United States).[b] Similar examples can be found in other producer services, particularly nontradable banking, financial and other business services.[c]

[a] See "Survey consumerism", *Business Central Europe*, June 1997, pp. 37-46.
[b] See "Survey insurance", *Business Central Europe*, November 1993, pp. 33-47.
[c] See, e.g., "Long-term punt", *Business Central Europe*, February 1997, pp. 51-52.

Foreign direct investment has also helped to ease the adverse effects on domestic production of opening an economy to competition through trade. The Hungarian pharmaceutical industry is an illustration. Here, the ability of the industry to compete with foreign imports after the market was opened benefited from foreign investment: the slowdown in the decline of domestic production in total sales over 1994-1995 (the market share of domestic products fell from 74 per cent in 1990 to 47 per cent in 1994 and 45 per cent in 1995) was due to the fact that five of the ten leading pharmaceutical companies became foreign-owned.[89] Likewise, the increase in car sales in Poland to more than 370,000 units in 1996 (an increase of 41 per cent over 1995 -- the biggest increase recorded in Europe that year) occurred after Fiat purchased its long-standing Polish partner FSM in 1992. Fiat's production in Poland meant that imports could be kept at a low level of 108,000 units in 1996 and that domestic production was able to compete successfully with foreign imports.[90]

Competition through FDI also helped to expose goods and services produced by Central and Eastern European firms to world market prices. This has sometimes led to closures of local companies incapable of competing with foreign affiliates in their own country. As a result, some industries became almost entirely foreign-owned. In the Visegrad countries, for example, only a few established television-producing firms (such as OTF in Slovakia, Videoton in Hungary and Elemis and Unimor in Poland) have survived competition from imports, foreign affiliates and private start-ups.[91]

In some instances, however, TNCs have led to reduced competition by, for example, foreclosing market entry, fixing prices and engaging in anti-competitive mergers. Eager to attract FDI, several countries in Central and Eastern Europe have sometimes made concessions to individual TNCs by, for example, granting exclusive market-supply rights for extended periods. As countries became more aware of the adverse impact on competition of providing such exclusive rights, they began to withdraw them. For countries aspiring to join the European Union, removing such exclusive privileges was a necessity. In Poland, for example, Daewoo's tariff incentives (in the form of duty-free imports of components which were granted under its $1.2 billion purchasing agreement of car-producer FSO in 1996 and are guaranteed until March 1998) have become an issue in the preliminary discussions on the country's European Union membership. The European Union has said the incentives are an anti-competitive practice that discriminates against European Union car-producers, which have to pay duties on their exports to Poland.[92]

Anti-competitive behaviour by foreign affiliates has prompted action by national competition authorities in the region. For example, Poland's competition authority fined FIAT $1.3 million for demanding pre-payments for Cinquecento cars.[93] Hungary imposed fines totalling $3.4 million on Sara Lee/Douwe Egberts (Netherlands), Eduscho (Austria), Tschibo Frisch Röst Kaffee (Germany), which has a $20 million greenfield investment in Budaörs, and Kraft Jacobs-Suchard and Nestlé (Switzerland), for fixing coffee prices. [94] However, such incidents do not appear to be more prevalent in Central and Eastern Europe than in other regions. In addition, import competition undermined the ability of foreign affiliates to engage in restrictive business practices and anti-competitive behaviour.[95]

3. Conclusion

Central and Eastern Europe's success in attracting FDI remains weak by global standards. In addition, the continued dependency of FDI inflows on privatization programmes in the region does not augur favourably for future FDI inflows. Most advanced economies -- with the exception of Poland -- have largely concluded their privatization drives, and the likelihood of major

privatization efforts in the next-tier countries looks small. However, once a major privatization that allows for foreign participation gets under way in the Russian Federation, FDI can be expected to increase considerably.

Despite the small numbers, FDI has been a factor in the region's transition process towards creating market economies. This has been particularly apparent in areas where foreign enterprises have introduced competition and the benefits arising therefrom (in the form of quality improvements, price-decreases and a consumer-orientation) in local markets, and where they salvaged domestic production from all-but-sure extinction brought about by the market opening to Western imports.

Notes

1 Real GDP growth in Latin America is estimated to be 3.8-4.6 per cent during 1997-1998, compared with 5-10 per cent for developing Asia and 3 per cent for all developed countries (OECD, 1996a, table 24).

2 Data reported by Eurostat do not include reinvested earnings in order to make FDI data comparable among all European Union member countries.

3 The data on reinvested earnings have been included in Japan's official balance-of-payments statistics only since 1996. The 1996 outflow data including and excluding reinvested earnings are $25,485 million and $22,994 million, respectively (Japan, Bank of Japan, 1997).

4 One aspect of New Zealand's and Australian's liberalization programmes that is not well understood is the role played by their bilateral agreement, the Australia New Zealand Closer Economic Relations Agreement. Although it is a preferential agreement motivated by the small size of their domestic markets, there was very little to gain from having preferential access to each other's market because the combined market is still small and there are a number of similarities between the two regions (Scollay, 1996). To increase market size, what is important is access to much larger markets -- hence Australia liberalized unilaterally *vis-à-vis* the rest of the world.

5 There is also scope for more FDI in Australia's financial industry, as recommended in a recent inquiry into the Australian financial system.

6 This figure has started to rise again during the past two years, but it is unlikely to match the 1981 level for some time.

7 For a list of these countries, see note to annex table B.1.

8 At least 11 LDCs have populations below 1 million (World Bank, 1996, pp. 188-189). By definition, among other criteria, the per capita GDP of LDCs is $765 or less.

9 Afghanistan, Bangladesh, Cambodia, Kiribati, Lao People's Democratic Republic, Maldives, Myanmar, Nepal, Samoa, Solomon Islands and Vanuatu.

10 Data from UNCTAD, FDI/TNCs data base.

11 "Worlds apart", *Far Eastern Economic Review*, 25 July 1996, p. 81.

12 Hiebert Murray and Lee Matthew, "Investors flock to Cambodia, but beware", *Far Eastern Economic Review*, 11 July 1996, p. 56.

13 Stéphane Dupont, "La zone franc s'élargit à la Guinée-Bissau", *Les Echos*, 2 January 1997.

14 "Watching the Mekong flow", *The Economist*, 7 September 1996, p. 59.

15 "Private-sector beer is best", *The Economist*, 2 November 1996, p. 54.

16 Mark Ashurst, "Africans forge closer trading links", *Financial Times*, 26 November 1996, p. 6.

17 This does not mean that no information is available: various publications (e.g., the Economist Intelligence Unit's country studies), some databases and a number of international organizations providing FDI promotion services, such as UNCTAD, World Bank and UNIDO, as well as governmental bodies and chambers of commerce in home countries touch upon FDI and provide some relevant information.

18 Through their IPAs, most LDCs offer promotional brochures and similar material, typically of short length, to foreign investors.

19 The discussion of FDI trends refers to all countries in Africa except South Africa, which is classified as a developed country.

[20] Sub-Saharan Africa includes all developing countries in Africa except the six North African countries (Algeria, Egypt, Libyan Arab Jamahiriya, Morocco, The Sudan and Tunisia).

[21] In 1995, Tunisia concluded a free trade zone agreement with the European Union to be phased in over 12 years. See, Roula Khalat, "Tunisia steps up sell-offs to attract funds", *Financial Times*, 29 May 1996.

[22] James Whittington and Mark Dennis, "Most markets restrict foreign investors", *Financial Times*, 10 January 1996.

[23] "New horizon economies", Union Bank of Switzerland, First Quarter, 1997, p. 84.

[24] In 1995, for example, Nigeria promulgated an indigenization decree allowing foreign companies to take a majority stake in local firms. See, "Foreign investors are in no hurry to divest", *Financial Times*, 14 November 1995.

[25] "An African success story", *The Economist*, 14 June 1997, p. 53.

[26] Nancy Dunne, "U.S. to reward growth in Africa", *Financial Times*, 30 April 1997, p. 5.

[27] "The world in 1997", *The Economist*, 1996, p. 79.

[28] If South Africa should become a growth pole, it may initiate a dynamic in the framework of which the country becomes increasingly a location for foreign investors from neighbouring countries.

[29] However, in the case of Malawi and Zimbabwe, bilateral trade agreements make these tariff barriers, at least in some products, less significant.

[30] See, for instance, Christopher Vadot, "La SADC et le modèle asiatique", *Jeune Afrique économie*, 16 September 1996, pp. 56-59.

[31] For a more detailed discussion of the "flying geese" paradigm, see UNCTAD, 1995a.

[32] ILO, "Unemployment in South Africa is probably lower than estimated, says ILO study". Press release, ILO/96/31, ILO: Geneva, 14 October 1996, p. 2.

[33] Almost the same results are obtained when more sophisticated indicators for levels of development are applied, for instance, the UNDP Human Development Index (HDI). According to the HDI, other SADC countries, namely, Mauritius and Botswana with index values of 0.825 and 0.741, respectively, are ranked higher than South Africa which has an index value of 0.649 (UNDP, 1996).

[34] Based on oral communication with South African experts.

[35] UNCTAD trade database, unpublished data.

[36] "America loses its Afrophobia", *The Economist*, 26 April 1997, p. 23.

[37] For instance, Mauritius and Zimbabwe, two of the more advanced countries in the region, seem to possess particular competitive advantages in food-processing and some manufactured goods, e.g. textiles.

[38] The study analyses trade opportunities between SADC and SACU. Therefore, the statement also holds true for SACU members other than South Africa, i.e., Botswana, Lesotho, Namibia and Swaziland.

[39] "Exchange curbs keep investors on wrong side of SA border", *Sunday Times*, 5 May 1996.

[40] At present, South Africa has not concluded any BITs within SADC. The country has prepared a draft of such a treaty with Mozambique, which may serve as a blueprint for similar agreements with other African states.

[41] The concept is Terutomo Ozawa's.

[42] Central Bank of Brazil, 1997.

[43] *Latin American Special Report*, August 1996, p. 5.

[44] *Prensa Economica*, March 1997, p. 56.

[45] UNCTAD, FDI/TNC database.

[46] See United States Department of Commerce, 1996d.

[47] Bernard Simon, "Time to learn Spanish", *Financial Times*, 22 April 1996.

[48] "Investors in Latin America more confident", *Financial Times*, 17 March 1997.

[49] Ibid.

[50] These are the Colonia Protocol for the Reciprocal Promotion and Protection of Investments in MERCOSUR of 17 January 1994 which applies to investments among MERCOSUR members; and the Buenos Aires Protocol for the Promotion and Protection of Investments of Third States of 5 August 1994, which applies to investments from non-MERCOSUR countries. Contained in UNCTAD, 1996d.

[51] The Decision 291 of the Commission of the Cartagena Agreement: Common Code for the Treatment of Foreign Capital, Trademarks, Patents, Licenses, and Royalties of 21 March 1991, which replaced the old

Decision 24 on the same subject matter. Contained in UNCTAD, 1996d.

52 In 1996, the inflation rate was brought down to 7 per cent, the lowest since 1993. China's foreign debt-service ratio was 7 per cent and its foreign exchange reserves now exceed $100 billion.

53 "Viet Nam defies gloom mongers", *Asia Times*, 3 January 1997, quoting the Ministry of Planning and Investment (MPI) of Viet Nam.

54 In fiscal year 1996-1997, FDI accounted for 40 per cent of total private capital inflows and portfolio investment for 37 per cent (excluding global depository receipts). See "Foreign direct investment pips FII funding in 96-97", *Economic Times*, 19 May 1997.

55 The United States tops the list of countries investing in India, followed by the United Kingdom and Mauritius (mainly investment by overseas Indians). According to the Office of the Director General of Foreign Trade of India, companies based in the Republic of Korea committed Rs 22.4 billion of FDI to India, 12 per cent of which was approved between April and September 1996 (the first six months of the 1996/1997 fiscal year). Thus, the inflow of FDI from the Republic of Korea to India rose more than 12 times compared to last year.

56 For example, the LG group announced it was committing $2 billion in investments to India in various industries, including petrochemicals, pharmaceuticals, cosmetics, household goods and other processed goods over the next few years.

57 Some developing Asian economies are among the leading investors in South Africa. Malaysia, Republic of Korea, Singapore, Taiwan Province of China and India are ranked fourth, fifth, tenth, eleventh and twelfth, respectively, as sources of FDI into South Africa during 1994-mid-1996 (Cargill, 1996).

58 The BOP implications of outward FDI of these countries, which are becoming important investors, are not explored in the discussion.

59 The current account balance can be defined in different ways: (1) the difference between exports (goods, services and income) and imports plus net transfer payments; (2) minus (capital and financial account balance) plus change in reserves; and (3) the difference between national savings and domestic investment.

60 For a detailed discussion of the subject see Milesi-Ferretti and Razin (1996).

61 Market-seeking investment could improve the BOP of the host country through foreign exchange saved, provided that it does not depend on very high rates of protection, which could result in artificially high profits, and hence remittances of such profits may exceed net savings from not importing.

62 The countries are Indonesia, Thailand (Ramstetter, 1997) and China (Sun, 1996).

63 Local procurement of Japanese affiliates in Asia increased from 27 per cent of total procurement in 1981 to 44 per cent in 1988, but declined to 34 per cent in fiscal year 1994. In Latin America, there was a steady increase in the ratio from 28 per cent in 1981 to 39 per cent in fiscal year 1994. The figures refer to all Japanese affiliates; but to be able to capture the vintage effect adequately, local procurement for the same set of firms should be compared over time.

64 For a more detailed discussion of the various approaches, see Dunning (1993).

65 There are serious problems involved in measuring these transactions. While there are specific items in published BOP statistics that can be directly attributed to TNC activities, for most of the items, transactions of TNCs are not separately identified. Note that in the current account, entries are on a gross credit or debit basis, whereas in the financial account, entries are on a net basis reflecting changes in assets and liabilities.

66 See, for example, Ramstetter (1996) on the manufacturing industry.

67 The corresponding figures for 1992 were $6.6 million for imports and $2.9 million for exports (United States, Department of Commerce, *Survey of Current Business*, various issues). Data do not fully measure the trade effect of United States TNCs because of the absence of intra-affiliate trade.

68 See Athukorala and Menon (1995) and Sivalingam and Yong (1993).

69 Sivalingam and Yong (1993) report that, in these industries, the local content of total input was 76 per cent in 1983.

70 The figure is the 1990-1993 average gross domestic savings rate for low and middle-income countries or countries with 1993 GNP per capita of less than $8,626 (World Bank, 1996).

[71] Since the creation of the Bangkok International Banking Facilities (BIBF) in March 1993, there has been a shift from intra-company loans to BIBF loans. For 1995, the rebooking of FDI loans was estimated at $437 million. This figure should be added to FDI in table II.9 to derive the total financial flows associated with FDI (Thailand, Bank of Thailand, 1996).

[72] Foreign-direct-investment data should be treated with caution because of problems of over-valuation and round-tripping (see UNCTAD, 1995a, pp. 59-60) but measures introduced recently towards national treatment should reduce data distortions.

[73] In 1993 and 1996, China recorded current account deficits amounting to around $12 billion and $5 billion, respectively.

[74] Israel, a developed country according to UNCTAD's classification, is not included unless otherwise specified.

[75] Bahrain, Islamic Republic of Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates.

[76] Cyprus, Jordan, Lebanon, Syrian Arab Republic, Turkey and Yemen.

[77] Reported in the *Oil & Gas Journal*, vol. 89 (2 December 1991), pp. 37-44.

[78] Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates.

[79] J. Whittington and M. Dennis, "Most markets restrict foreign investors", *Financial Times*, 10 January 1996.

[80] "Bilan du monde", *Le Monde*, 1997, p. 113.

[81] "New horizon economies", Union Bank of Switzerland, First quarter 1997, p. 89.

[82] "A survey of Poland", *Business Central Europe,* February 1997, pp. 42-45.

[83] See *BNA's Eastern Europe Reporter*, 24 February 1997, p. 119; see also *Figyelö*, 6 February 1997, p. 7.

[84] Lansbury and Pain found a significant effect from privatization programmes, labour costs and research intensity, and existing trade linkages; see Lansbury and Pain (1997).

[85] For the automobile industry, see, e.g., Haig Simonian, "Into the east at full throttle", *Financial Times*, 13 February 1997, p. 11.

[86] For example, over the first nine months of 1995, 40 joint ventures between CIS partners were registered in Kazaksthan, 1,042 in the Russian Federation and 63 in Uzbekistan. See V. Komarov, "Investitsionnoye sotrudnichestvo stran SNG", *Ekonomist,* May 1996, pp. 82-87.

[87] *Business Central Europe,* 1996, various issues.

[88] This finding has been recently supported by econometric research in Hungary. See Hooley *et al.* (1996).

[89] Information provided by the Hungarian Ministry of Industry, Trade and Tourism, Division of Trade Development and Investment Promotion.

[90] See Stefan Wagstyl, "Manufacturers have moved into the fast lane", *Financial Times*, 26 March 1997, p. 9.

[91] See "Twilight zone", *Business Central Europe*, March 1996, p. 33.

[92] See Christopher Bobinski, "Poland tightens up on Daewoo under EU pressure", *Financial Times*, 3 February 1997; and *BNA's Eastern Europe Reporter*, 24 February 1997, p. 140.

[93] "Crossborder monitor", *Business Eastern Europe,* 8 February 1995, p. 3.

[94] Ibid..

[95] See Péter Kaderják, "A hazai közvetlen külföldi befektetéseket meghatározó tényezökröl - egy kvantitativ elemzés", *Közgazdasagi Szemle*, December 1996, pp. 1072-1087.