CHAPTER II

REGIONAL TRENDS

A. Developed countries

Developed countries registered record levels of FDI inflows and outflows in 1998 amounting respectively to $460 billion (68 cent more than 1997) and $595 billion (or 46 per cent more) (annex tables B.1 and B.2). Their share in worldwide outflows further increased from an already high ratio of 86 per cent in 1997 to about 92 per cent in 1998, while their share in inflows rose even more from 59 per cent to 72 per cent. This marked change reflects a combination of factors both in developed and developing countries: first, a solid growth performance in the United States, and in several member countries of the EU (and non-EU European countries), resulting in a stimulation of outflows from TNCs from these countries, and in greater attractiveness of these economies as an investment location; second, the significant wave of M&As that took place last year, especially between the EU and the United States as well as in Japan as a new eager host; and, third, the economic and financial crisis experienced by a number of developing economies in 1997 and 1998 which reduced the capacity of firms in affected countries to invest abroad and at the same time made some types of investment – market seeking FDI – in their domestic economies relatively less attractive.

As in the past, the Triad (EU, Japan and the United States) dominate the picture (figures II.1 and II.2), accounting for about 93 per cent and 91 per cent of FDI inflows into and outflows from developed countries in 1998. Outside the Triad, Australia, Canada and Switzerland remain significant FDI recipients, the latter two also being significant outward investors. Particularly striking in that respect is the difference between the ratios of FDI outflows and FDI inflows to gross fixed capital formation which characterized Switzerland; at 26 per cent during 1995-1997, the ratio of outflows to gross fixed capital formation is much higher than that of inflows (seven per cent during the same period) (figure II.3).

1. United States

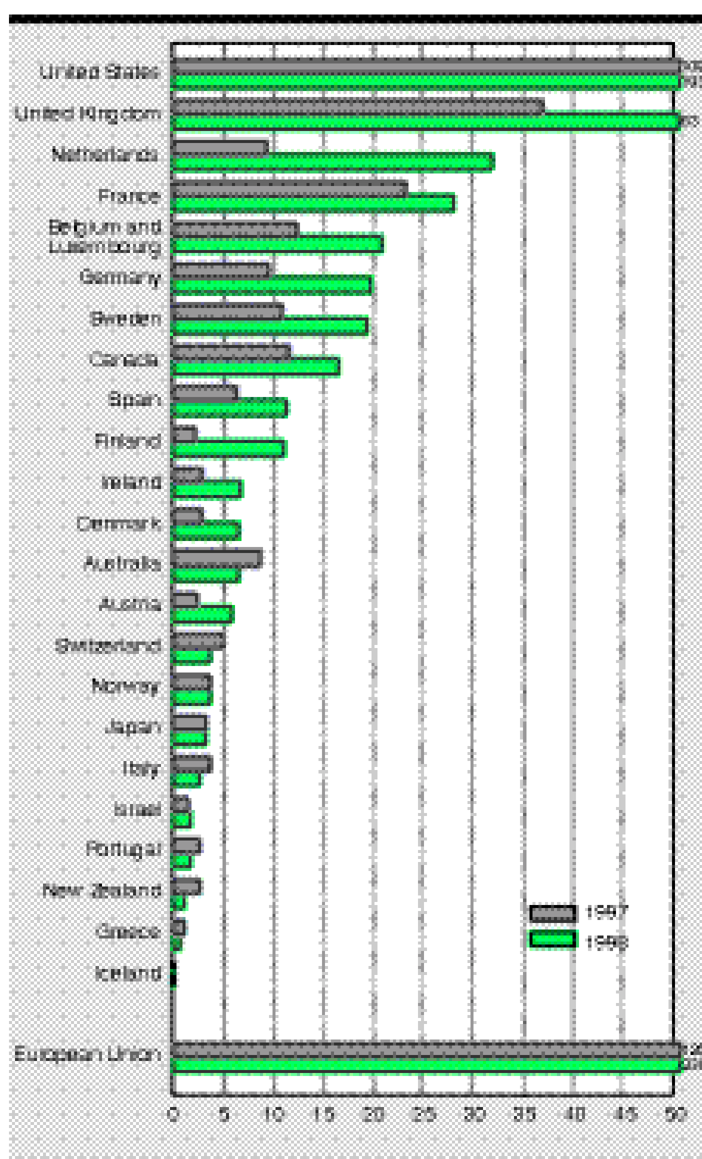
FDI inflows to, and FDI outflows from, the United States were at record highs in 1998 (figures II.1 and II.2). FDI inflows nearly doubled to $193 billion, mainly because of large-scale M&As (see chapter III.B). Inflows soared even though Japan, the most important investor in the United States after the European Union (EU), suffered from persistent recession and structural problems in the financial sector. While Japan's FDI flows to the United States slightly declined to less than $9 billion in 1998, EU FDI flows to the United States tripled to $155 billion. European investors were eager to benefit from the economic boom in the United States, a boom that

continued into the seventh consecutive year. In particular, German FDI flows to the United States increased fourfold, and United Kingdom FDI flows rose more than eightfold. Taken together, these two investor countries contributed almost 60 per cent to total FDI inflows to the United States in 1998.

The expanding United States economy and rising asset prices – which enhance a firm's capacity to raise funds – stimulated United States FDI outflows as well: they reached $133 billion in 1998. Compared to inflows, however, the growth of FDI outflows was marginal (figure II.2). The EU continued to be the most important recipient of United States FDI, accounting for 54 per cent of total outflows in 1998. Outflows to Latin America declined by 26 per cent, mainly because of sharply reduced flows to Brazil. Outflows to Mexico, too, suffered a significant setback. By contrast, outflows to some host countries in Asia and the Pacific (notably to Australia, Japan and Thailand) increased significantly.

Figure II. 1. Developed countries: FDI inflows, 1997 and 1998[a]

(Billions of dollars)



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

[a] Ranked on the basis of the magnitude of 1998 FDI inflows.

The sectoral composition of FDI in 1998 differed significantly between inflows and outflows. Manufacturing (48 per cent) and petroleum (30 per cent) accounted for the bulk of total FDI inflows. Booming inflows in the petroleum industry were related to exceptionally high M&A activities in this industry (see annex table B.9). By contrast, services industries (notably non-bank finance and insurance) figured most prominently in FDI outflows in 1998, considerably exceeding the share of manufacturing in total outflows (around 60 per cent against 28 per cent). FDI outflows in services were encouraged by the worldwide trend towards privatization and deregulation in this sector.

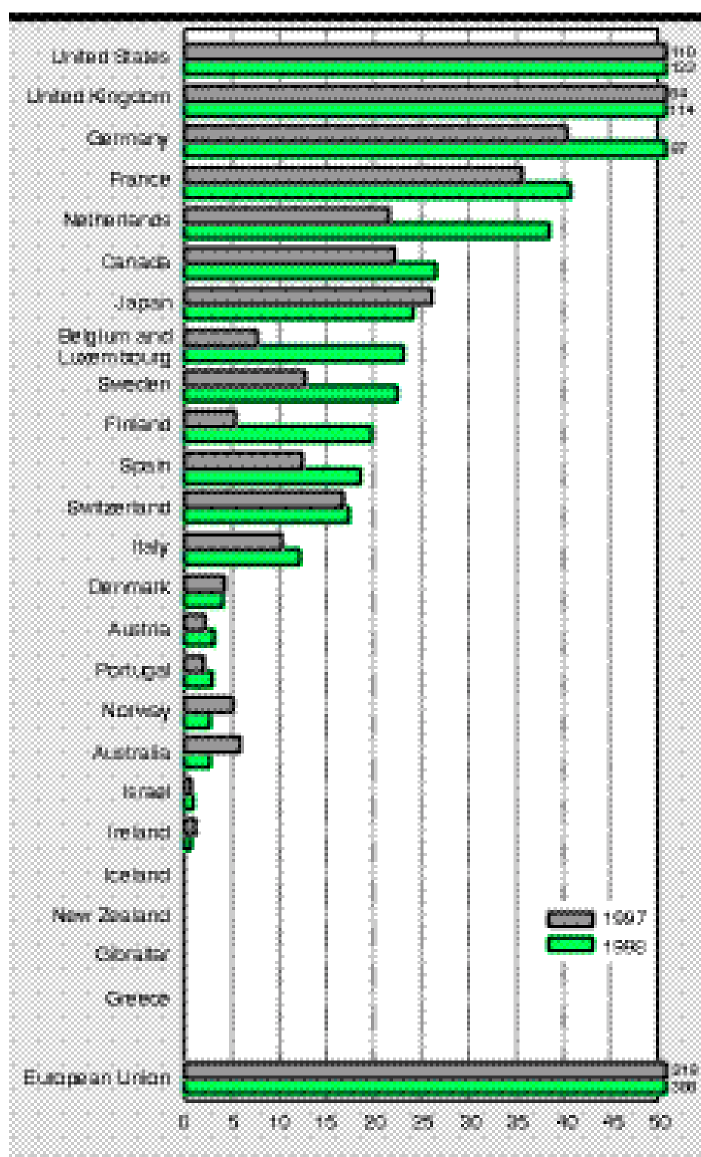
Likewise, the mode of financing differed between FDI inflows and FDI outflows. Inflows were financed up to 80 per cent by equity capital in 1998, while intra-company loans and reinvested earnings each accounted for roughly one tenth (Bach, 1999). Increases in equity capital were quite significant in 1998, amounting to $157 billion compared to only $46 billion in 1997 (or half of total FDI inflows). This prominence seems to be related to M&A activities, which accounted for the bulk of FDI inflows to the United States.[1] Equity capital also was important for FDI outflows, but the largest source of financing of FDI outflows was reinvested earnings. Intra-

company loans provided a much less important source of FDI outflows — less than one tenth of the overall total.

The United States' overall attractiveness to FDI tends to disguise the uneven distribution of foreign investment across individual states of the country. This is reflected, for instance, in the wide differences between states in the share of private sector employment accounted for by affiliates of foreign TNCs (figure II.4). In 1996, they were highest in Hawaii (11 per cent), South Carolina (eight per cent) and North Carolina (seven per cent). Japanese-owned affiliates contributed about 70 per cent to affiliate employment in Hawaii, whereas European-owned affiliates accounted for about three-quarters of affiliate employment in the Carolinas. At the opposite extreme, the employment share of foreign affiliates was below two per cent in Montana, North Dakota and South Dakota. Apart from Hawaii, the employment impact of FDI was concentrated on the east coast of the United States.

Figure II.2. Developed countries: FDI outflows, 1997 and 1998[a]

(Billions of dollars)

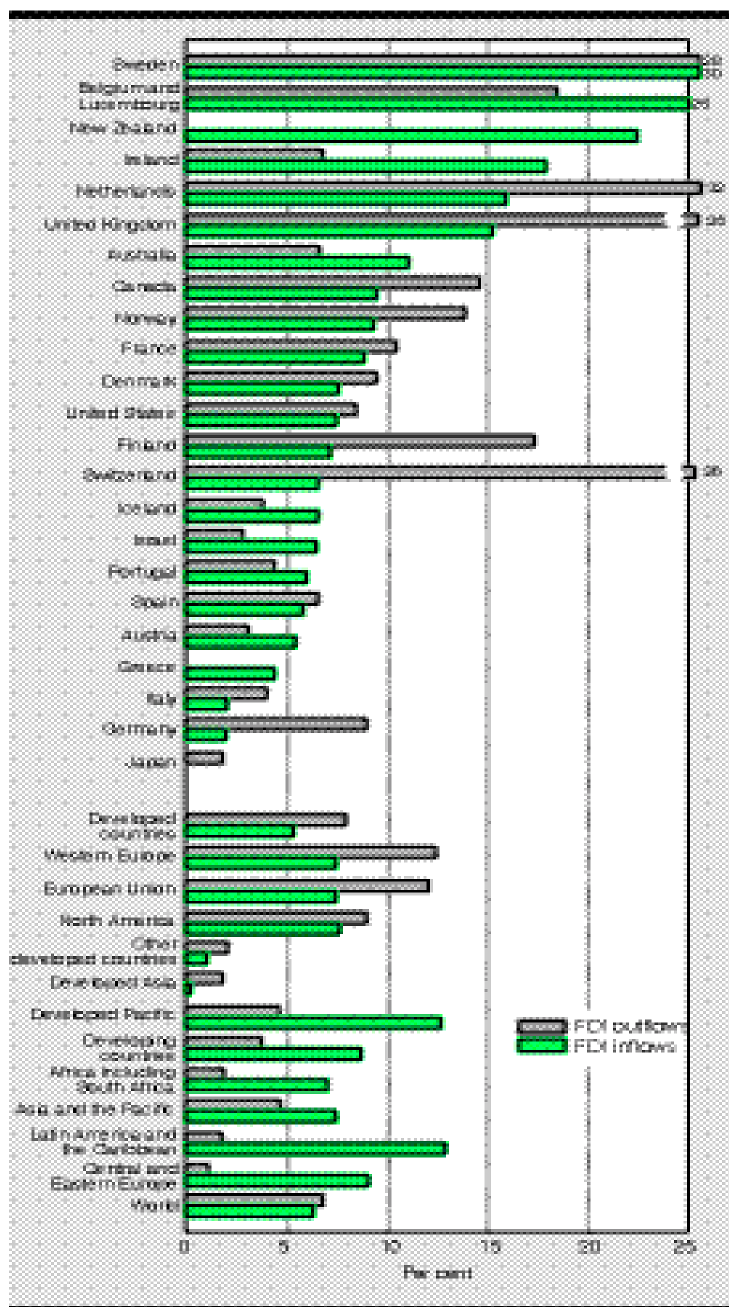


Source: UNCTAD, FDI/TNC database and annex table B.2.

[a] Ranked on the basis of the magnitude of 1998 FDI outflows.

On average, the share of employment accounted for by foreign affiliates was higher in manufacturing than in other sectors.[2] But across states it was not significantly linked to the share of manufacturing in gross state product, whereas it was positively correlated with the share of finance, insurance and real estate in gross state product (table II.1). Not surprisingly, the employment impact of FDI was relatively low in states in which the agricultural sector figured prominently. While the share of foreign affiliates in employment was higher in richer states than in poorer ones, the wage level does not appear to be of relevance in this respect. Other factors that may have had an impact on the allocation of FDI across states cannot easily be captured empirically. For example, the discouraging effect of relatively high wage costs in particular states may have been outweighed by a better endowment of highly skilled labour and/or the provision of financial and tax incentives to foreign investors by state authorities. Two observations tend to support this reasoning: high-wage economic areas have a higher proportion of their manufacturing jobs in industry clusters, allowing foreign (and domestic) investors to take advantage of benefits associated with clustering, such as economies in transportation and access to common input suppliers (Bernat, 1998, p. 55). At the same time, these economic areas tend to

Figure II.3. Developed countries: FDI flows as a percentage of gross fixed capital formation, 1995-1997[a]



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

[a] Ranked on the basis of the magnitude of 1995-1997 FDI inflows as a percentage of gross fixed capital formation.

[b] The ratio of FDI outflows to gross fixed capital formation was -6.7 per cent.

have a well-educated and diverse workforce.

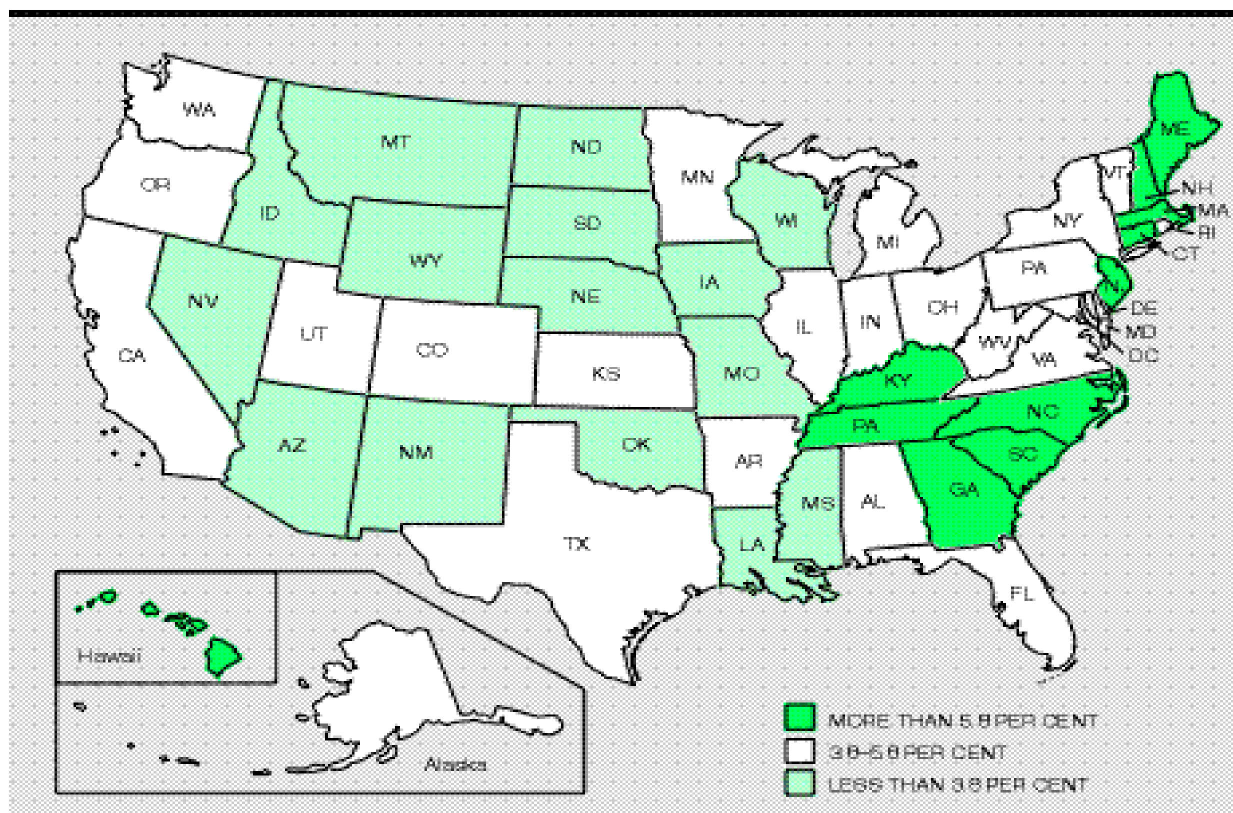
It remains to be seen whether the record FDI inflows and outflows in 1998 for the United States as a whole can be sustained. In the short run, various factors working in opposite directions have to be taken into account when assessing this question. Much depends on short-term business conditions in the United States. While the United States economy is widely expected to grow in 1999, inflationary pressures may induce the Federal Reserve to raise interest rates. Such a move could affect FDI in- and outflows in two major ways:

- A rise in United States interest rates could further strengthen the dollar *vis-à-vis* the euro and the yen. The effects on United States FDI outflows would be ambiguous. While higher interest rates add to the costs of financing FDI outflows, a stronger dollar would counteract this cost factor. In the case of inflows, experience suggests that a dollar appreciation tends to discourage FDI into the United States (Graham and Krugman, 1995, pp. 45-47).

- A still more critical question is whether rising interest rates would trigger a major correction in asset prices. If stock markets were to decline significantly, United States FDI outflows could be affected negatively as United States investors would be constrained financially. On the other hand, foreign investors (e.g. from Europe) might take advantage of reduced asset prices to enter through M&As and expand their activities in the United States.

Besides internal factors in the United States, economic conditions prevailing in partner countries have an impact on the sustainability of record FDI inflows and outflows. For FDI outflows, the situation in Asia – where United States firms are already active as acquirers of assets through M&As – is of particular relevance. If the optimistic perception proves to be correct that emerging markets in Asia have largely overcome the financial crisis, United States

Figure II.4. United States: employment share of foreign affiliates across states,[a] 1996



Source: Based on data from Fahim-Nader and Zeile, 1998.

[a] Employment by non-bank United States affiliates of foreign companies as a percentage of total private sector employment in the state. The average share for the United States was 4.8 per cent.

investors may strengthen their engagement in this region, in order to benefit from economic recovery. Moreover, if China were to become a WTO member, this would be an incentive for export-oriented FDI flows from the United States (and other investor countries) to China. As for FDI outflows to Europe, the expected decline in economic growth in several members of the European Monetary Union (EMU) (notably in Germany and the Netherlands) and in the United Kingdom may discourage United States investors from increasing their engagement in this region. A stronger euro could work in the same direction. In the longer run, however, United States investors are likely to take an active part in the restructuring and globalization of manufacturing and services industries in Europe.

An important factor shaping United States FDI inflows in the short run relates to the capacity of Japan to solve its internal problems and resume its traditional role with respect to acquiring and establishing new businesses in the United States. If Japan recovers, large-scale investments in the United States that have contributed significantly to the recent boom in overall inflows may receive another boost. The number of investments of $100 million or more has tripled between 1991-1993 and

Table II.1. United States: possible determinants of the employment impact of FDI across states, 1996, correlation results[a]

Correlation of employment share of affiliates of foreign TNCs with:	Pearson correlation coefficient
Per-capita income (United States average = 100)	0.30[b]
Share in gross state product (per cent)	
Agriculture, forestry and fishing	-0.51[b]
Manufacturing	0.1
Transportation, public utilities	-0.11
Finance, insurance and real estate	0.28[b]
Other services	0.07
Wages and salaries per capita (dollars)	0.02
Population density	-0.07

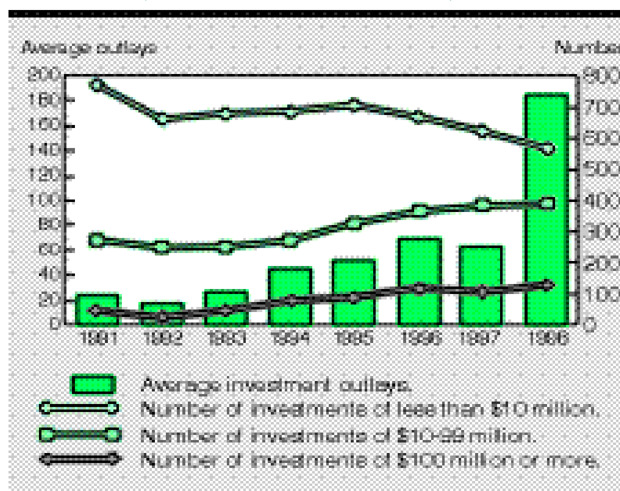
Source: UNCTAD, based on data from *Survey of Current Business*, June and October 1998 and January 1999.

[a] The number of observations is 51.
[b] Significant at the five per cent level (two-tailed test).

1996-1998 (figure II.5). Likewise, the average size of FDI outlays has tripled since the early 1990s. Investments of $100 million or more contributed 87 per cent to total outlays in 1996-1998, compared with 57 per cent in 1991-1993.

Figure II.5. FDI projects in the United States, by size of outlays, 1991-1998

(Millions of dollars and number)



Source: UNCTAD, based on data from Fahim-Nader and Zeile, 1998, and "Foreign investors' spending to acquire or establish U.S. businesses tops $200 billion for the first time in 1998", BEA News Release (www/bea.doc.gov/bea/newsrel/fdi98.htm).

As a result, and as in the case of FDI outflows, the sustainability of record FDI inflows cannot be taken for granted in the short run. Yet, in the longer term, the United States can be expected to remain an attractive location for foreign investors. Indeed, based on a positive perception by investors of a number of locational factors that go beyond market size and include, for instance, the country's domestic labour and financial markets, its favourable business environment (which for instance facilitates the start of new business), the quality of its infrastructure, its leading role in technological innovation and the close collaboration between research institutions and industries, the United States is widely considered to be today one of the most competitive developed countries (World Economic Forum, 1998).

2. European Union

The EU as a whole continued to be the world's most important outward investor in 1998, with $386 billion FDI outflows registered during that year, 77 per cent more than in 1997. The United Kingdom maintained its position as the largest EU investor, followed by Germany, France and the Netherlands. The increase in FDI outflows in 1998 was most pronounced for some smaller investor countries, including Finland, and Belgium/Luxembourg. Another familiar feature was that the EU reported substantially lower FDI inflows than FDI outflows. The discrepancy between inflows and outflows almost doubled from $92 billion in 1997 to $156 billion in 1998. Nonetheless, with $230 billion in 1998 (82 per cent more than in 1997), the EU succeeded once again in outperforming the United States as the single most important FDI recipient (annex table B.1). Finland and the Netherlands were the best performers in the EU in terms of growth of FDI inflows in 1998, whereas FDI inflows declined in Greece, Portugal and, most notably, Italy (figure II.1). Sweden turned to become one of the major recipients for FDI flows recently (box II.1), with again the highest ratio of FDI inflows to gross fixed capital formation among EU members (figure II.3). However, in terms of FDI inward stock to GDP, Belgium and Luxembourg led the way, while the Netherlands outperformed all other EU members in terms of outward stock to GDP (annex table B.6).

In light of the experience with previous steps towards market integration and their impact on intra-EU FDI flows, expectations were that intraregional FDI would be on the rise again after the announcement of the EMU. The EU recorded a boom in FDI inflows in the process of completing the internal market programme (Dunning, 1997; UNCTAD, 1993). The fact that the EU's share in world FDI inflows peaked at 50 per cent in 1991 indicates that foreign investors largely anticipated effective market integration at that time. The effects of the internal market programme on FDI have tapered off since 1993 (Gundlach and Nunnenkamp, 1994).

In contrast to the internal market programme, the data available so far suggest that the prospect of launching the single currency in January 1999 had little effect on FDI flows:

Box II.1. Policy changes and FDI: the case of Sweden

Sweden represents an interesting empirical case of how a change in attitudes and policies can make a difference in attracting FDI. For many decades, Sweden has been a prominent base for TNCs and thus a significant source of outward FDI. As a recipient of FDI, however, the country has historically played a more modest role. This was particularly the case in the 1980s, when Swedish companies invested heavily abroad but very little foreign investments entered the country. Between 1981 and 1990, the cumulative flows of FDI from Sweden amounted to about $48 billion, while inflows were $9 billion. Among the developed countries, only Japan had a greater discrepancy between outflows and inflows during the same period (Andersson and Fredriksson, 1993).

Today, the picture is quite different. In 1993, Sweden experienced a net FDI inflow for the first time in 25 years. Despite its population of only nine million inhabitants, Sweden was the fifth largest recipient of FDI flows in 1995 and the ninth in 1998 (annex table B.1). The big discrepancy between inflows and outflows has disappeared. As in most OECD countries, M&As partly explain this increase, although an increasing number of green-field and expansion investments have also been undertaken. Between 1990 and 1998, the number of foreign affiliates in Sweden increased by more than 52 per cent, from 2,600 to 3,953 entities.[a] Meanwhile, total employment in foreign affiliates rose from 200,000 to 333,000 employees. Interestingly, United States firms, which invested virtually nothing in Sweden during the 1980s, accounted for the largest volume of investment in the 1990s. Since 1990, the number of United States companies present in Sweden has risen from 350 to 670.

Several factors explain this dramatic shift. These include a number of measures that were taken at the end of the 1980s and in the early 1990s: the removal of exchange controls, tax reforms, the relaxation of restrictions for foreign participation in the financial sector and for M&As of Swedish companies and liberalization and deregulation policies in a number of industries (telecommunications, transport and electricity, for instance). Changes in the external political and economic environment were also important factors. On the one hand, the major political changes in Central and Eastern Europe meant the opening up of significant consumer markets for which Sweden is particularly well positioned for historical and geographical reasons. Indeed, since the early 1990s, Swedish trade and investment flows with Poland, the Russian Federation and the Baltic States have expanded rapidly, and a growing number of TNCs are locating in Sweden as a base for future expansion eastward. On the other hand, the enlargement of the European Union with Austria, Finland and Sweden in 1995 also enhanced Sweden's attractiveness to foreign investors: from being a country on the periphery of the European Union, it became strategically positioned in one of the most dynamic regions of Europe.

The tendency for TNCs to focus more on the availability of skilled labour, good infrastructure facilities, technology and innovative capacity – created assets – than on more traditional determinants such as labour costs, access to natural resources and large domestic markets (UNCTAD, 1998), is also a factor which works in favour of Sweden. In that respect, it is interesting to note that Sweden spends about 3.4 per cent of its GDP on R&D, the highest ratio in the world (among all reporting countries (UNESCO, 1998). Leading-edge industrial clusters exist for instance in fields such as telecommunications and information technology, pharmaceuticals and health care, and the automotive, steel and paper and pulp industries.

Source: Fredriksson, 1999.

[a] Majority-owned foreign affiliates only, surveyed by NUTEK (Swedish National Board for Industrial and Technical Development).

- In particular, world FDI flows to EMU member countries increased only slightly more than the world's FDI flows to non-EMU member countries (Denmark, Greece, Sweden and the United Kingdom) in 1998 (88 versus 74 per cent). The share of EMU members in total EU FDI inflows in 1998 (61 per cent) was still below their share in 1996 (70 per cent; see also figure II.6).

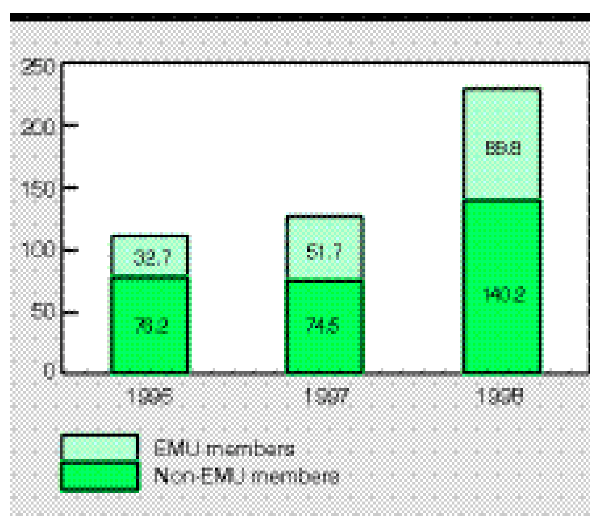
- The share of the EU in world FDI inflows of about 36 per cent in 1998 was about the same as in 1995.

- In contrast to expectations, the growth of EU FDI outflows to non-EU countries surpassed the growth of intra-EU flows in 1997.[3] As a result, the extra-EU share in total outflows reached an unprecedented high (figure II.7).

- The rising share of intra-EU flows in total EU FDI inflows since 1995 has to be attributed to the EU's rather poor record in attracting inflows from outside the EU (figure II.7).[4] The negative balance between EU FDI inflows from non-EU investors and outflows to non-EU host countries reached ECU 42 billion in 1997 (compared with an accumulated ECU 28 billion in 1993-1996).[5]

Figure II.6. FDI inflows to the EU: EMU members of the EU versus non-EMU members of the EU, 1996-1998

(Billions of dollars)



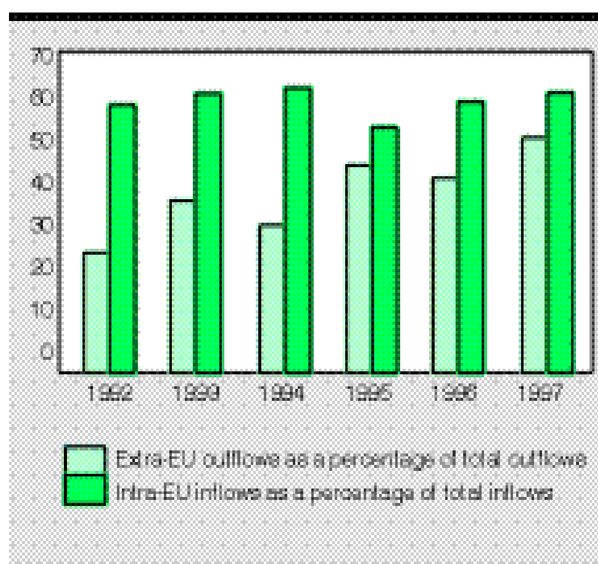
Source: UNCTAD, FDI/TNC database.

[a] Denmark, Greece, Sweden and the United Kingdom.

There are various reasons why anticipatory effects of EMU on FDI turned out to be less impressive than those emanating from previous measures towards a closer regional integration of the EU. First of all, important decisions (e.g. on EMU membership) were taken only in May 1998; there were still rumours in early 1998 that the whole project may be postponed. Second, incentives to increase intra-EU FDI were weakened, if not dominated, by incentives to invest outside the EU. Notably the booming United States economy stimulated EU FDI outflows: as documented above, EU FDI in the United States tripled in 1998. However, the rather weak anticipatory effects should not be understood as indicating that the euro will not affect FDI flows after its introduction in early 1999. It is obviously too soon to assess the longer-term impact of the single currency on FDI flows. As a matter of fact, the effects of EMU on the member countries' locational attractiveness continue to be debated controversially.

Figure II.7. Intra-EU and extra-EU FDI flows,[a] 1992-1997

(Billions of ECU and percentage)



Source: EUROSTAT, 1999.

[a] Excluding reinvested earnings which are available only since 1995. Intra-EU flows according to outflow data reported by investor countries.

The sectoral structure of intra-EU FDI flows differed significantly from the sectoral structure of extra-EU FDI outflows (table II.2). In 1995-1996, manufacturing accounted for 28 per cent of total intra-EU FDI flows, while its share in total extra-EU FDI outflows exceeded 40 per cent, signaling perhaps a more intensified international division of labour. As a corollary, services figured more prominently in intra-EU FDI. This is largely because many service industries were highly regulated in EU countries prior to 1993. Hence, the completion of the internal market involved effective market integration with regard to services in the first place (Hiemenz et al., 1994). Privatization and deregulation of service industries induced enterprise restructuring and encouraged cross-border investment relations in this sector.

Within the manufacturing and services sectors, however, intra-EU and extra-EU FDI flow patterns were rather similar in 1995-1996 (see table II.2). The capital-intensive chemical industry clearly figured most

Table II.2. Sectoral distribution of intra-EU and extra-EU

FDI flows, 1995-1996

(Millions of ECU and percentage)

	Outflows				Inflows	
	Intra-EU		Extra-EU		Extra-EU	
Sector/industry	Million ECU	Per cent	Million ECU	Per cent	Million ECU	Per cent
All industries	110 148	100	88 346	100	65 640	100
Primary	1 796	1.6	108	0.1	1 349	2.1
Agriculture, fishing	27	–	-1 630	-1.8	34	0.1
Mining, quarrying	1 769	1.6	1 738	2.0	1 315	2.0
Manufacturing	31 014	28.2	36 051	40.8	21 727	33.1
Food products	1 467	1.3	3 762	4.3	523	0.8
Textiles and wood	4 231	3.8	3 556	4.0	3 260	5.0
Refined petroleum, chemicals, rubber	9 364	8.5	13 950	15.8	11 732	17.8
Metal and mechanical	3 264	3.0	3 986	4.5	1 010	1.5
Office machinery, radio	2 689	2.4	956	1.1	2 906	4.4
Motor vehicles, other transport equipment	4 458	4.0	1 031	1.2	1 013	1.5
Miscellaneous	5 540	5.0	8 808	10.0	1 283	2.0
Services	71 131	64.6	47 923	54.2	40 185	61.2
Electricity, gas, water	1 355	1.2	1 817	2.1	4 224	6.4
Construction	1 541	1.4	1 402	1.6	2 039	3.1
Trade and repairs	11 357	10.3	8 144	9.2	6 278	9.6
Hotels, restaurants	2 346	2.1	297	0.3	420	0.6
Transport	252	0.2	974	1.1	550	0.8
Telecommunications	4 060	3.7	3 851	4.4	230	0.4
Financial intermediation	31 407	28.5	18 571	21.0	11 946	18.2
Real estate	1 517	1.4	1 179	1.3	2 492	3.8
Computer activities	1 012	0.9	475	0.5	831	1.3
Research and development	805	0.7	691	0.8	1 047	1.6
Other business activities	15 479	14.1	10 522	11.9	10 128	15.4
Not specified industries	6 207	5.6	4 264	4.8	2 379	3.6

Source: UNCTAD, based on EUROSTAT, 1999.

prominently in manufacturing. More surprisingly perhaps, FDI in relatively labour-intensive and standardized lines of manufacturing tended to be at least as important as FDI in relatively human-capital intensive and technology-intensive industries; this may be partly explained by the fact that in some industries, usually considered as low-technology, upgrading has taken place. For example, the textiles and wood industries on the one hand and motor vehicles and other transport equipment on the other hand accounted for similarly high shares in intra-EU FDI. In extra-EU FDI outflows, human-capital intensive and technology-intensive industries (office machinery/radio and motor vehicles/other transport equipment) were significantly less important than labour-intensive and resource-based industries (textiles/wood and food products). FDI inflows from non-EU foreign investors were roughly of the same order in these two groups of industries. The industrial structure of FDI in manufacturing seems to suggest that the EU (at least up to the mid-1990s) had not achieved its objective to improve its competitive position in high-technology segments of manufacturing.[6] High-technology items are most likely to be found in relatively human-capital intensive and technology-intensive industries. As shown before, such industries were of minor importance with regard to both FDI outflows from, and FDI inflows to, the EU.

Recent developments may change the industrial pattern of FDI, however. For example, the trend towards global networking in the motor vehicles industry is likely to result in an increasing share of this industry in manufacturing FDI inflows and outflows. An indication of this effect may be that the share of the motor vehicles industry in German FDI outflows in manufacturing increased over the years from 2.6 per cent in 1991-1992 to 15.8 per cent in 1996-1997. This trend was further strengthened in 1998 due to large-scale investments in this industry

(e.g. Daimler-Chrysler). On the other hand, EMU may encourage additional intra-EU FDI in standardized lines of manufacturing. The competition-enhancing effect of higher transparency, going along with the introduction of the euro as the single currency, is likely to be most pronounced in industries producing standardized and fairly homogeneous goods. For these goods, competitiveness depends on sales prices in the first place. Hence, EU companies supplying these goods may increasingly resort to intra-EU FDI, in order to reduce production and transaction costs (unless, of course, they are located in low-cost production sites outside the EU).

The structure of intra-EU and extra-EU FDI is similar within the services sector, too (table II.2): financial intermediation, other business activities (including the management of holding companies as a prominent item) and trade and repairs (in descending order of importance) accounted for the largest FDI shares. Especially in financial intermediation, both inward and outward FDI was associated with enterprise restructuring and the response of banks and insurance companies to European integration as well as to the globalization of these service industries. In striking contrast, FDI inflows and FDI outflows did not play significant roles in computer activities and research and development.

In summary, FDI patterns in the EU suggest that growing integration at the regional level so far has had limited effects on the EU's attractiveness to FDI in sophisticated lines of manufacturing and in innovative service industries. While EMU is rather unlikely to result in a strongly overproportionate growth of intraregional FDI, the longer-term effects are not yet clear. EU companies in important manufacturing and service industries, e.g. in the automobile industry and in financial intermediation, appear to be increasingly involved in global restructuring (Economist Advisory Group, 1998). Hence, close investment relations with non-EU countries in these industries, notably with the United States, are likely to be maintained or even strengthened.

3. Japan

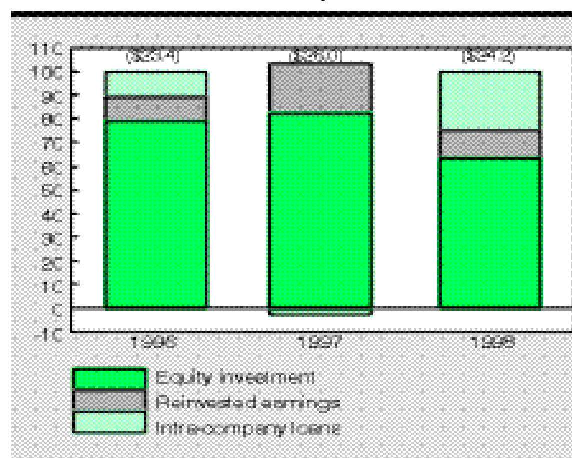
While Japan's FDI *outflows* declined in 1998 by seven per cent to $24 billion in 1998, *inflows* remained almost at the same level as in 1997 of $3.2 billion.[7] Lower profitability [8] and depressed domestic demand [9] in the wake of the economic recession led to changes in the corporate strategies of a number of Japanese TNCs faced with a reduced ability to expand abroad. On the other hand, the perception that foreign firms had of Japan as an investment location changed as opportunities for investment, in particular through M&As, became more attractive. While Japanese FDI outflows in recent years were only half of their 1989-1990 level (the peak period of Japanese investment), the level of inflows has been no longer the lowest among developed countries since 1997 (figure II.I). As a result, the discrepancy between FDI outflows and inflows has shrunk remarkably: the ratio of outflows to inflows declined from 60 during the outward FDI boom by Japanese TNCs in the latter half of the 1980s to slightly above seven in 1998.

FDI outflows declined in 1998 mainly because of lower equity investment and reinvested earnings (figure II. 8). Intra-company loans, on the other hand, rose significantly, perhaps aided partly by significantly low interest rates. Japan's economic recession had a direct impact on the flow of equity investment, while host country factors affected all three components of FDI flows. Increases in intra-company loans in particular aimed partly at stabilizing Japanese affiliates, especially those faced with serious difficulties in East and South-East Asia as a result of the financial crisis in that region (see section B.2 below). Toyota's affiliate in Thailand, for instance, obtained funds in equity form worth eight times its capital base from its parent firm. On the other hand, Japanese TNCs also took advantage of relaxed rules regarding M&As and equity ownership in a number of countries in the region: for example, the number of firms acquired by Japanese TNCs increased from two to 14 between 1997 and 1998 in the Republic of Korea and from 10 to 26 in Thailand.[10]

It is interesting to note that FDI flows increased to tax havens such as Panama and the Cayman Islands in 1998. The Cayman Islands became actually the second largest recipient of Japanese FDI, after the United States, accounting for 11 per cent of total flows (on a notification basis).

Figure II.8. Japanese FDI outflows, by component, 1996-1998

(Percentage)



Source: UNCTAD, FDI/TNC database.
Note: Figures in the parentheses show absolute values of FDI flows.

The restructuring of Japanese firms triggered by the recent economic difficulties was most pronounced in financial industries (banking, securities firms etc.), and affected most particularly their foreign affiliates. For instance, the number of foreign branches and affiliates of Japanese TNCs had declined by more than 40 per cent in early 1999 compared to 1995,[11] and the assets of foreign branches and affiliates of Japanese banks had diminished to half of the peak level registered in 1990.[12] The restructuring process has now been extended to foreign affiliates of Japanese TNCs in the manufacturing sector, particularly in East and South-East Asia. Various surveys illustrate the decline in the activities of these affiliates; one by JETRO indicates for instance that about two-thirds of Japanese manufacturing affiliates in East and South-East Asia experienced a decline in sales due to the impact of the financial crisis.[13]

In response to the crisis in East and South-East Asia, a number of Japanese foreign affiliates tried to shift to more export-oriented production. However, about half of these faced serious difficulties in doing so (Nishiyama, Kushima and Noda, 1999). Therefore, and contrary to its practice as regard the permanent employment for full-time staff, a number of employees had to be laid off in affiliates of Japanese TNCs, such as in an Indonesian affiliate of Mitsubishi Electric (220 employees), a Thai affiliate of Mazda (550 employees), and Singaporean affiliates of Hitachi (363 employees) and Sony (296 employees).[14]

If the slow-down in outward FDI persists, it may affect Japanese exports and imports, and the trade balance. Indeed, the high and increasing levels of FDI outflows registered till recently have led to increased imports of manufactured products (especially consumer products) from, and increased exports of capital goods to, affiliates of Japanese TNCs abroad, with a small overall negative impact on Japan's trade balance (box II.2). Indeed, about one tenth of imported goods in Japan (in value terms) originated in foreign affiliates of Japanese firms in the mid-1990s. Conversely, the decline in FDI outflows, if maintained, may well result in a reduced share of imports from foreign affiliates, without exports to them increasing.

Prospects for significantly higher FDI by Japanese TNCs are not very promising in the near future. In 1998, for instance, only slightly more than a quarter of Japanese manufacturing TNCs projected increased investment abroad during the next three years (1999-2001), compared with more than 40 per cent in 1997 (figure II.9). If FDI outflows should increase in 1999, it would be led by M&As,[15] away from greenfield FDI – the dominant mode preferred by Japanese TNCs so far.

Relatively high levels of FDI *inflows* in 1997 and 1998, though still small relative to the size of the economy as well as to other large developed countries, took place partly as a consequence of the weakening of Japanese firms due to the economic recession. M&As have been the most important way of entering the Japanese market. This entry mode appears to foreign firms to be more efficient than greenfield FDI as it involves less hustle and transaction costs in a complex business environment. The growth of M&As also reflects changes in the attitude of

Japanese firms – including SMEs – towards such deals (chapter III.B and box III.2). More than three-quarters of Japanese SMEs for instance consider M&As as an important tool of management strategy.[16] Recent government measures to facilitate M&As, particularly fiscal measures, have also played a role. As a result, M&As by foreign firms have come to account for one tenth of all M&A deals involving Japanese firms in 1998, compared to only 2.5 per cent in 1990 (figure II.10).

Box II.2. Effects of FDI on Japan's trade

The integrated international production systems that are increasingly being built by Japanese TNCs have intensified the relationship between trade and FDI, changing the volume as well as the composition of Japan's trade. Increased FDI has contributed to a rise in both exports and imports, suggesting that Japanese TNCs are taking advantage of increased opportunities for an international division of labour through their investments abroad. Even if substitution effects on exports due to overseas production — the reduction in exports of some goods and services for which foreign affiliates' sales are a substitute — are taken into account, the net impact on merchandise exports amounting to $29 billion in fiscal year 1995, the most recent available year (box table II.1), accounted roughly for seven per cent of total exports from Japan. The positive net effects of FDI on exports reflects the fact that, at early stages of international production, capital goods from home countries constitute essential inputs for production by foreign affiliates and that, in international integrated production systems, parent firms provide goods that are inputs for further processing or assembly and finished products for sale by trading affiliates. The value of capital goods (equipment as well as parts and components) directed to foreign affiliates has been increasing, accounting for an estimated 36 per cent of Japan's total capital goods exports in fiscal year 1995, compared with 31 per cent in fiscal year 1991 (Japan, MITI, 1995, p. 29). On the import side, it has been estimated that, given certain assumptions, Japan's imports were higher by some $30 billion in fiscal year 1995 on account of FDI by Japanese TNCs (box table II.1). Imports from Japanese foreign affiliates have been on the rise, accounting for 9 per cent of merchandise imports in fiscal year 1995, compared to 6 per cent in fiscal year 1991 (Japan, MITI, 1998a, pp. 63-64).

Estimates of the impact of FDI on trade indicate that, in the aggregate, the sum of the export inducement effects and the export-substitution effects was slightly lower than reverse import effects resulting in a small negative impact on the trade balance (box table II.1). During 1991-1995, imports induced by FDI grew while exports triggered by FDI stagnated: in fiscal year 1995 the overall impact on the merchandise balance is estimated to be $0.3 billion, compared to $5 billion in fiscal year 1991. However, in textiles, electric machinery, transport equipment, and precision equipment the impact on trade has been negative since the early 1990s, reflecting that FDI in these industries was at least partially directed towards sourcing low-cost resources for production geared to the home-country market. This trend has been reinforced by the efforts of Japanese TNCs to increase the local-content ratio of their foreign affiliates and by the appreciation of the yen.

Box table II.1 . Effects of FDI on merchandise trade in Japan, fiscal year 1995[a]

(Billions of dollars)

Industry	Effects on exports[b]	Effects on imports[c]	Net effect on trade balance[d]
Primary	-	0.4	-0.4
Manufacturing	28.9	29.3	-0.3
Chemicals	4.8	1.7	3.1
General machinery	6.5	1.7	4.8
Electric machinery	6.3	16.7	-10.4
Transport equipment	-15.5	0.3	-15.8
Services	-	0.05	-0.05
All industries	28.9	29.6	-0.7

Source: Japan, MITI, 1998a, table 2-99-5.

a Ending March 1996.

b Export-substitution effects (decreases in exports) plus export-inducement effects (increases in exports).

c Reverse import effects (increases in imports due to goods and services exported to Japan from Japanese foreign affiliates) plus import-conversion effects (changes in imports caused by changes in domestic production owing to FDI).

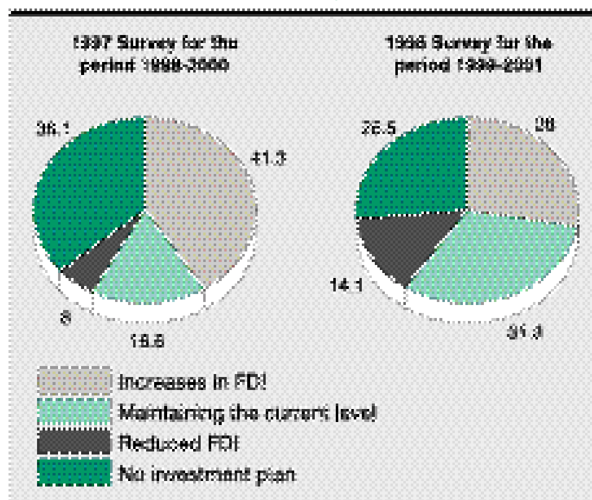
d Exports minus imports.

Note: Negative signs before a number indicate negative effects on the trade balance. The MITI survey takes into account situations of substitution effects with and without FDI.

Source: UNCTAD.

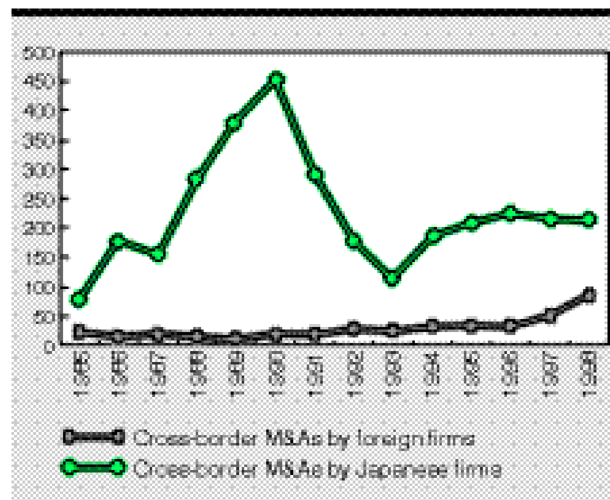
Figure II.9. Prospects for Japanese outward FDI in manufacturing, 1999-2001

(Percentage)



Source: UNCTAD, based on data from Nishiyama, Kushima and Noda, 1999, p. 18.

Figure II.10. Number of cross-border M&As in Japan, 1985-1998



Source: UNCTAD, based on data provided by Recof (Japan).

Large M&As by foreign firms continued to take place in 1999 as well. Each of the two biggest deals to date — the acquisition of a 37 per cent stake in Nissan by Renault (for $5.4 billion) and the purchase by GE Capital of Japan Leasing Corporation, the second largest leasing company in Japan[17] (for an undisclosed transaction value, but likely the largest acquisition in Japan by a foreign firm) — already exceeded the amount of the record 1998 FDI inflows. Even if part of these M&As are not financed by FDI inflows, it is highly likely that 1999 will be a record year for FDI inflows into Japan.[18]

B. Developing countries

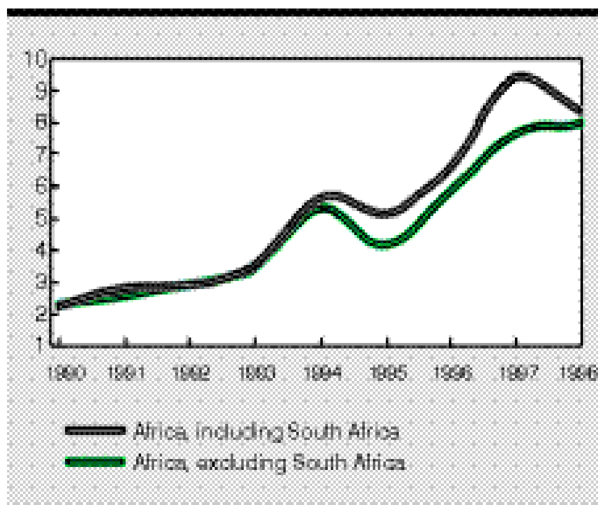
For the first time in 13 years, FDI flows into developing countries declined in 1998, by four per cent to $166 billion. The decline was mainly due to reduced flows to Asia's developing countries ($85 billion compared to $96 billion in 1997) and, more specifically, to reduced FDI into three economies, Indonesia, Taiwan Province of China and Hong Kong (China) (which together registered a reduction of $11.5 billion in FDI flows). As a result, the share of Asia in total FDI inflows to developing countries declined from 55 per cent in 1997 to 51 per cent in 1998. The performance of Latin America and the Caribbean, on the other hand, remained strong, even if the growth rate of FDI inflows (at about five per cent) was less impressive than in 1997. That region received 43 per cent of the FDI flows to developing countries. Particularly striking in that respect was the increase in FDI flows to Brazil which, in spite of the economic difficulties experienced by this country in 1998, attracted about 40 per cent of the total inflows of $72 billion received by the region. Inflows to Africa (excluding South Africa) increased modestly compared to 1997, a year of a significant rise in inflows. Including South Africa, however, the continent registered a decrease in such FDI inflows.

1. Africa[19]

FDI *inflows* into Africa in 1998 amounted to $8.3 billion, compared to the record $9.4 billion achieved in 1997. The decrease was largely accounted for by South Africa (see below). Still, the value of flows remained considerably higher than the average flows recorded in the first part of the 1990s (figure II.11).[20] Africa benefited from the rise in FDI flows that characterized the period 1990-1997, though to a much lesser extent than other developing regions. Its share in

Figure II.11. FDI inflows to Africa, 1990-1998

(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

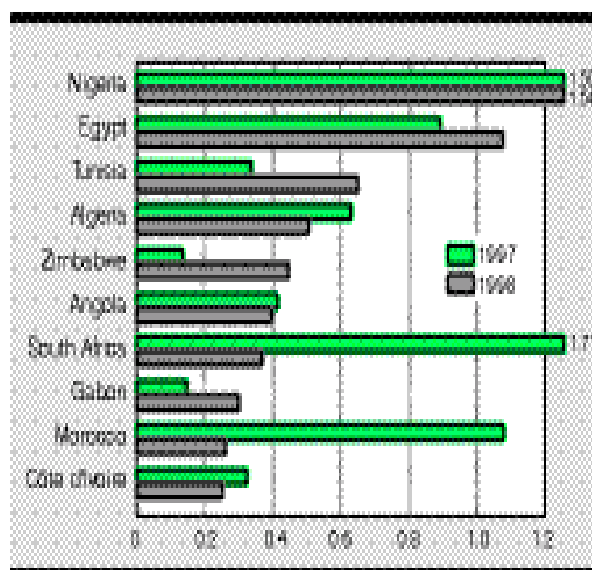
total FDI inflows to developing countries as a group was only five per cent.

As in previous years, two countries were by far the most important FDI recipients in 1998: Egypt and Nigeria, which together accounted for about one third of FDI inflows. In the case of Egypt, a significant increase in FDI inflows to $1.1 billion (figure II.12) was directly due to increased flows into manufacturing (accounting for almost 50 per cent of all FDI inflows in 1998). Beneficiaries were especially chemicals, building materials, engineering, food, metals and textiles, as well as the tourism industry – in the upgrading of which foreign investors were actively involved through privatization programmes and various forms of non-equity investment. Nigeria, which has ranked first for many years, received slightly lower FDI inflows than in 1997. The growth in inflows registered by Egypt, combined with that registered in Tunisia, and to a lesser extent Zimbabwe and Gabon (figure II.12), helped to maintain a relatively high level of FDI inflows, at least compared to the early 1990s. Some of the other large recipients experienced a decline. This was due in some cases to reduced inflows for privatization projects (Morocco, South Africa), or reduced inflows in the oil and other natural resource industries (Angola).[21]

The 33 least developed countries (LDCs) in Africa experienced an increase in FDI inflows for the sixth consecutive year. This raised their share in total FDI inflows into the region from one fifth in 1997 to one quarter in 1998. Nevertheless, at about $2.2 billion in 1998, the amount of FDI this group of countries receives remains very low. In addition, this increase was not evenly distributed among the LDCs; it was concentrated in only a few countries, namely Equatorial Guinea, Ethiopia, Mozambique, Uganda and the United Republic of Tanzania. While in a country like Equatorial Guinea a significant share of FDI flows went into natural resources, in such countries as Ethiopia or Mozambique much of the newly recorded FDI was in manufacturing or service industries. Angola, with about $400 million, was the biggest recipient of FDI among African LDCs in 1998 (slightly down from $412 million in 1997); as in previous years, it went to a large extent into offshore petroleum and natural gas exploration and production. Liberia's surprisingly high inflows of $250 million in 1997-1998 do not necessarily represent real investment flows, for a number of reasons, including statistical ones; data relating to Liberia have therefore to be treated with caution.[22]

Figure II.12. Africa: FDI inflows, top 10 countries, 1997 and 1998[a]

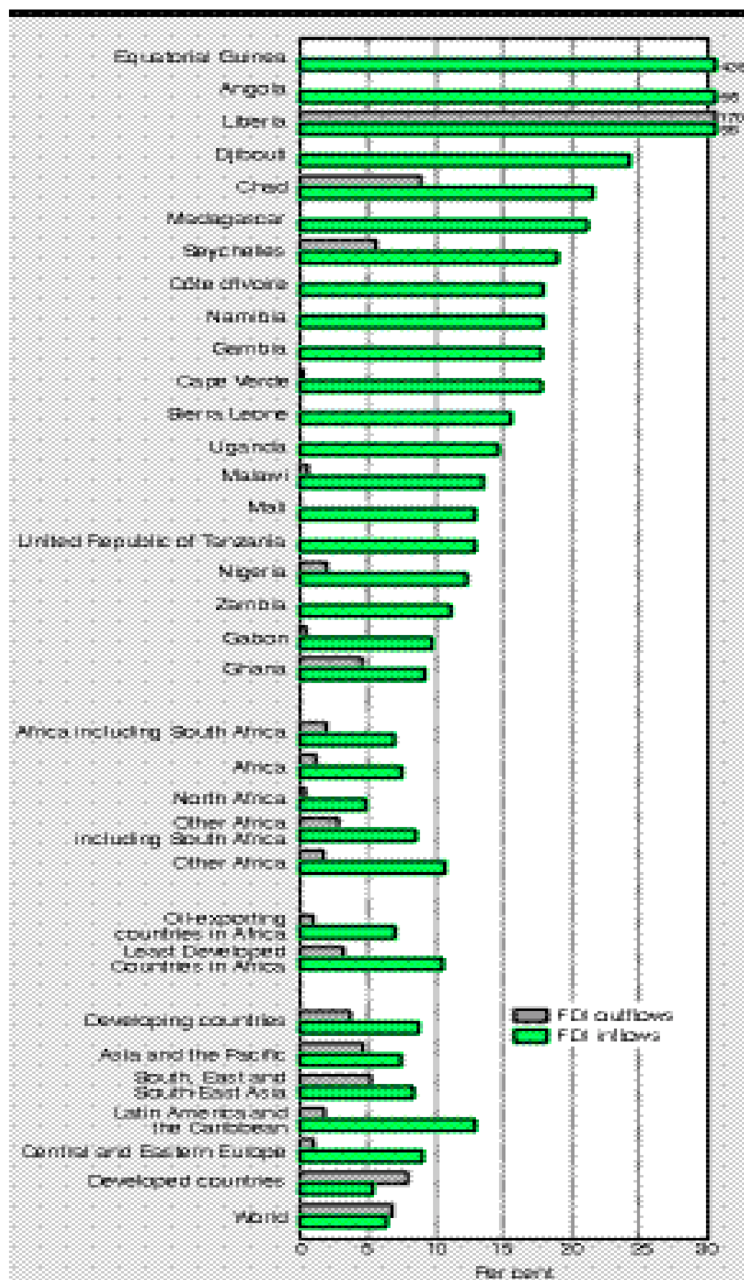
(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

[a] Ranked on the basis of the magnitude of 1998 FDI inflows.

Figure II.13. Africa: FDI flows as a percentage of gross fixed capital formation, top 20 countries, 1995-1997[a]



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

[a] Ranked on the basis of the magnitude of 1995-1997 FDI inflows as a percentage of gross fixed capital formation.

As in previous years, the ratio of FDI to gross fixed capital formation (GFCF), which was quite high by international standards for a number of African countries, illustrates the relative importance of FDI in these countries, in particular in smaller economies such as Equatorial Guinea, Djibouti, and the Seychelles (figure II.13).[23] These ratios need, however, to be seen against the very low level of investment in those other economies.

The main sources for FDI into Africa have traditionally been France, the United Kingdom and the United States and – to a lesser extent – Germany and Japan. While these countries remain important home countries for FDI flows into Africa, others such as Canada, Italy and the Netherlands have gained in importance (UNCTAD, 1999i, p.10). In 1997, the latest year for which figures were available, the United States topped the list with $3.7 billion of FDI outflows to Africa, followed by Belgium with $1.2 billion, the United Kingdom with $1.1 billion and France with almost $600 million.[24]

FDI inflows into South Africa in 1998 – when denominated in dollars and South African Rand[25] – fell far short of the record inflow figure attained in 1997. This was mainly due to lower privatization-related FDI[26] and, though to a lesser extent, reduced investment by Asian companies (especially from Malaysia) which had become an important source of FDI just before the Asian crisis.[27] The industries attracting most FDI in South Africa in 1998 were energy and oil, mining and quarrying, construction and materials, motor vehicles and components as well as food and beverages. In mining in particular, a marked increase took place with major investments by Billiton from the United Kingdom and Placer Dome of Canada (Business Map, 1999; IRRC, 1999d). Service industries such as retail and distribution industries as well as finance, insurance and real estate, on the other hand, attracted lower FDI than in previous years. While it is not possible to get the exact ranking of the most important home countries, it appears that Germany, Italy, Malaysia, Switzerland, the United Kingdom and the United States are the main sources for FDI inflows into South Africa.[28] Italy is a newcomer in this group, mainly due to Aeroporti di Roma's investment. All in all, FDI into South Africa is driven by M&As (Business Map, 1999), suggesting that many South African firms are regarded as interesting partners for foreign companies.

Prospects for higher FDI into South Africa in 1999 are good. This is particularly the case in mining where – despite a recent drop in gold prices – South African mining firms such as Anglo Gold continue to raise capital abroad, and in manufacturing, where major investments were announced such as a $146 million project by Daimler-Chrysler in East London. Forthcoming privatization projects (in telecommunications, for example) are likely to contribute to higher levels of FDI as well (IRRC 1999d). Major factors influencing FDI flows to South Africa in the medium and long term include the successful pursuit of regional integration and market liberalization within the South African Development Community (SADC), the conclusion of trade agreements with both the United States and the EU, as well as domestic economic and political developments. The latter include for instance the handling of the security issue that – whether justified or not – continues to cause concern among foreign investors.

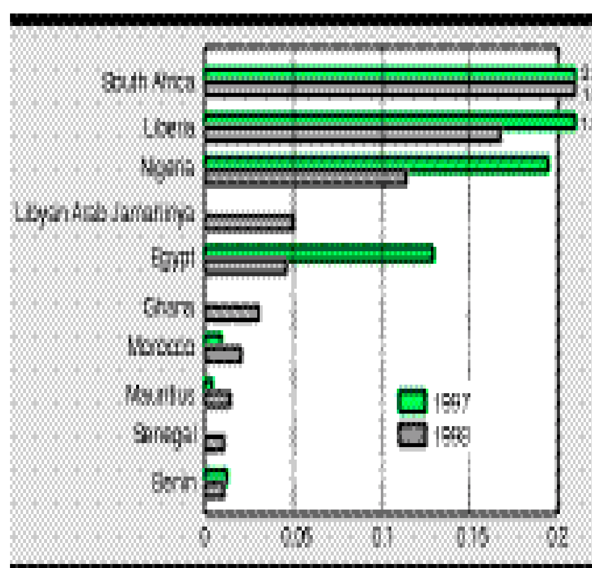
FDI *outflows* from Africa represent only a small fraction – less than five per cent – of total FDI outflows from developing countries. In 1998, $2 billion were invested by African TNCs outside their respective home countries, a decline of $1.7 billion compared to 1997; this was largely due to a sharp decrease in outflows from South Africa (figure II.14). Outflows by South African companies had been growing in recent years, largely because, with less restrictions on capital movements than before, they resorted to outward FDI to maintain and increase competitiveness in global markets. Despite the drop registered in 1998, however, the level of South African FDI outflows still far exceeds that of the preceeding five years when the apartheid regime ended and international sanctions against the country were lifted. South African investments have been oriented towards other African economies, in particular such neighbouring countries as Namibia, Swaziland, Lesotho and Mozambique. In 1997, the latest year for which figures are available, South Africa's outward FDI stock in other African countries increased by about one third to more than $1.3 billion.[29]

Looking into the near future, prospects for increased FDI inflows into Africa have improved, as illustrated by the results of a survey conducted by UNCTAD for *WIR99* of 44 African investment promotion agencies (IPAs).[30] Of the 31 agencies that responded, the vast majority indicated that FDI prospects for the period 2000-2003 for their own country, as well as for Africa in general, are expected to "improve" or be "significantly improved".[31] Most of the respondents also considered that "many African countries" are a better place to do business than the overall negative image of Africa would suggest. Replies differed, however, regarding the five countries that are expected to offer the most attractive investment opportunities in 2000-2003 (figure II.15a) and those that would make most progress in creating a business-friendly environment (figure II.15b).

Out of the more than 30 countries that were named by the IPAs, South Africa, Nigeria, Botswana, Côte d'Ivoire and Tunisia stand out as countries most frequently mentioned as the most attractive destinations in Africa for FDI in 2000-2003. In terms of countries which, according to IPAs, would make most progress over 2000-2003 in creating a business-friendly environment, Botswana tops the list, followed by South Africa, Nigeria, Uganda and Côte d'Ivoire. Interestingly, Botswana, Ghana and Uganda as well as a few other countries (all of them LDCs) – Burkina Faso, Ethiopia, Malawi,

Figure II.14. Africa: FDI outflows, top 10 countries, 1997 and 1998[a]

(Billions of dollars)



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

[a] Ranked on the basis of the magnitude of 1998 FDI outflows.

Mali and Madagascar – have a higher ranking for their progress on business environment than for their general attractiveness as a location over the next four years. These findings support the proposition that, in particular in LDCs, the creation of a business-friendly environment (including a better regulatory framework) does not automatically make a country more attractive for FDI. One of the most striking differences in rankings is in the case of Uganda (ranked eleventh in terms of attraction, and third in terms of business environment progress), a country which has in general a good reputation in terms of economic reform. The situation is reversed in the case of South Africa and Nigeria, which suggests that these two economies are perceived (by other IPAs) as attractive locations because of factors (such as a large market) other than business environment. Six of the top countries – Botswana, Ghana, Mozambique, Namibia, Tunisia and Uganda – that were most frequently mentioned in connection with an improvement of the business environment had actually been singled out by UNCTAD last year (UNCTAD, 1998a) as "African FDI front runners", i.e. countries that demonstrated a particular dynamism in attracting FDI throughout the 1990s.[32] Interestingly, too, with the notable exception of Côte d'Ivoire, Mozambique and Nigeria, the majority of countries identified by African IPAs as most attractive destinations for FDI had also been singled out as the most competitive African countries, according to the competitiveness index published by the World Economic Forum in 1998 (WEF, 1998).

Figure II.15a. African countries ranked according to their attractiveness for FDI in 2000-2003: frequency of replies

(Percentage) [a]

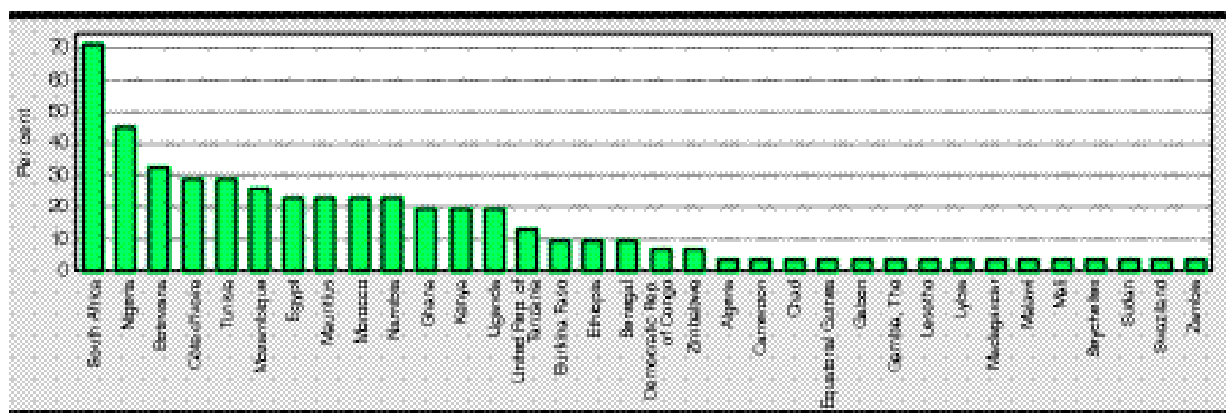
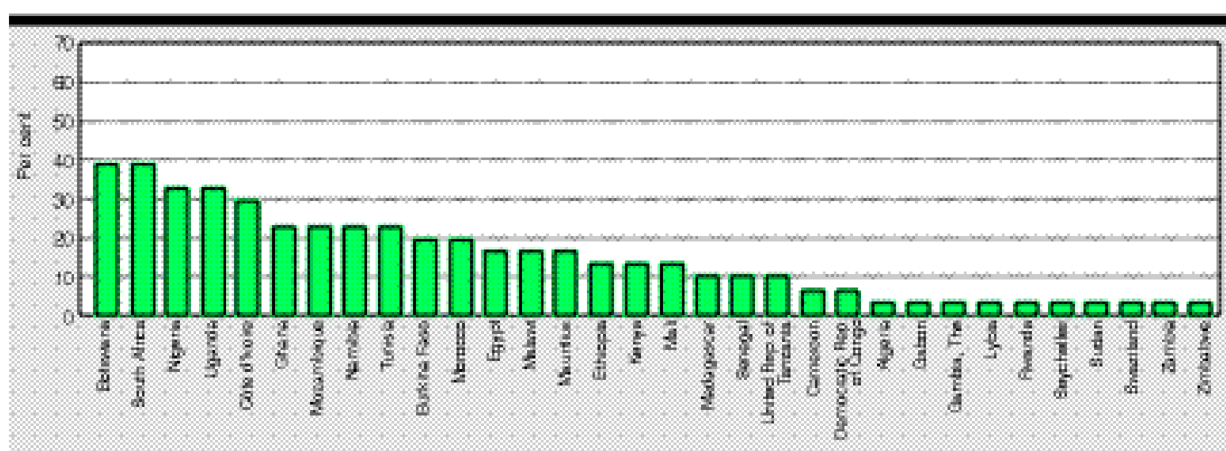


Figure II.15b. African countries ranked according to their progress in creating a business-friendly environment in 2000-2003: frequency of replies

(Percentage) [a]



Source: UNCTAD, based on results of an UNCTAD Survey of African investment promotion agencies, 1999.

[a] The percentage figures in the chart represent the share of responses naming a particular country in total responses received from African IPAs.

The most attractive industries for FDI in 1996-1998 were telecommunications, food and beverages, tourism, mining and quarrying and textile and leather (figure II.16a). For 2000-2003 (figure II.16b), all of the four most frequently mentioned industries were either from the manufacturing or from the services sector, led by tourism and followed by food and beverages, textile and leather as well as telecommunications. Agriculture and mining and quarrying ranked in only fifth and sixth positions respectively. Petroleum, gas and related production were ranked near the bottom. This suggests that many African countries are receiving significant FDI flows in non-natural resource industries, confirming earlier findings (UNCTAD, 1999i). The most striking differences in terms of past record and future prospects were for tobacco, petroleum, gas and related production, and forestry. While the first two industries were mentioned much less frequently in terms of attraction over 2000-2003, forestry was much more often listed for the future than for 1996-1998, implying a growth potential for this industry.

In terms of the factors that are likely to have a *positive* impact on TNC decisions to invest in their country (figure II.17a), the profitability of investments (confirming earlier findings – UNCTAD, 1999), the regulatory and legal framework and the political and economic outlook for FDI were most frequently mentioned.[33] Access to regional markets (and to a lesser extent global markets), trade policy, tax regime as well as access to low-cost skilled labour were also mentioned by most agencies as positive factors. Only about half of the participating agencies

Figure II.16a. Africa: industries that received considerable FDI inflows in 1996-1998[a]: frequency of replies

(Percentage)[b]

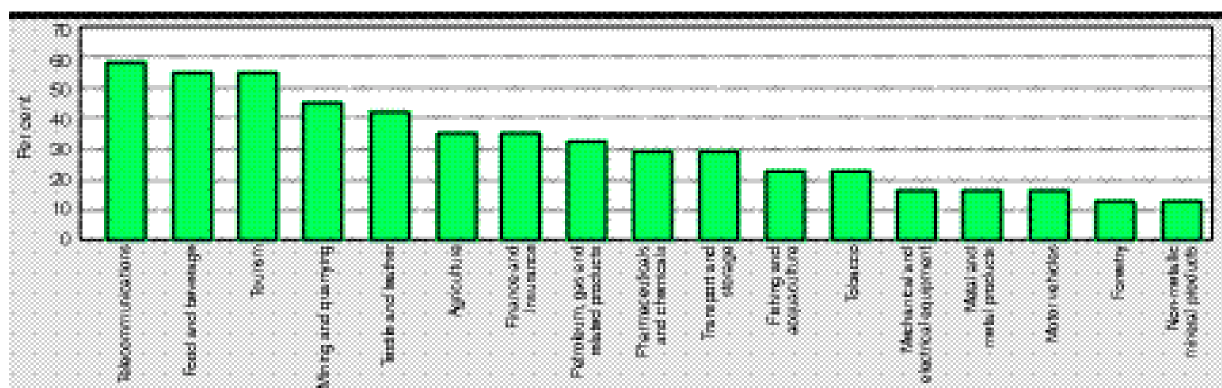
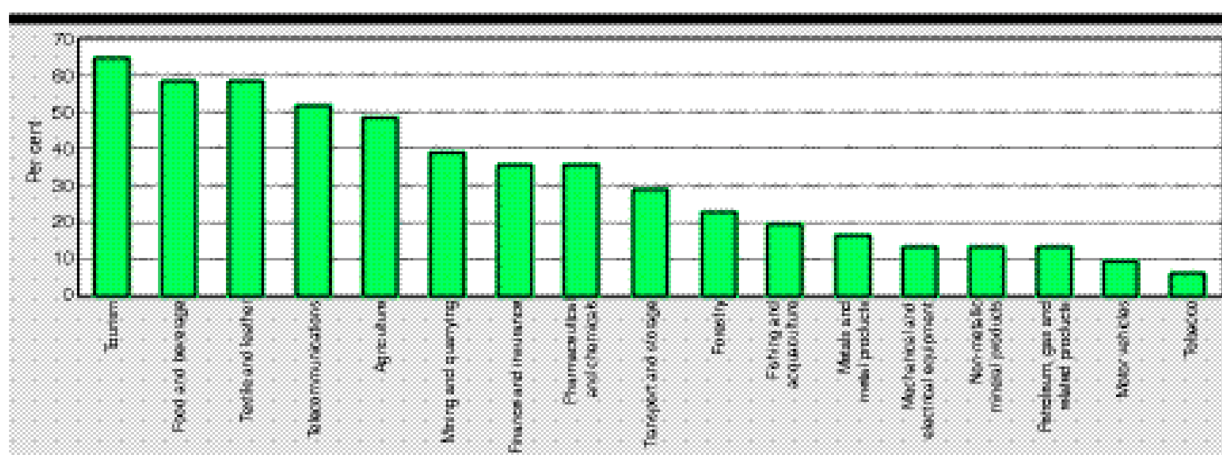


Figure II.16b. Africa: most attractive industries for FDI in 2000-2003: frequency of replies

(Percentage)[b]



Source: UNCTAD, based on results of a survey among African investment promotion agencies, 1999.

[a] Defined as having received a share of more than 10 per cent of a country's FDI.

[b] The percentage figures in the chart represent the share of responses naming a particular industry in the total of responses received from African IPAs.

Figure II.17a. Africa: most frequently mentioned positive factors for FDI inflows in 2000-2003: frequency of replies

(Percentage)[a]

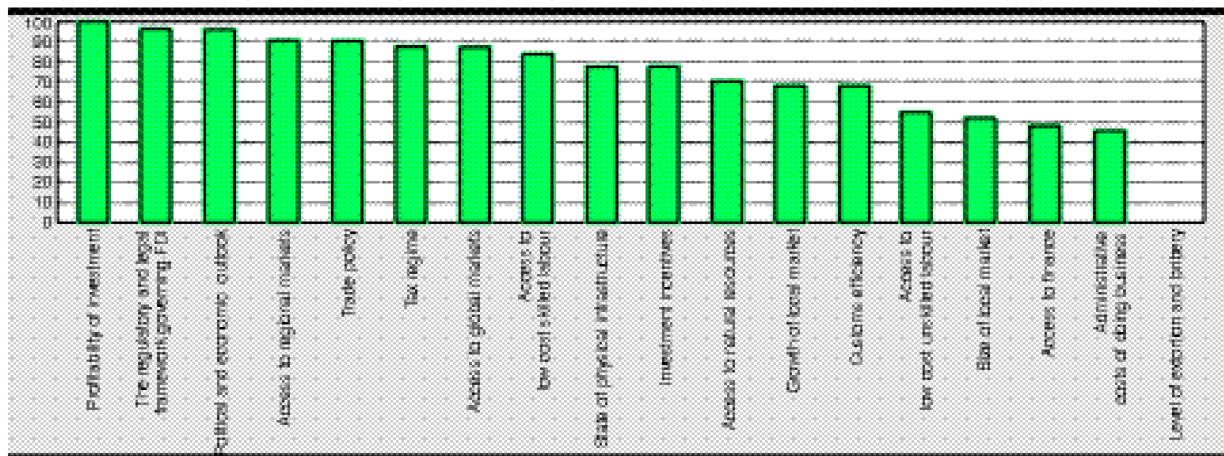


Figure II.17b. Africa: most important factors affecting FDI inflows in 2000-2003

(Rating average)[b]

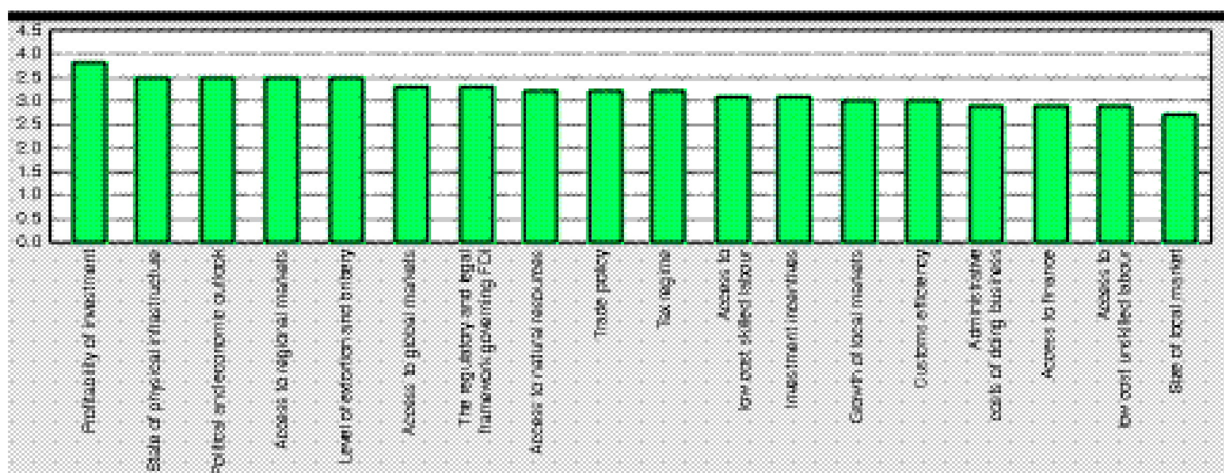
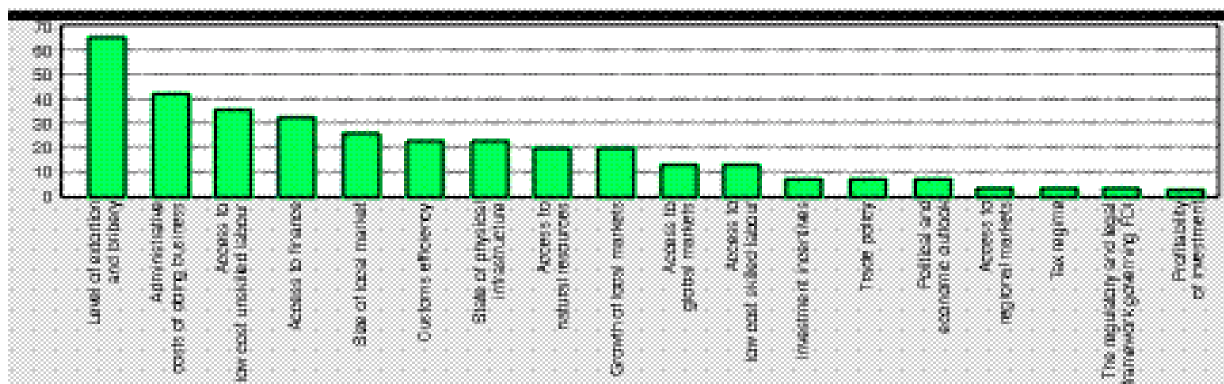


Figure II.17c. Africa: most important factors with a negative impact on investment decisions by TNCs: frequency of replies

(Percentage)[a]



Source: UNCTAD, based on results of an UNCTAD survey among African investment promotion agencies, 1999.

[a] The percentage figures in the chart represent the share of responses naming a particular factor in the total of responses received from African IPAs.

[b] Rating scale: 1 to 4.

considered access to low-cost unskilled labour, access to finance, and relative low costs of doing business to be particular advantages for their country in attracting FDI. This result is surprising in particular regarding low-cost unskilled labour, which is in abundant supply in most African countries.[34]

In terms of rating on the basis of the degree of influence, the profitability of investments was seen as the factor with the highest influence, followed by the state of physical infrastructure, political and economic outlook and access to regional markets (figure II.17b).[35] As regards physical infrastructure, however, it should be noted that considerably fewer agencies mentioned it as a positive factor compared to other factors. This should be kept in mind when considering the degree of influence of factors.

The most frequently mentioned factor with a *negative* influence on TNCs investment in 2000-2003 was extortion and bribery (figure II.17c). Other frequently mentioned negative factors include high administrative costs of doing business and, interestingly, the availability of low cost unskilled labour as well as problems related to access to finance for investment. Of all factors, extortion and bribery, administrative costs of doing business and access to capital were the only ones which received more negative than positive answers, underlining that – according to the IPAs – these are core problem areas for FDI into Africa.

The ranking of the regulatory and legal framework factors, the tax regime, trade policy and investment incentives and – by contrast – the ranking relating to the administrative costs of doing business suggest a strong feeling, shared by many IPAs, that the legal and regulatory framework and the investment incentive schemes – having gone through substantive revisions – are less of a problem for foreign investors than the implementation and administration of laws and regulations on a daily basis (i.e. the cost of doing business).

In general, although many IPAs are – not surprisingly – rather optimistic about attracting FDI in the near future, the survey identified a number of areas in which they feel that improvements could be made. Among the most important policy changes that they deem necessary to further attract FDI in 2000-2003, they ranked first those related to stabilization of the political situation; macro-economic stabilization; deregulation of the economy and privatization; business facilitation measures (including measures to facilitate the administrative decision-making processes and increased transparency) and other measures to implement the liberalized legal framework on FDI set up in many of the countries surveyed.

* * *

In conclusion, African countries lag behind other developing countries regions in terms of attracting FDI inflows. As the survey of IPAs – which, after all, know best the potential of their countries – indicates there are a number of industries that could be particularly attractive to foreign investors (annex table A.II.1). For these industries to catch the attention of corporate executives who make locational decision in TNCs requires, first of all, that they look beyond the image of Africa and take a more differentiated look at the continent, country by country, industry by industry, opportunity by opportunity. Changing Africa's image is, of course, a task for African countries backed up by information on investment opportunities and the regulatory framework for FDI. But international organizations can help. And helping to change the image of Africa (box VI.6) and providing information (box II.3) are precisely areas in which some efforts are being made.

2. Asia and the Pacific

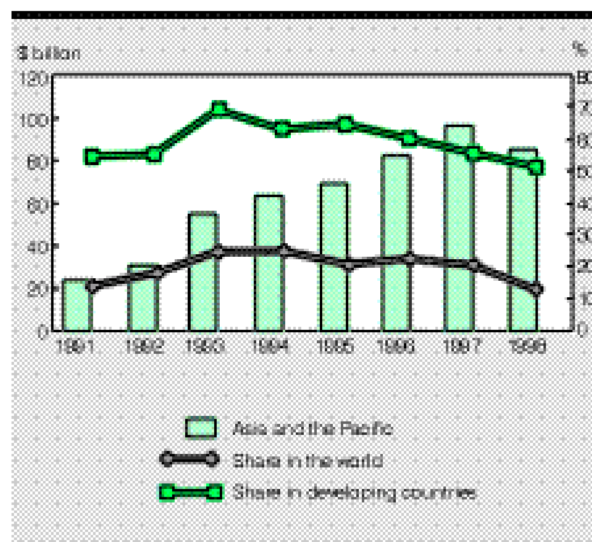
FDI *inflows* to developing Asia as a whole have weathered the financial crisis that hit the region in 1997-1998 and the economic downturn that followed. Flows into the region in 1998 were $85 billion, compared to $96 billion in 1997. Although down – for the first time since the mid-1980s – by 11 per cent, 1998 flows remained above the level of 1996 and well above the

average of annual flows recorded during 1991-1995 (figure II.18). The decrease in 1998 was almost entirely due to a steep decline in FDI flows to Indonesia (resulting in net divestment), Taiwan Province of China and Hong Kong, China (figure II.19). In some of the countries directly hit by the financial crisis, however, FDI remained resilient (box II.4).

Despite the decline in inflows, the region still accounted for over half of flows into developing countries and over half of their FDI stock. The FDI stock in the region reached $717 billion in 1998, an increase of 13 per cent over that in 1997. The region's FDI inflows as a percentage of gross fixed capital formation in 1995-1997 remain slightly lower than the corresponding averages for all developing countries, and much lower than that of Latin America and the Caribbean. Singapore ranked at the top of the list of Asian countries by the ratio of FDI inflows to gross fixed capital formation (figure II.20).[36]

Figure II.18. FDI flows into developing Asia and the Pacific and its share in world and developing countries inflows, 1991-1998

(Billions of dollars and percentage)



Source: UNCTAD, FDI/TNC database.

Box II.3. The joint UNCTAD/ ICC project on investment guides and capacity-building for least developed countries

UNCTAD and the International Chamber of Commerce have undertaken a joint project on investment guides and capacity-building for least developed countries. In a pilot phase, the project will be implemented in six countries - Bangladesh, Ethiopia, Madagascar, Mali, Mozambique and Uganda.

This project is a response to the fact that LDCs are receiving less than one per cent of the world's FDI flows, even though most LDCs have removed many obstacles for foreign investors and are now actively seeking FDI. The project attempts, first, to supply potential foreign investors with an objective and up-to-date overview of investment conditions in LDCs in the form of an investment guide. Second, it aims at building capacity in LDCs in the area of investment promotion, inter alia by organizing workshops on this issue in each country participating in the project, and by involving local partners (both from the public and private sector) in the preparation of the guide. Third, and in the long run most importantly, it launches a process at the heart of which is an ongoing dialogue between LDC governments and the business community.

Ethiopia was the first LDC in which the project was implemented and for which a guide has been prepared (UNCTAD/ICC, 1999c). UNCTAD has also started to implement the project in Mali. Work will begin on most of the other countries in the pilot phase before the end of the year.

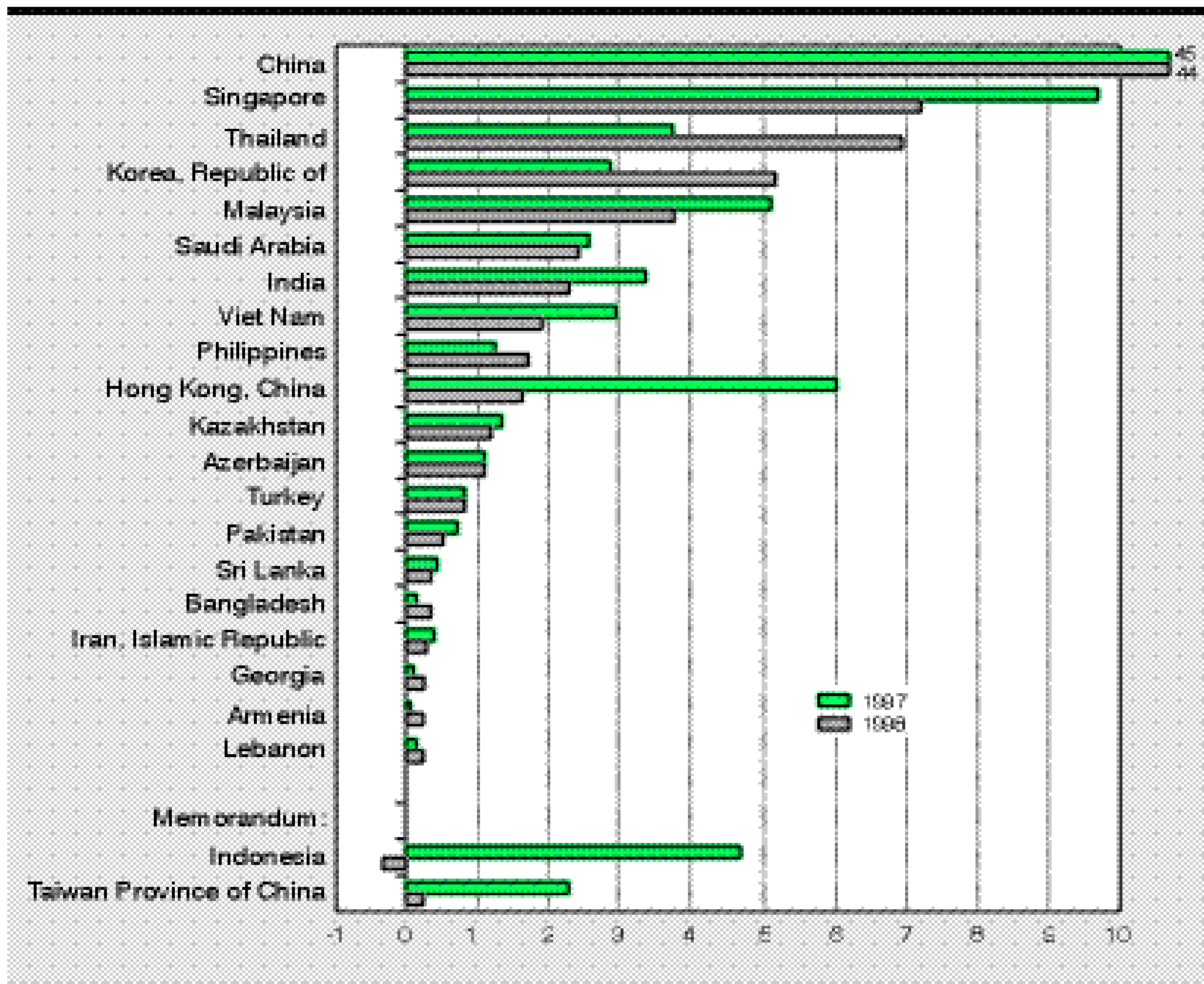
The project is financed by contributions from donor countries: China, Finland, France, India and Norway.

Source: UNCTAD.

In contrast to portfolio investment and bank lending, the withdrawal of which triggered a downturn in overall private capital inflows, FDI remained relatively stable and increased its importance in private capital flows into the region (box figure II.4.1). TNCs, particularly from the United States and Europe, continued to be very active in the region. Some are restructuring

Figure II.19. Asia and the Pacific: FDI inflows, top 20 economies, 1997 and 1998[a]

(Billions of dollars)



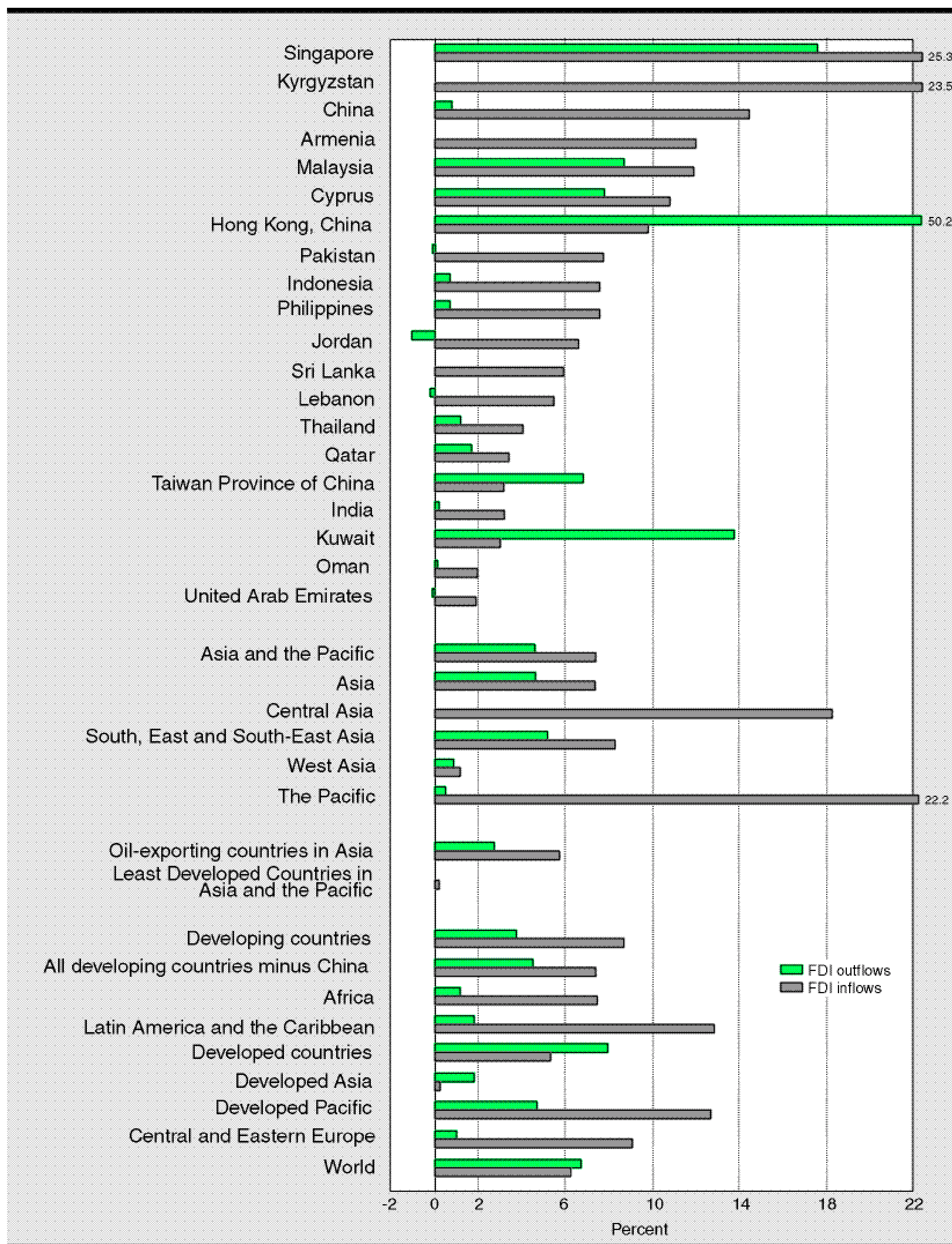
Source: UNCTAD, FDI/TNC database and annex table B.1.

[a] Ranked on the basis of the magnitude of 1998 FDI inflows.

their production networks in Asia to respond to changes in supply and demand patterns in the light of the crisis. Further FDI liberalization, the availability of cheap assets in some countries and the longer-term prospects of the region have been the main driving forces behind TNC decisions to expand in developing Asia.[37]

Efforts to attract FDI have been intensified in all of the crisis-affected economies of the region and at all levels (chapter IV). The shortage of capital for financing production and trade, combined with the recognition of the role that FDI can have in restoring growth and development, has led governments to intensify their efforts to attract FDI. Recent moves include the further opening of certain industries (in particular, in the services sector) to FDI and the relaxing of rules with respect to ownership, mode of entry and financing. At the regional level, member states of the ASEAN agreed in October 1998 on the establishment of the ASEAN Investment Area. They have also undertaken measures to accelerate the realization of the ASEAN Free Trade Area and to grant special incentives and privileges to attract FDI into the region.

Figure II.20. Asia: FDI flows as a percentage of gross fixed capital formation, top 20 economies, 1995-1997[a]



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

[a] Ranked on the basis of the magnitude of 1995-1997 FDI inflows as a percentage of gross fixed capital formation.

Box II.4. FDI in the five countries most affected by the financial crisis

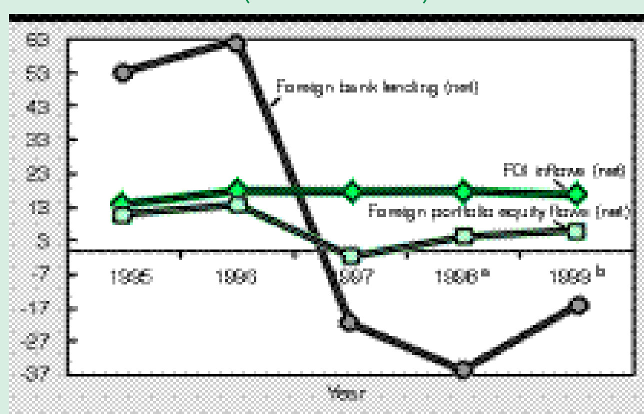
Despite a disparate performance among individual countries in the group, FDI flows into the five crisis-hit countries (Indonesia, Republic of Korea, Malaysia, the Philippines and Thailand) as a group remained resilient in 1998, down only two per cent from the peak level of $18 billion in 1997 (figure II.21). Viewed from the perspective of the preceding decade, 1998 inflows to those countries as a group stood up well, remaining substantially above the average of flows recorded during the 1991-1995 period ($11 billion). However, individual national performances varied greatly. Inflows into the Republic of Korea, the Philippines and Thailand showed dramatic increases; Malaysia showed a decline, while Indonesia suffered divestment for the first time since 1974.

FDI flows to the five countries as a group were remarkably resilient when compared with foreign bank lending and foreign portfolio equity investment before and during the financial crisis (box figure II.4.1). There are several reasons for this: corporate networks of integrated international production that have already existed in Asia allowed some TNCs to compensate for declining domestic sales through increased exports spurred by devaluations; some TNCs took advantage of cheaper asset prices; in some cases, parent firms increased investment stakes in their existing affiliates, either to buy some or all shares of distressed joint venture partners or to alleviate affiliates' financial difficulties in the wake of the crisis; and some TNCs have increased capital investments in response to the relaxation of FDI regimes that has taken place after the financial crisis.[a]

Barring an unforeseen worsening of the crisis, FDI inflows in 1999 are likely to remain at a level above annual average inflows during the 1990s so far (i.e., $13 billion), although the performance of individual countries is likely to continue to differ. Measures to deal with the severity of the impact of the crisis continue to be necessary.

Box figure II.4.1. FDI flows, foreign portfolio equity flows and foreign bank lending to the five Asian countries most affected by the financial crisis, 1995-1999

(Billions of dollars)



Source: UNCTAD, FDI/TNC database for FDI inflows and Institute of International Finance, 1999b for portfolio flows and bank lending.

Source: UNCTAD.

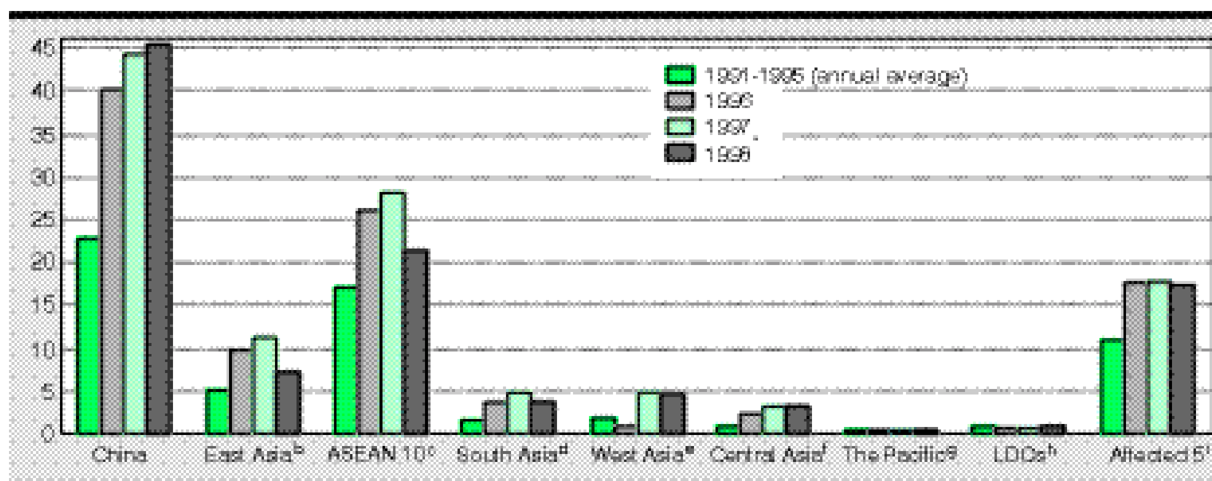
[a] For an elaboration, see UNCTAD, 1998c.

Cross-border M&As have become more important as a mode of entry to Asia for TNCs. Majority-owned M&As in South, East and South-East Asia in 1998 increased by 28 per cent in value over 1997, to $12.5 billion. The significant increases that occurred in two of the five countries directly hit by the financial crisis, namely in the Republic of Korea and Thailand, are particularly noteworthy. However, if the value of cross-border M&As in Asia is placed in relation to FDI inflows into Asia, the percentage remained relatively low (figure II.22); it was only 16 per cent compared to 46 per cent in Latin America.

Within these overall trends, the performance of individual sub-regions and economies varied considerably (figure II.21).

China remained the single largest FDI recipient in the developing world. Inflows to China were $45 billion, a slight increase over 1997. While FDI inflows from within the region declined by over nine per cent, flows from the United States and Europe increased by 21 per cent and three per cent, respectively. Faced with a number of adverse factors, including the negative consequences of the Asian financial crisis and the slow-down of growth, China intensified its efforts to attract investment. At the beginning of 1998, the Government revised its industrial

Figure II.21. FDI flows into developing Asia and the Pacific, by country group, 1991-1998
(Billions of dollars)



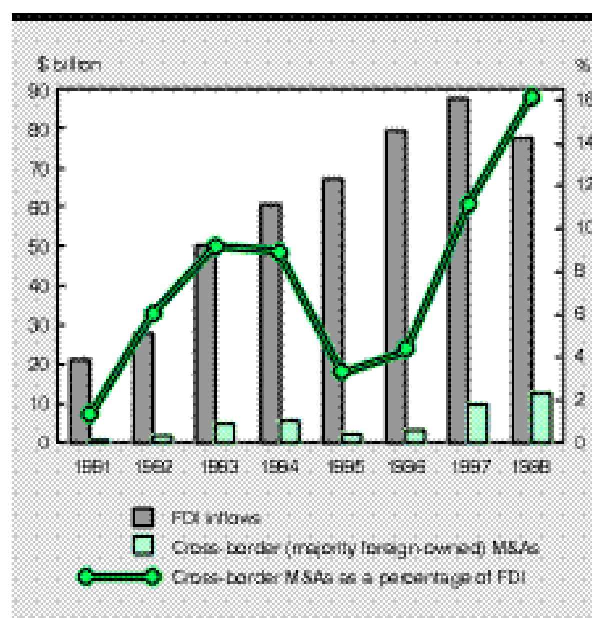
Source: UNCTAD, FDI/TNC database.

[a] Estimates.
[b] Includes Hong Kong, China; Republic of Korea and Taiwan Province of China.
[c] Includes Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam.
[d] Includes Bangladesh, India, Nepal, Pakistan and Sri Lanka.
[e] Includes Bahrain, Cyprus, Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Turkey, United Arab Emirates and Yemen.
[f] Includes Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.
[g] Includes Fiji, Kiribati, New Caledonia, Papua New Guinea, Solomon Islands, Tonga, Vanuatu and Samoa.
[h] Includes Afghanistan, Bangladesh, Cambodia, Kiribati, Lao People's Democratic Republic, Maldives, Myanmar, Nepal, Solomon Islands, Vanuatu, Samoa and Yemen.
[i] Includes Indonesia, Republic of Korea, Malaysia, Philippines and Thailand, the five countries most affected by the Asian financial crisis of 1997-1998.

guidelines for FDI. A part of the incentive scheme for foreign investors abolished earlier, such as the exemption of import duties and value-added tax on imports of equipment, was reinstated, particularly for industries listed as having high priority for attracting FDI.

East Asia (Hong Kong, China; the Republic of Korea; and Taiwan Province of China) experienced a mixed performance. The Republic of Korea received its largest-ever annual volume of FDI inflows in 1998 ($5 billion), a four-fold increase over its average annual performance during the first half of the 1990s. The country became a net FDI recipient after having been a net FDI outflow country since the beginning of 1990s. In Hong Kong (China) and Taiwan Province of China, the slowdown of the domestic economies and the regional economic situation prompted a sharp decline of FDI inflows in 1998. The number of TNC regional headquarters in Hong Kong, China declined by 10 per cent in 1998. Taiwan Province of China suffered from divestment in the fourth quarter of 1998, leading to a sharp decline of FDI for the year as a whole.

Figure II.22. South, East and South-East Asia: cross-border M&As in relation to FDI inflows, 1991-1998

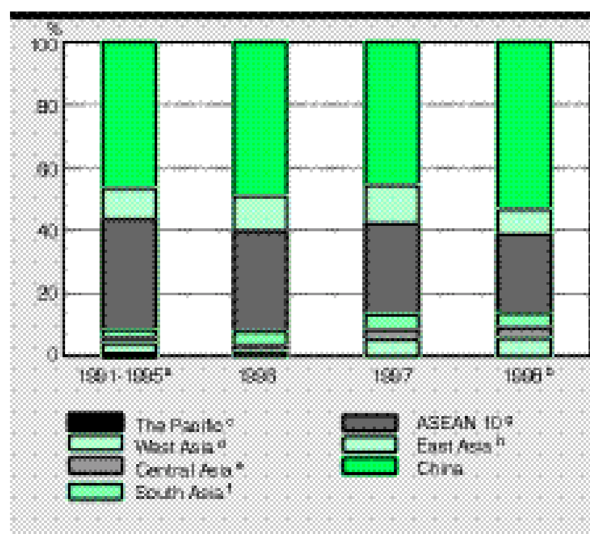


Source: UNCTAD FDI/TNCs database, and data provided by KPMG Corporate Finance.

FDI in *South-East Asia* (ASEAN 10) decreased by 23 per cent in 1998. The share of these countries as a group in total FDI in Asia has declined by nearly one tenth during the 1990s (figure II.23). The performance of individual countries was, however, highly uneven. In particular, FDI in Thailand, unaffected by plummeting GDP growth, has boomed to historical highs since the onset of the crisis, increasing by 87 per cent in 1998. Financial institutions (with inflows 10 times higher than the year before), and machinery and automobile industries were the largest recipients of FDI. The dramatic increase in FDI flows to Thailand reflected a significant rise in cross-border M&As. Flows into the Philippines, which had started to slow down at the end of 1997, regained momentum in the fourth quarter of 1998, pushing FDI to a record high in 1998. This reflects partly the recognition by foreign investors of two distinct features of the Philippines, namely its continuing strong export performance and its relatively sound financial sector. Singapore experienced a reduction of inflows by 26 per cent, and the Government adopted measures, such as tax concessions, to reduce business costs and stimulate FDI. Inflows to Malaysia in 1998 declined by 27 per cent over the previous year. The value of manufacturing FDI projects approved, however, registered a 14 per cent increase in 1998. Viet Nam, although not directly hit by the financial crisis, experienced a decline in inflows, largely due to its heavy dependence on other countries in the region for investment and the loss of export competitiveness as a result of the sharp currency depreciation in neighbouring countries.[38] Indonesia has been hit the hardest by the Asian financial crisis. All major sectors suffered setbacks. The impact of the crisis was aggravated by some serious non-economic factors. The resultant loss of confidence of foreign investors caused a net divestment in 1998 compared with annual average inflows of $5.4 billion during 1996-1997.

Figure II.23. FDI in developing Asia and the Pacific, by country group, 1991-1998

(Percentage)



Source: UNCTAD, FDI/TNC database.

a Annual average.

b Estimates.

c Includes Fiji, Kiribati, New Caledonia, Papua New Guinea, Solomon Islands, Tonga, Vanuatu and Samoa.

d Includes Bahrain, Cyprus, Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Turkey, United Arab Emirates and Yemen.

e Includes Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

f Includes Bangladesh, India, Nepal, Pakistan and Sri Lanka.

g Includes Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam.

h Includes Hong Kong, China; Republic of Korea and Taiwan Province of China.

Although the financial crisis did not significantly affect FDI in *South Asia,* the growth momentum of FDI into the sub-region was lost in 1998. Inflows to India, the single largest recipient in the sub-region, were unable to maintain a level similar to that of 1997. Measures to encourage private investment and foreign participation in the domestic economy were strengthened in 1998. FDI flows into the other economies in the sub-region remained low. The sub-region has, however, considerable potential to attract FDI. Bangladesh, unlike other Asian LDCs, experienced fast FDI growth in 1998, particularly in the energy sector (box II.5).

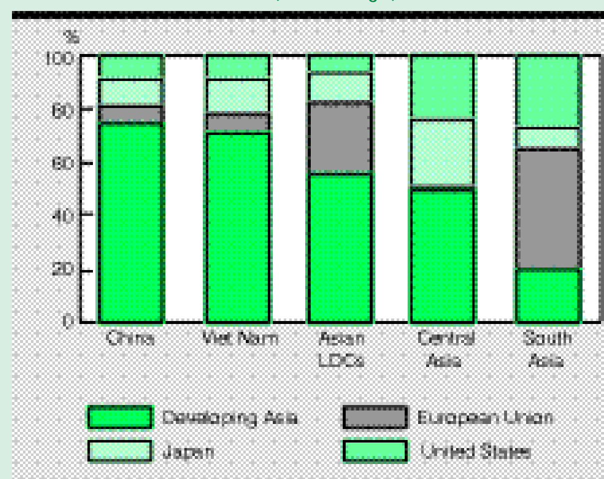
FDI flows into developing *West Asia* remained at a level similar to that of 1997 ($4.6 billion), after a sharp increase in 1997, a slow-down largely due to the sharp fall in the price of oil. Overall, the level of FDI inflows registered during the 1990s is still significantly lower than that of the early 1980s, though it has recovered markedly from the fall of FDI inflows in the second half of the 1980s. The share of the region in total developing country FDI inflows has in fact eroded significantly, falling from 25 per cent during 1980-1985 to less than five per cent during the 1990s. Oil and oil-related activities are still attracting most FDI, though non-oil related activities such as tourism and some manufacturing industries (electrical machinery and

Box II.5. Negative effects of the financial crisis on FDI flows to Asian LDCs

FDI inflows to Asia's LDCs (Afghanistan, Bangladesh, Cambodia, Lao People's Democratic Republic, Myanmar and Nepal) declined dramatically in 1998. Except for Bangladesh, LDCs in South, East and South-East Asia saw a substantial decline in FDI flows in the second half of 1997 and in 1998: they attracted 20 per cent less in 1997-1998 than in 1995-1996, and their share in total FDI in this sub-region fell from 0.6 to 0.4 per cent. The heavy dependence of Asian LDCs on investments by firms from developing Asia (box figure II.5.1), whose capacity to invest abroad had weakened due to the financial crisis, and the effects of the currency depreciation that occurred in the most affected countries, have had negative implications for FDI flows into the LDCs. The current financial crisis in Asia has, indeed, led to a slowdown of the process of TNC-assisted restructuring that had begun to facilitate the development of LDCs in the region along the lines of the "flying-geese" pattern.

Source: UNCTAD.

Box figure II.5.1. FDI in selected Asian economies/ subregions, by source, cummulative flows, 1993-1996
(Percentage)



Source: UNCTAD, FDI/TNC database.

electronics, textiles) in non-oil exporting countries are also drawing in foreign investors. However, plans to expand oil and gas production capacity in Kuwait, Oman, Qatar, United Arab Emirates, and Yemen, and the opening up of the petroleum sector to foreign investors in Kuwait and the Islamic Republic of Iran [39] should lead to increased FDI.

FDI in *Central Asia* in 1998 also remained at a level similar to that of 1997 ($3 billion), losing the growth momentum it had built up since the beginning of the decade. The reduction of inflows in Kazakhstan was compensated for by increases in flows to Armenia and Georgia. The economies in the region are heavily dependent on investment in petroleum exploration and extraction, a sector that suffered from weakened international demand for oil, contributing to the suspension or postponement of some investment projects. FDI in non-oil sectors, on the other hand, rose. The difficulties of Central Asian economies in attracting FDI were further exacerbated by the fact that investors from both the East Asian economies and the Russian Federation (which had been important sources of FDI in that sub-region) reduced their levels of investment due to their respective financial crises.

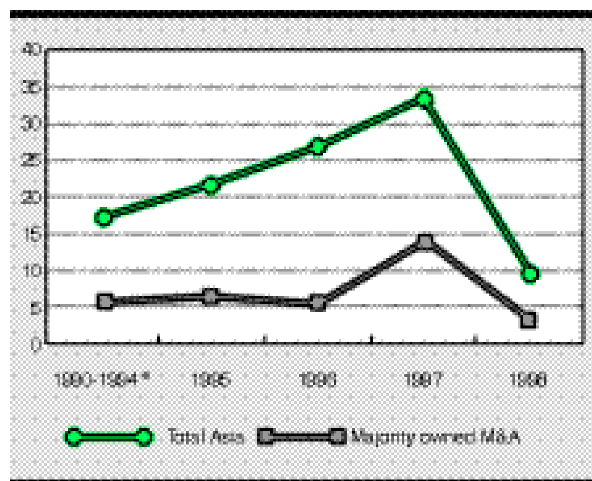
Inflows to the *Pacific Island* economies in 1998 were estimated at $175 million. The main sources of FDI continued to be Australia, Japan and New Zealand, while several European countries as well as the United States also remained important. Most recently, there has been a growing interest in tourist facilities as well as tourism-related activities in the sub-region. Declining official development assistance (ODA) and diminishing benefits from non-reciprocal preferential treatment by the major trading partners due to trade liberalization is encouraging the liberalization of investment regimes in the sub-region.

The financial crisis in Asia has reduced both the capacity and the incentives for Asian TNCs to undertake FDI, both within and outside the region; furthermore, some policy measures adopted by some governments to contain the crisis have also discouraged outward FDI.[40] As a result, *outward FDI* from developing Asia and the Pacific as a whole decreased in 1998 by a quarter, to $36 billion. The reversal of the upward trends in outward FDI from Asian TNCs is

paralleled by the declining value of cross-border M&As undertaken by them (figure II.24). Although total outflows remain at a level similar to the annual average during the 1990s, their share in world outflows in 1998 dropped to its lowest level in the 1990s (figure II.25). Most of the outflows originated in no more than 10 economies, primarily in East and South-East Asia (figure II.26). Out of the top 10 outward-investor countries, six experienced a sharp decline in their FDI outflows in 1998. The stock of outward FDI from developing Asia reached $317 billion, accounting for over four-fifths of the total outward stock from developing countries world-wide. Over half of this stock is located in other economies in the region. China alone absorbed over half of developing Asia's outflows, mainly from Hong Kong (China) and Taiwan Province of China.

Figure II. 24. Cross-border M&As by TNCs headquartered in developing Asia, 1990-1998

(Billions of dollars)

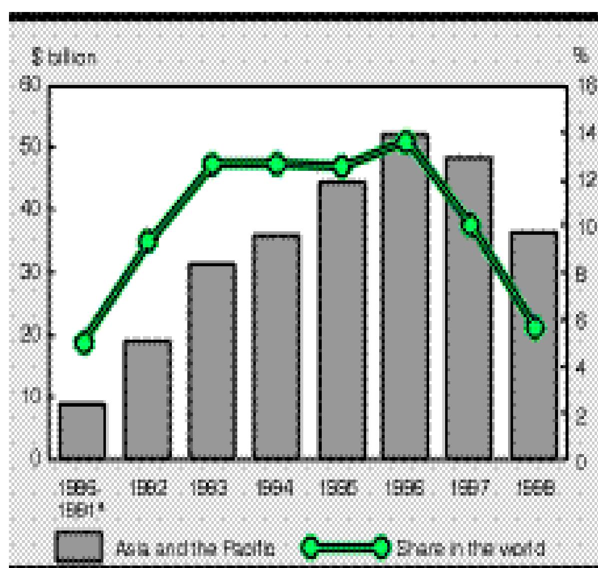


Source: UNCTAD, FDI/TNC database and data provided by KPMG Corporate Finance.

[a] Annual average.

Figure II. 25. Outward FDI flows from developing Asia and the Pacific and its share in world outflows, 1986-1998

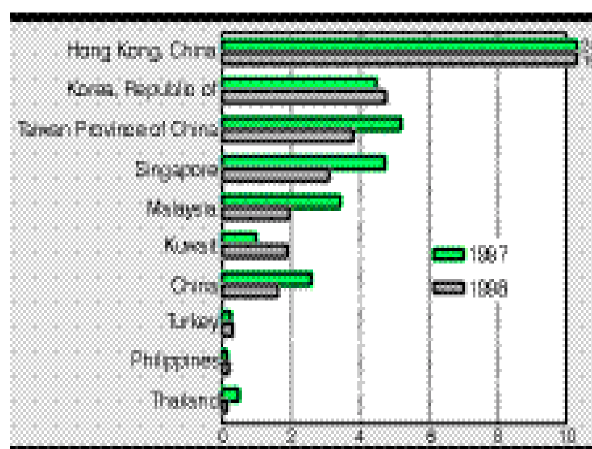
(Billions of dollars and percentage)



Source: UNCTAD, FDI/TNC database.

Figure II. 26. Asia and the Pacific: FDI outflows, top 10 economies, 1997 and 1998[a]

(Billions of dollars)



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

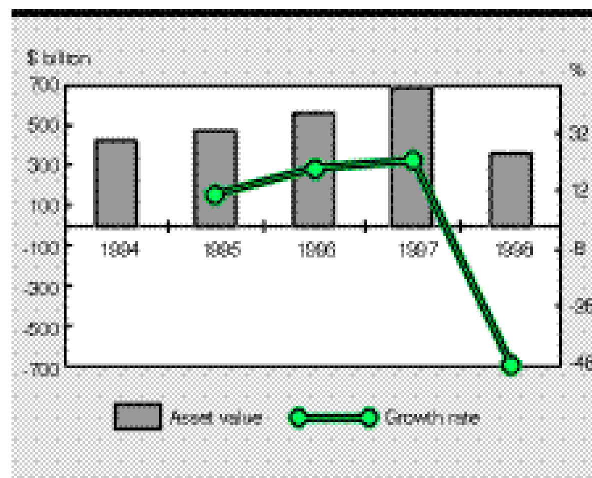
[a] Ranked on the basis of the magnitude of 1998 FDI out flows.

Over the past decade, TNCs owned by overseas Chinese as well as Korean *chaebols*, have been two major forces for outward FDI from developing Asia. The former – headquartered all over East and South-East Asia and whose business has been focused largely within the region – suffered heavy loss from the financial crisis. For instance, the market capitalization of the assets owned by the top 500 overseas Chinese firms was reduced by nearly half in 1998 (figure II.27). Surprisingly, however, FDI outflows from the Republic of Korea increased by seven per cent in 1998, to a record level of $4.8 billion. This is due mainly to a sharp increase in financing directly from headquarters of existing overseas operations and ongoing investment projects. Their foreign

affiliates had difficulties in raising funds in the international financial market in the light of their lowered credit ratings. Indeed, Korean TNCs had little choice but to channel funds from the parent companies to their overseas affiliates that experienced difficulties in debt servicing owing to the crisis. While engaged in divestment both at home and abroad, Korean TNCs have apparently struggled to maintain some of their core international operations, for longer-term strategic consideration. The drastic decrease in cross-border M&As undertaken by Korean TNCs in 1998 shows that there were very few new investment projects initiated during that year. The shortage of cash induced a number of Korean TNCs to cancel some of their investment plans and to divest some of their assets held abroad in order to raise funds. According to the records of the Ministry of Finance and Economy, 68 overseas investment projects with a value of $336 million were liquidated during 1998 and the first quarter of 1999.[41]

Figure II. 27. The asset value and its growth rate of the top 500 overseas Chinese firms

(Billions of dollars and percentage)



Source: Yazhou Zhoukan, *Asia Weekly*, "Top 500 international Chinese firms", 9-15 November 1998.

Looking ahead, FDI flows into the developing Asia region may decline further in 1999, especially if China does not maintain its previous high level. The decline of FDI approvals in 1998 and the first quarter of 1999 in a number of countries signals the possibility of a trend in that direction. However, in the region as a whole, FDI in 1999 is likely to remain above the average of the 1990s. In the longer run, FDI growth is likely to be resumed, as the fundamental determinants of inward FDI in the region remain sound. FDI outflows from developing Asia, too, can be expected to lower in 1999 than they were in 1997. Asian TNCs are likely to continue their focus on restructuring, spinning off non-core activities. The revitalization of their outward investment drive will take some time. Moreover, Asian TNCs may well be more cautious than before in their overseas business expansion (and, perhaps, diversify a bit away from Asia) – a lesson learnt from their past experience.

3. Latin America and the Caribbean

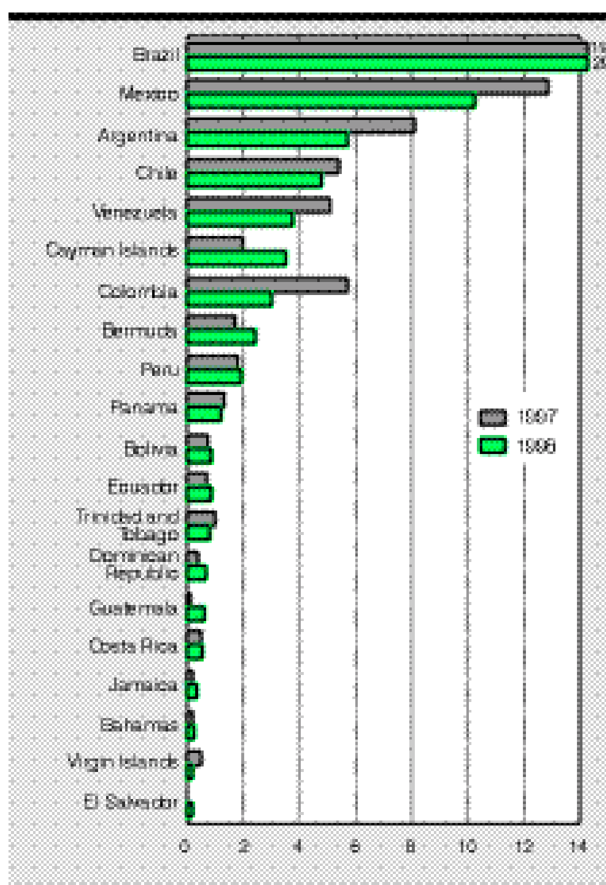
In 1998, a year of turbulence for emerging markets, FDI *inflows* into the region remained strong, exceeding $71 billion, a five per cent increase over the already record level of 1997 (annex table B.1). South American countries attracted 70 per cent of these inflows, with the countries of the Southern Common Market (MERCOSUR — Argentina, Brazil, Paraguay and Uruguay) receiving about half of all inflows to Latin America and the Caribbean. For a third consecutive year, Brazil was the single largest host country, receiving FDI inflows of more than $28 billion (figure II.28), 53 per cent more than in 1997, equivalent to 40 per cent of all inflows into the region as a whole. Mexico maintained its position as the second largest host country, but its share in total inflows declined from 19 to 14 per cent, followed by Argentina, Chile and Venezuela, each accounting for 5-8 per cent of the region's total in 1998. Inflows as a percentage of gross fixed capital formation to Latin America and the Carribean remain at high levels (16 per cent in 1997) compared to other developing regions. This is particularly noteworthy in countries such as Bolivia, Chile, Colombia, Costa Rica, Nicaragua and Venezuela which, with ratios exceeding 20 per cent, are clearly above international standards (figure II.29).

The increase in FDI inflows to Brazil in 1998 is largely a reflection of the country's privatization process, and it underlines the commitment of long-term investors to this country, despite short-term turbulence. TNCs long established in the country are restructuring existing

operations; new entrants compete for a share of this large market, often through the acquisitions of private companies and their participation in the privatization process. Overall, privatizations accounted for almost 25 per cent of FDI inflows in 1998 (Banco Central do Brasil, 1999). The biggest operation in this respect in 1998 was the participation of foreign companies in the sale of the telecommunications giant Telebrás. Additional privatizations and the opening up to private investment of the state-owned oil company Petrobras suggest that the momentum of this process would be maintained. In the case of Mexico, despite inflows having dropped by 20 per cent compared to 1997, they remained around their 1995-1997 average of about $10.5 billion. An important proportion of FDI in this country in recent years has been directed to manufacturing industries producing for the extended North American market, institutionalized through the North American Free Trade Agreement (NAFTA).

Figure II.28. Latin America and the Caribbean: FDI inflows, top 20 countries, 1997 and 1998[a]

(Billions of dollars)



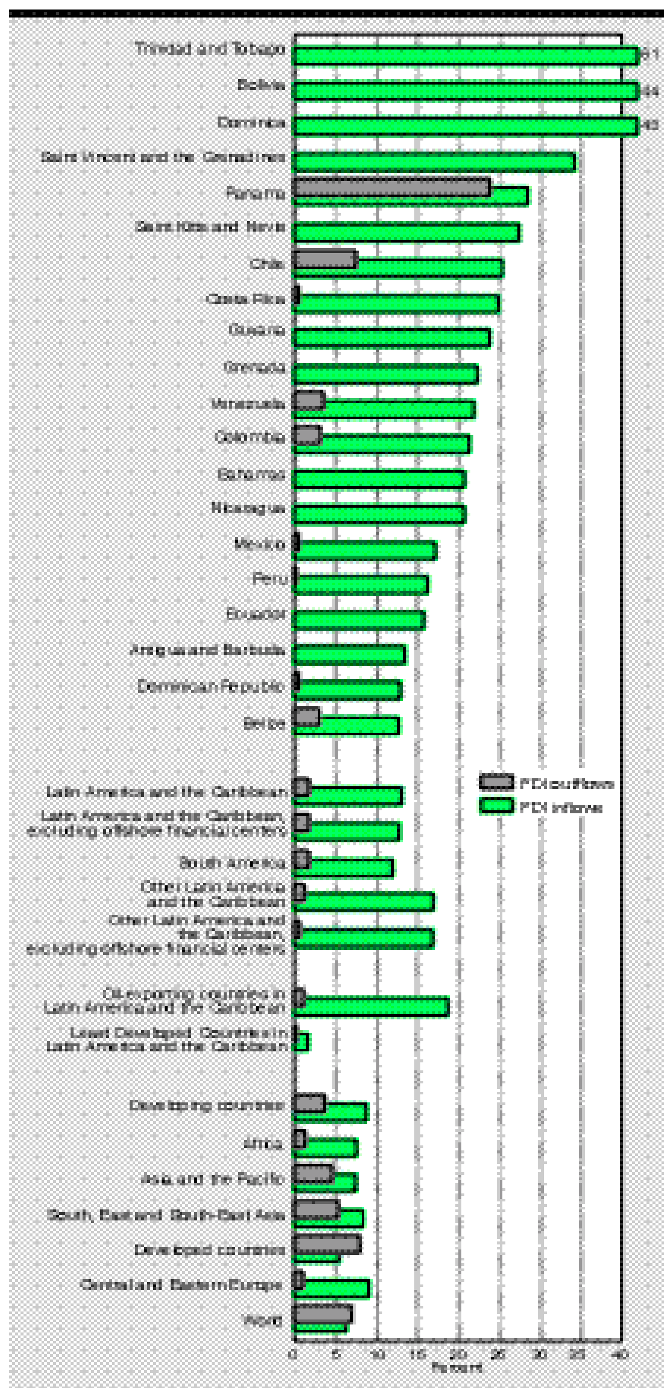
Source: UNCTAD, FDI/TNC database and annex table B.1.

[a] Ranked on the basis of the magnitude of 1998 FDI inflows.

Recent FDI inflows into Argentina (as into Brazil, Paraguay and Uruguay) have also been influenced by the extension of the country's market into the larger MERCOSUR area. In 1998 inflows to Argentina experienced a 30 per cent fall compared to 1997 but remained around their 1994-1997 average of nearly $6 billion. After the accelerated privatization process — which was a main driving force for attracting FDI during the first part of the decade — most inflows to Argentina in recent years have been directed to the acquisition of private companies, an important proportion of which have been in the banking industry, telecoms and media as well as hydrocarbons. In Colombia and Venezuela, new FDI attracted by the privatization of service industries in the past few years has complemented continuing strong inflows in their oil and natural gas industries. In Chile, an important proportion of recent investments has gone into the acquisition of private companies in service industries, such as banking and electricity, while traditional investments in mining have also continued strongly.

Inflows into other medium-sized natural resource-rich Andean countries, such as Bolivia, Ecuador and Peru, have increased rapidly in recent years due both to the liberalization of their investment regimes and privatization programmes. In an overall turbulent year for financial movements, inflows into offshore financial centres such as Bahamas, Bermuda and Cayman Islands increased in 1998, representing about half of total inflows into Central America and the Caribbean (excluding Mexico). Inflows into the Central American countries of El Salvador and Guatemala also rose in 1998, largely on account of the privatization of companies in the services sector (see annex table B.7 for M&A sales). These inflows complemented more traditional investments in export-oriented assembly manufacturing activities, also important in Costa Rica, the Dominican Republic and Jamaica. In Costa Rica, one third of total inflows as of 1998 were directed to electronics which is expected to be the most dynamic industry in the near future.

Figure II.29. Latin America and the Caribbean: FDI flows as a percentage of gross fixed capital formation, top 20 countries, 1995-1997[a]



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

[a] Ranked on the basis of the magnitude of 1995-1997 FDI inflows as a percentage of gross fixed capital formation.

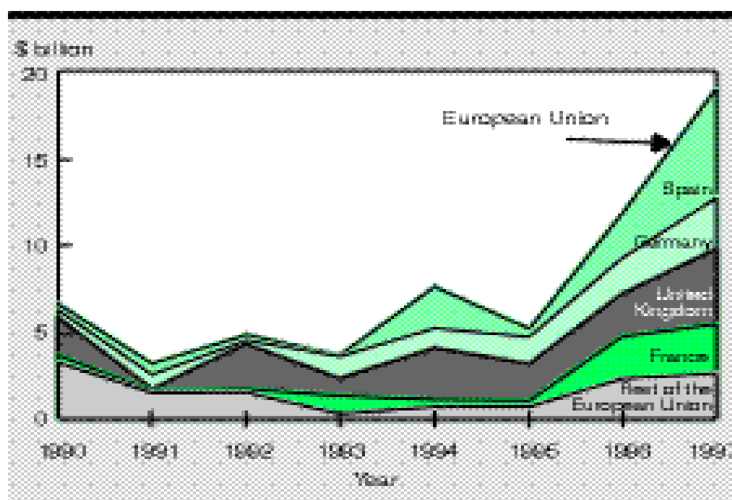
As regards the origin of FDI in the region, the United States continued to be the largest single investor country with outward flows amounting to about $17 in 1998.[42] United States TNCs have invested heavily in manufacturing in Mexico and the Caribbean Basin, seeking efficiency gains, and in service industries in South America, competing with other TNCs in these markets. Inflows from Japan reached $5.6 billion in 1998, compared to $2.3 billion in 1997.[43] A strong increase in inflows from European countries in recent years, however, has begun to challenge the traditional dominance of United States TNCs in the region: inflows from the European Union (EU) were almost equivalent to those from the United States in 1997 while they were less than half of the level of such flows in 1995 (IDB-IRELA, 1998 and IDB, 1999a).[44]

Within the EU, the largest investor country in 1997 was Spain (figure II.30), as FDI inflows from this country accounted for one third of all inflows from the EU into Latin America and the Caribbean. Spanish TNCs have acquired controlling stakes in important companies in the electricity industry in Brazil and Chile and the oil and gas industries in Argentina, and in telecommunications industries in Argentina, Brazil, Chile and Peru. Inflows from the United Kingdom, the second largest EU investor country in 1997, accounted for 23 per cent of EU inflows into the region that year, while both France and Germany each were the origin of a further 15 per cent of total EU inflows. A similar picture emerges when one examines the origin of foreign companies operating in the region: in 1997, 44 of the largest 100 foreign affiliates in the region (ranked by sales) were from the United States, 37 from the EU, five from Switzerland and only three from Japan (América Economía, 1998).

During 1998, FDI inflows to the region as a whole played an important role in stabilizing overall capital inflows (figure II.31) in the context of highly volatile short-term capital flows and the sharp increase in the cost of debt financing experienced by the region, particularly during the second half of the year. This financial effect also coincided with an abrupt fall in Latin America's terms of trade, due to the sharp fall in commodity prices registered in 1998. More specifically, about $38 billion of net portfolio investment and private bank loans (including other private flows) left Latin America and

Caribbean in 1998, precisely at a moment when the region's current account deficit reached $87 billion (World Bank, 1999). During most of the 1990s, the current account deficit was more than offset by private capital inflows, half of it FDI[45] (figure II.31). In 1998, bank loans and portfolio investment collapsed. That year, FDI inflows financed two-thirds of the region's current account deficit. The stability of FDI inflows in the turbulent financial environment of 1998 proved important for Brazil as it faced strong speculative attacks against its currency following the Russian devaluation and debt moratorium in August 1998, and again in the first quarter of 1999. However, while FDI flows to Brazil increased significantly in 1998, dividend and profit remittances ont he accumulated stock of FDI also grew by about 18 per cent comapred to those in 1997 – to reach an estimated $7.7 billion. FDI inflows continued to increase in the first quarter of 1999, reaching $8 billion, more than double the level of inflows in the first quarter of 1998. Around half of these inflows were linked to privatization.

Figure II.30. European Union [a] FDI outflows to Latin America and the Caribbean, 1990-1997



Source: UNCTAD, FDI/TNC database.

[a] Includes Austria, Belgium and Luxembourg, Denmark, Finland, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom.

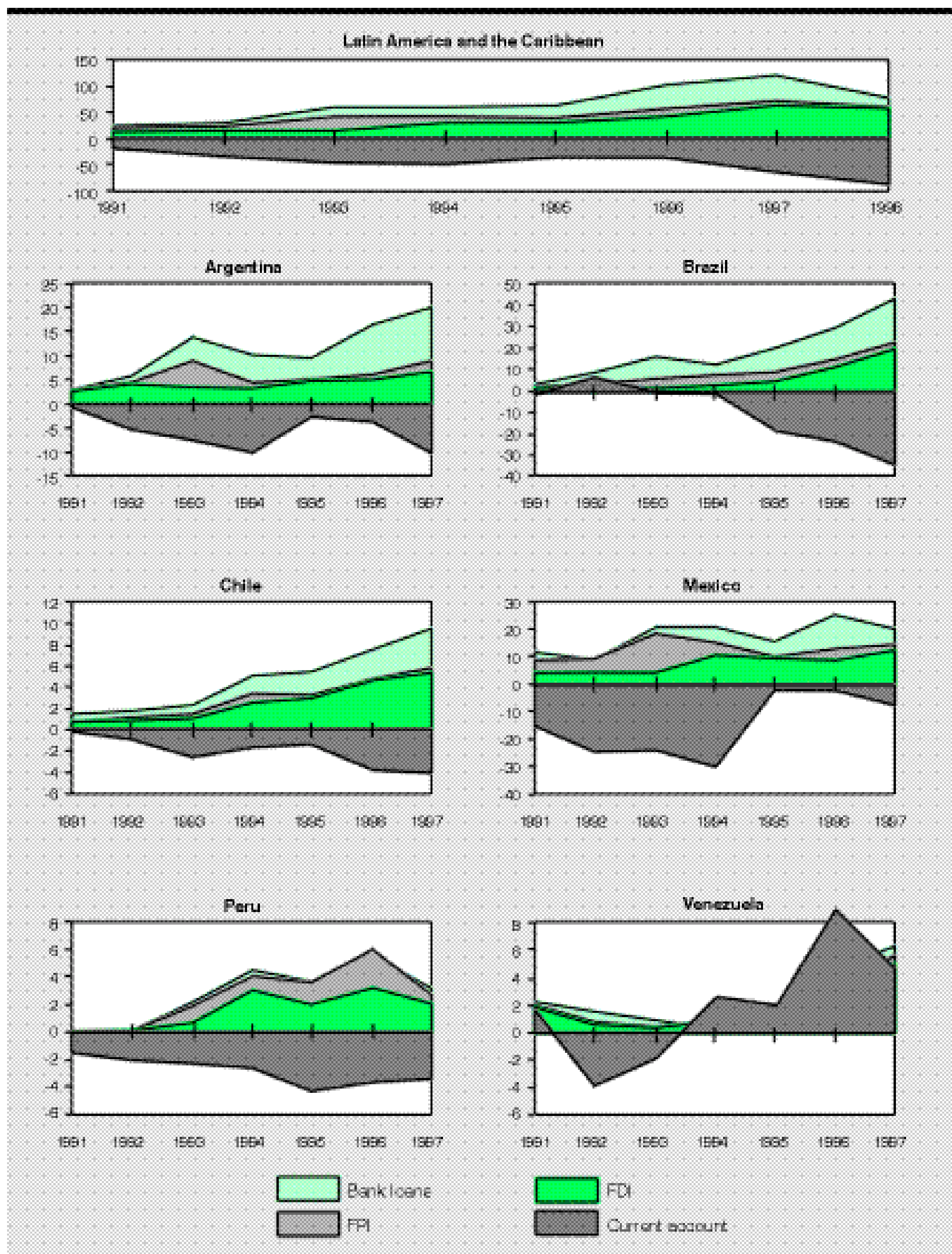
FDI inflows were also important for countries such as Argentina, Chile and Peru – that were hard hit by the trade – related effects of the Asian crisis, through lower commodity prices and sluggish Asian demand for their exports, aggravating their already existing 1997 trade deficits - for Mexico and Venezuela, that were significantly affected by low oil prices. In the case of Venezuela (dependent on oil for two-thirds of its exports earnings), a $10.5 billion trade surplus in 1997 dropped to $3.5 billion in 1998, while in Mexico the trade balance turned from a modest 1997 surplus into a $7.8 billion deficit in 1998. Although FDI inflows into these countries declined in 1998, their relatively high levels helped offset the current account deficit.

FDI *outflows* from Latin American and Caribbean countries also continued to be strong in 1998, at more than $15 billion (figure II.32). An important distinction, however, needs to be made between outflows from offshore financial centres and those that originate in other countries. Offshore financial centres are commonly used by TNCs as an intermediate destination for funds to be invested in other countries of the region or outside it. Most outflows from these centres were not originally generated in the region, but rather cancel out previous inflows into these centres. The confidentiality with which these centres operate makes it difficult to discuss their potential significance from an analytical perspective. In quantitative terms, however, FDI outflows from offshore financial centres in 1998 represented almost two-fifths of total FDI outflows from countries in the region, reaching about $6 billion, almost the same level as in 1997.

FDI outflows originating in some of the larger countries of South America and Mexico, on the other hand, follow a different economic logic and reflect, by and large, an incipient but accelerated process of internationalization, mostly within the region, of some leading Latin American companies (box II.6). This recent process of internationalization within the region, which accelerated in Chile in the early 1990s, can also be observed in the latter part of the decade in Argentina (box II.7), Brazil, Colombia and Mexico, and has led to a large increase in intra-regional FDI. Though accurate data are scarce, the evolution of total outflows from countries in

Figure II.31. Private net resource flows and current account deficits in Latin America and the Caribbean, 1991-1998

(Billions of dollars)

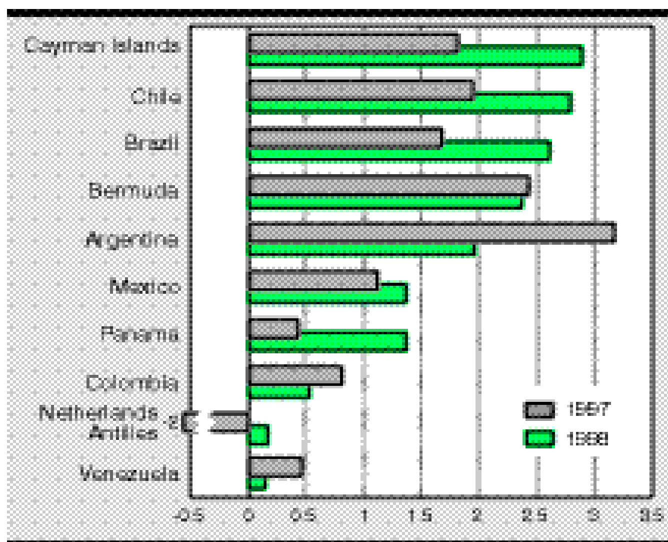


Source : World Bank, 1999.

Notes : FPI = Foreign portfolio equity investment. Bank loans include bonds and other private flows.

Figure II.32. Latin America and the Caribbean: FDI outflows, top 10 countries, 1997 and 1998[a]

(Billions of dollars)



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

[a] Ranked on the basis of the magnitude of 1998 FDI outflows.

the region which do not operate as offshore financial centres provides an indication as to the growth of intra-regional FDI.

In 1998, FDI outflows from Latin American and Caribbean countries (excluding offshore financial centres) were about $10 billion, comparable to the level of 1997. It is, however, more than twice the 1994-1996 average, and remains particularly impressive given the financial turbulence faced by Latin America in 1998. If one assumes that three-quarters of all FDI outflows from these countries in 1998 went into other countries of the region (estimates for Argentina, one of the most internationalized economies of the region, suggests that this is a prudent assumption), intra-regional investment would have reached almost $8 billion in 1998. Intra-regional investment in Latin America involves in particular Argentine and Brazilian companies extending their activities to cover the larger MERCOSUR region; large Chilean service companies expanding in neighbouring countries through participation in privatization projects; the integration of the Colombian and Venezuelan markets through FDI; and investments by Mexican companies in Central and South America.

Box II.6. A new wave of FDI from developing countries: Latin American TNCs in the 1990s

Several Latin American countries (Argentina, Brazil, Colombia, Mexico and Venezuela) were involved in the "first wave" of FDI from developing countries which took place in the 1960s and 1970s. It consisted mainly of market-seeking FDI, motivated by the existence of trade barriers in host countries (Lall, 1983). Latin American countries lost ground in the 1980s during the "second wave" of outward FDI from developing countries, which was led by Asian firms (Dunning, Van Hoesel and Narula, 1997).

The "third wave" of FDI from developing countries, which began during the 1990s, has been led by Latin American firms, mainly from Argentina, Chile and Mexico and, to a lesser extent, Brazil. Assets abroad by firms headquartered in these countries can be estimated at between $40 and $50 billion. Only a few of these firms started their foreign investments in the first wave, though many have been operating for a long time in their home economies.

The current wave of Latin American FDI cannot be separated from the adoption of more outward-oriented economic strategies and of structural reform programmes – including trade liberalization, privatizations and deregulation –- in most Latin American countries in the 1990s. These programmes have significantly increased competitive pressures on domestic firms, and have induced processes of restructuring in the economies of the region. In this sense, it is not surprising that Chile and Mexico were the first countries to enter the third wave of outward FDI from developing countries (in the early 1990s), followed by Argentina a few years later, while Brazil is still lagging in this respect. FDI outflows from Chile increased from an annual average of only $8 million during 1986-1990 to $525 million during 1991-1995 and to $2.0 billion during 1996-1998. In Mexico, official figures – which do not fully capture the magnitude of this phenomenon – indicate that from an annual average of $142 million during 1986-1990, FDI outflows reached nearly $300 million in 1991-1995 and, after the financial crisis, amounted to $836 million during 1996-1998. In Argentina, the outward FDI "boom" began in 1994. FDI outflows increased from an annual average of a mere $5 million during 1986-1990 to $869

/...

(Box II.6, concluded)

million during 1991-1995 and to $2.2 billion during 1996-1998. In this sense, the sequence in the countries' FDI process is to some extent a mirror of the sequence of the structural reform processes in their home economies.

Chile is the country in which outward FDI stock in relation to GDP is the highest among non-offshore financial centres, while in Brazil it is among the lowest (annex table B.6) . Mexico and Argentina are in-between cases. Among the factors that foster outward FDI in these countries are the relative size of their home economies, the sequence and timing of structural reforms, the insufficient availability of raw materials in the home country and the fact that many firms have already acquired dominant positions in their domestic markets.

Though there are cases of investments in the United States, Europe and some developing countries in East Asia, the bulk of current Latin American FDI stays in Latin America and especially in neighbouring countries and is geared towards their markets.

The majority of FDI from the region has been made by domestic economic conglomerates, though some Brazilian medium-sized enterprises made significant investments as well. Some of these large firms are trying to gain world leadership in specific market segments. Cemex (Mexico) for instance, is the second world producer of cement, with plants in the United States, Europe and Asia; and Techint (Argentina) accounts for 30 per cent of the world market in seamless pipes for the oil industry and operates a global network with a productive presence in Argentina, Mexico and Italy.

As a rule, ownership advantages of Latin American TNCs are based more on management capabilities, knowledge of well-diffused technologies, efficient quality and production management, sound marketing experience and access to financial resources, rather than on technological assets. In some cases the ownership advantages are also strongly based on the capability to work in similar cultural environments and on the knowledge of tastes and specific conditions in certain markets, due to geographical, cultural, linguistic or other forms of proximity.

Even those few Latin American firms operating in advanced technology industries do not seem to have entered yet into a path of technological accumulation (Cantwell and Tolentino, 1990) to become genuine innovators. As a result, contrary to what happened with Asian TNCs that tend to operate in skill-intensive industries, Latin American firms invest very little in developed countries' economies. In addition, their outward FDI takes place more specifically in services, mature industries or resource-based activities, though some cases of FDI in more skill-intensive and more technology-oriented activities can be found: in pharmaceuticals, custom-made capital goods, telecommunications and information services in Argentina; in autoparts and transport equipment in Brazil; and in biotechnology, television, telecommunications and transport equipment in Mexico, for instance.

Two opposite forces are at work, which have an impact on the maintenance (or development) of this third wave of outward FDI by Latin American companies. On the one hand, for a growing number of firms an FDI strategy is becoming indispensable for their own survival and expansion in the new context of globalization. It is hence plausible to assume that a growing number of Latin American firms will enter into a global FDI path and acquire a portfolio of locational assets, to maintain or strengthen their competitive position in a global environment: by investing abroad, domestic firms can better exploit their tangible and intangible assets and achieve economies of scale. This situation can be summarized in the dilemma faced by many domestic firms "to buy or to be bought", in a scenario in which foreign TNCs have shown a growing propensity to invest in Latin America.

On the other hand, the relative small size of the Latin American firms, compared with TNCs from developed and even developing Asian countries, may be a constraint for a sustainable FDI path. The costs of obtaining financial, technology and human resources are greater than those faced by their competitors based in developed and Asian countries. In addition, not only are Asian firms generally more transnationalized than Latin American enterprises; a number of them have also made more inroads in technology and skill-intensive activities.

The significant financial, technological and human resources constraints faced by Latin American enterprises are to some extent a consequence of the many weak points that characterize their home economies including in some cases relatively small domestic capital markets mostly geared towards short-term finance, educational systems not generally producing the kind of human power and management required for competing in open economies, and an inappropriate level of infrastructure. Overcoming these structural problems needs time, as well as systematic efforts and well designed and implemented public policies.

Source: Chudnovsky, Kosacoff and López, 1999.

Box II.7. Regional integration and the internationalization of Argentine companies

In terms of magnitude and characteristics, the internationalization of Argentine companies has responded over time to the different policy regimes that the country has experienced. Some early examples of internationalization of Argentine companies occurred in the first decades of this century as, within an overall exporting model of agricultural products, a selected number of companies set up affiliates in less developed neighbouring countries to expand their natural resource export base. A second wave of about 100 companies developed an international presence during the import-substitution period, spanning from the 1930s to the 1970s. However, the strategy and activities of these companies were essentially oriented towards the domestic market, and their incipient internationalization, still not very significant, served mainly as a complement to their domestic strategies.

The third and by far most active wave of internationalization of Argentine companies has occurred in the 1990s in a different context. The economic structure that emerged from the accelerated process of liberalization and privatization of the Argentine economy in the late 1980s and in the 1990s is characterized by strong competitive pressures and a concentration of economic activity in foreign affiliates and a few large domestic conglomerates, which together accounted for 83 per cent of total assets of the largest 1,000 companies in Argentina in 1997 (Kosacoff, 1999). Some large conglomerates expanded their activities into other Latin American countries, and in some cases into countries outside the region (Indonesia, Italy, Malaysia and the United States). In general, and with the exception of some important resource-seeking investments by the oil company Yacimientos Petroliferos Fiscales (YPF), the overwhelming motivation for recent FDI outflows from Argentina appears to be market-seeking through the sub-regional integration of production and distribution networks with neighbouring countries, particularly in the context of MERCOSUR.

This expansion into other Latin American countries to enlarge productive networks and access larger regional markets, already manifest in effective outflows in the first half of the 1990s, appears even clearer in planned investments. Indeed, while company surveys show that 68 per cent of actual and planned investments by leading Argentine companies in the 1990s were directed to other South American countries (26 per cent to Brazil), all major planned investments after the year 2000 are in South America, particularly in MERCOSUR countries (60 per cent of them being directed to Brazil — Kosacoff, 1999). In this respect, the institutionalization and consolidation of the sub-regional MERCOSUR market is playing a crucial role not only in the strategies of TNCs from outside Latin America that invest in the region but also in the internationalization strategies of Latin American companies.

In quantitative terms, the largest foreign investments by Argentine companies in the region are in the oil industry, which concentrates just under half of all actual and planned Argentine investments abroad since 1990. In this respect, the internationalization of YPF in neighbouring countries, in production and distribution of oil and gas in its energy-importing partners in the MERCOSUR and Chile, is a relevant example. Other interesting examples of internationalization by Argentine companies, especially within the MERCOSUR region, can be observed in particular in the food industry (Arcor, Bemberg, Socma), pharmaceuticals (Bago) and autoparts (IMPSA). As the sub-regional South American integration process consolidates further, with planned agreements between MERCOSUR and the Andean Community and the eventual accession of Chile as a full member of MERCOSUR, the process of intra-regional investment by Argentine companies is likely to increase, both in magnitude and coverage.

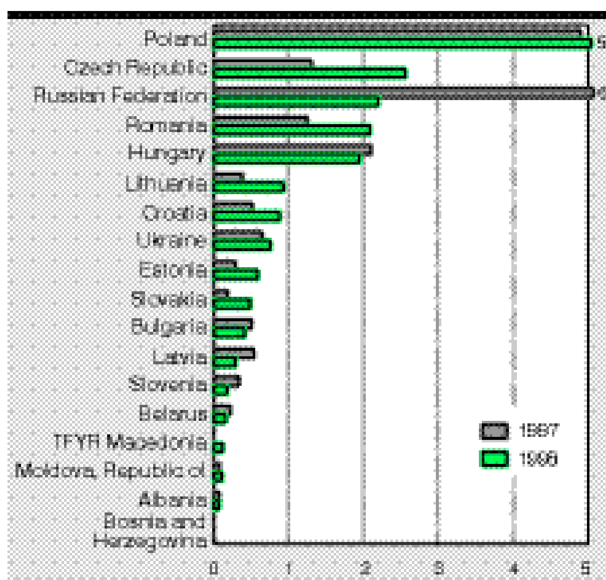
Source: UNCTAD based on IDB-IRELA, 1998; and Kosacoff, 1999.

C. Central and Eastern Europe

Overall FDI inflows to the countries of Central and Eastern Europe (CEE)[46] were remarkably resilient in 1998, registering a minor reduction of four per cent compared with 1997, to about $19 billion. However, this apparent stability masks two dramatically different trends: on the one hand, the Russian Federation saw its FDI fall by more than 60 per cent, to a mere $2 billion in 1998; on the other hand, the rest of the CEE region as a whole registered another record year, with FDI inflows topping $16 billion, i.e. 26 per cent above in 1997 (figure II.33). Even in some economies that have close trade and investment links with the Russian Federation, such as Ukraine and the Republic of Moldova, FDI inflows continued to increase in 1998, indicating that the Russian financial crisis had limited contagion effect on FDI inflows to other CEE countries.

Figure II.33. Central and Eastern Europe [a]: FDI inflows, 1997 and 1998[b]

(Billions of dollars)



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

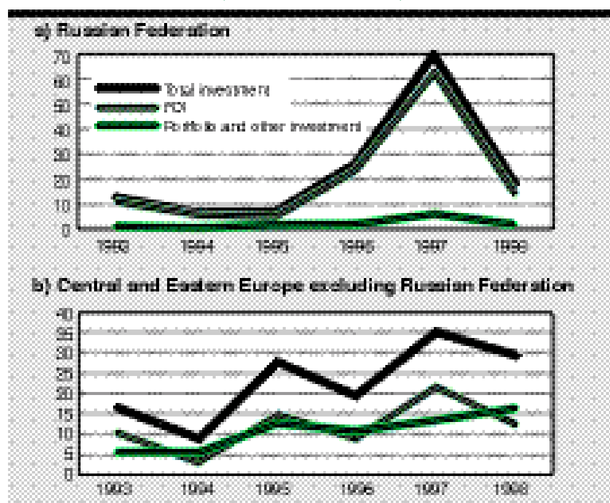
[a] Central and Eastern Europe includes countries that are classified under developing Europe according to the United Nations classification.

[b] Ranked on the basis of the magnitude of 1998 FDI inflows.

Though the decrease in FDI inflows (65 per cent) was less acute in the Russian Federation than the drop in portfolio and other investment inflows (by 75 per cent, to $18 billion in 1998), the divergence between FDI and portfolio and other investment flows was much more striking in the rest of the region: the above-mentioned 26 per cent increase in FDI inflows contrasts with the 40 per cent decline in portfolio and other investment flows registered by the other countries of the region in 1998 (figure II.34).

Figure II.34. Total foreign investment inflows in Central and Eastern Europe, 1993-1998

(Billions of dollars)



Source: UNCTAD, FDI/TNC database, and UNCTAD estimates, based on national reports.

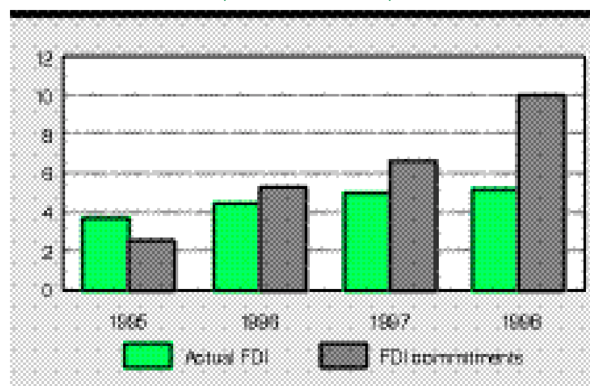
Central and Eastern Europe is catching up with the rest of the world as evidenced in the growth rates of FDI inflows in 1993-1997: over that period the inflows of Central and Eastern Europe increased faster (28.5 per cent per year) than those of the developing world (23 per cent), the developed countries (16 per cent), and the world as a whole (19 per cent). And this catching up may be even faster than data suggest because inflows into the region are often under-reported.

FDI inflows remained concentrated in a few countries in 1998. Five countries Poland, Czech Republic, Romania, Hungary and the Russian Federation accounted for 74 per cent of total FDI flows into the region. In Poland, by far the top

recipient if measured on the basis of total inflows, the growth of FDI was relatively moderate (five per cent); however, FDI commitments to this country, increasing by more than 50 per cent in 1998, indicate that the upward trend may be maintained in the near future (figure II.35). In spite of negative GDP growth, the Czech Republic and Romania saw a significant increase of FDI inflows. The reasons were privatization programmes, some of which included large companies and banks, particularly in Romania. Hungary, which registered a slight decline in FDI inflows in 1998, has been experiencing a smooth transition from privatization-led to greenfield-led FDI; in 1998, non-privatization investment accounted for 94 per cent of FDI inflows, compared to 34 per cent in 1995 (UNCTAD, FDI/TNC database).

Figure II.35. Actual FDI inflows and FDI commitments into Poland, 1995-1998

(Billion of dollars)



Source: UNCTAD, FDI/TNC database (actual FDI), and Polish Foreign Investment Agency

The impact of the economic and financial crisis in the Russian Federation on its inward FDI flows was felt through a number of channels:

- The crisis reduced investor confidence in the strength of the Russian economy, leading to a scaling down or postponement of investment plans.

- The depreciation of the ruble (by 71 per cent) resulted in a reduction in asset values and revenues in dollar terms (or other currency terms) which was and will be (because of the time effect) strongly felt by foreign investors. A survey of 50 United States affiliates in the Russian Federation conducted by the American Chamber of Commerce in that country in September 1998, one month after the outbreak of the crisis, estimated that the immediate losses for these enterprises already amounted to almost $500 million (American Chamber of Commerce, 1998). However, while only two per cent of the respondents to the survey indicated that they planned to divest, 13 per cent planned to suspend production; and 28 per cent would reduce their workforce.

- In addition, as a result of the crisis, finance for the current operations of firms from domestic or international capital markets virtually dried up. This was a particularly severe blow to smaller-sized foreign investors. Already in September 1998, 72 per cent of the respondents to the above-mentioned American Chamber of Commerce survey indicated that the lack of access to finance was a major problem they faced.

- The crisis also increased uncertainty about Russian economic policies, particularly as far as privatization policies were concerned. In fact, privatization-related FDI inflows were among those worst hit. In 1997, these transactions accounted for more than one-third of (larger) total inflows; in 1998, there were virtually none.

- Another reason for the collapse of inward FDI flows in the Russian Federation lies in the nature of such flows: according to 1998 stock data, less than 16 per cent of inward FDI is efficiency-seeking, (which usually includes investment that generates exports and would hence have benefited from the ruble depreciation). Thus, the Russian Federation's capabilities to transform its inward manufacturing FDI into an engine of export-led growth were limited. Foreign investors were instead attracted to the country's natural resources and large domestic market, with a preference for mining (13 per cent of 1998 FDI stock), basic metallurgy (nine per cent), food production (17 per cent) and services (40 per cent).

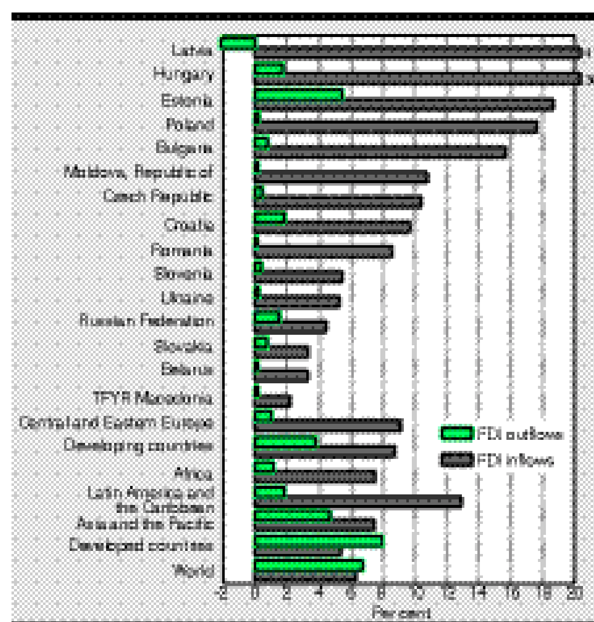
- Finally, the amount of FDI inflows was further reduced by a sharp reduction in round-tripping, confirming the findings of WIR98 in this respect (UNCTAD, 1998a).[47]

In the coming years, various factors could mitigate the negative impact of the Russian financial crisis on FDI inflows to the Russian Federation. They include privatization, FDI liberalization in industries in services and natural resources that are now closed to such investment, and opportunities for small- and medium-sized foreign investors to acquire Russian assets at low prices partly as a result of the ruble depreciation. Besides, while it is true that the crisis led to a suspension of investment plans and a reduction in the workforce of foreign affiliates, only a small number of foreign investors have decided to leave the Russian Federation altogether (American Chamber of Commerce, 1998).

In seven other Central and Eastern European countries— (Croatia, Estonia, Lithuania, TFYR Macedonia, Republic of Moldova, Slovakia, Ukraine), FDI inflows also increased in 1998. An increase took place in the Republic of Moldova and in Ukraine in spite of these economies' negative GDP growth, again casting doubt on the link between GDP growth and FDI in this region. In the other countries of the region, FDI inflows remained virtually unchanged, or registered minor decreases.

Compared with the size of domestic economies, and the level of domestic investment, FDI inflows play a significant role in at least half of Central and Eastern European countries. In 1995-1997, the ratio of FDI to gross fixed capital formation exceeded 40 per cent in Latvia, 30 per cent in Hungary, and 15 per cent in Estonia, Poland and Bulgaria. The average of this ratio for the region as a whole (9 per cent) compares well with those of other regions: it is slightly higher than the average of developing countries and significantly higher than the world average (figure II.36).

Figure II.36. Central and Eastern Europe[a]: FDI flows as a percentage of gross fixed capital formation, 1995-1997[b]



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

[a] Central and Eastern Europe includes countries that are classified under developing Europe according to the United Nations classification.

[b] Ranked on the basis of the magnitude of 1997 FDI inflows

The inward FDI stock of Central and Eastern Europe reached about $90 billion in 1998, and is expected to exceed $100 billion in 1999. Inward FDI stock continues to be concentrated in four countries (Poland, Hungary, Czech Republic and the Russian Federation), which together account for three-quarters of the region's stock (see annex table B.3). Four countries have very high ratios of inward FDI stock to GDP by international standards: Hungary (35 per cent in 1997), Estonia (25 per cent), Latvia (23 per cent) and the Czech Republic (23 per cent) (annex table B.6).

The inward FDI stock of CEE countries is dominated by investors from the European Union, whose share accounted for almost two-thirds of the total in 1998 (figure II.37).[48]

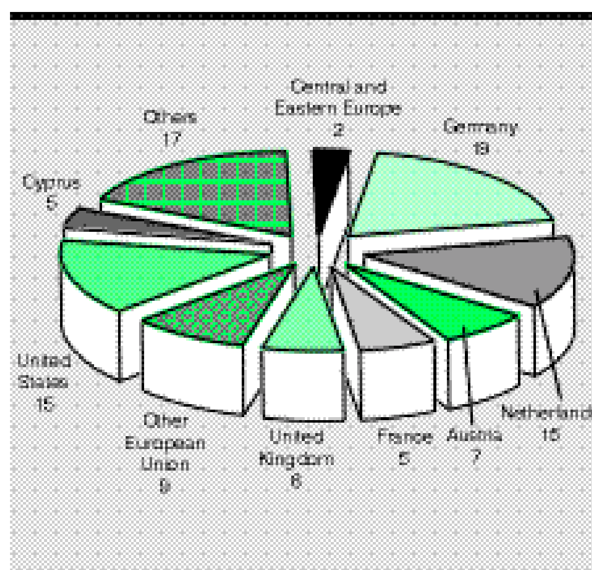
In this respect, the possible accession of some countries in the region to the European Union partly explains the relative importance of EU investment in Eastern Europe. Next in line were investors from the United States, with 15 per cent. The United States is the single most important investor in the Russian Federation and Croatia and the Ukraine, although in the Ukraine its share is somewhat lower than that of the European Union as a whole (annex table A.II.2).

Investors from the Russian Federation accounted for one per cent of inward FDI to Central European countries. Besides the Russian Federation and Croatia (for specific reasons), no other country of the region is among the top three investors in another Central and Eastern European economy, which points to the still relatively small importance of intra-regional FDI (table II.3).

A sectoral breakdown of inward stock indicates that the primary sector (mainly mining) is not very significant (figure II.38 and annex table A.II.3), except in Belarus and, to a lesser extent, in the Russian Federation. The secondary and tertiary sectors are quite similar in terms of importance: manufacturing is the lead sector in six countries (Bulgaria, Croatia, Czech Republic, Poland, Romania and Ukraine), although in three of them (Czech Republic, Poland and Ukraine) it is closely followed by the services sector. Services are dominant in nine countries (Bosnia and Herzegovina, Estonia, Hungary, Latvia, Lithuania, Republic of Moldova, Russian Federation, Slovakia and Slovenia).

Figure II.37. Central and Eastern Europe: geographical sources of inward FDI stock, 1998[a]

(Percentage)



Source: UNCTAD, FDI/TNC database.

[a] Estimates.

In 1998, FDI outflows from Central and Eastern Europe declined by 44 per cent from an already low level to $2 billion. Just as for inward trends, there was a sharp difference between the Russian Federation and the rest of the region. Russian enterprises, suffering from the crisis,decreased their outward investment by 60 per cent to $1 billion (figure II.39), while FDI outflows from the rest of the region as a whole decreased by a modest six per cent to about $1 billion. Despite this sharp decline, the Russian Federation continues to be the biggest outward investor in the region. It alone accounts for more that half of the outward FDI stock of Central and Eastern Europe in 1998, estimated at $13 billion.

Table II.3. The top three source countries of inward FDI stock in Central and Eastern Europe, 1998

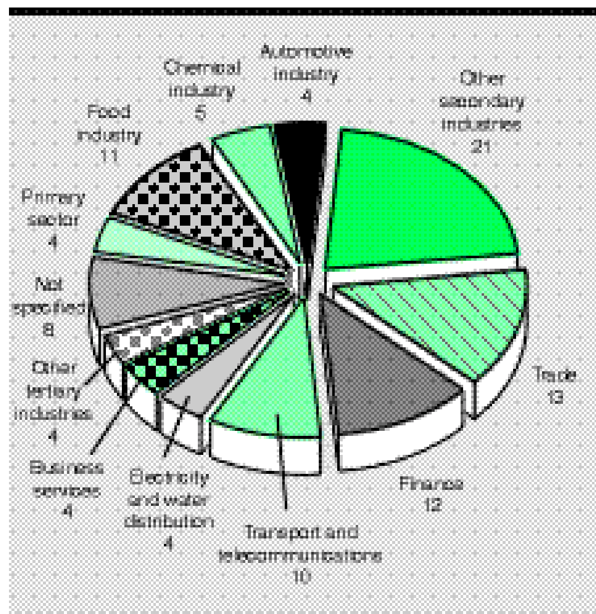
Host country	Top source country	Second source	Third source
Belarus[b]	Germany	Netherlands	United States
Bosnia and Herzegovina[b]	Kuwait	Germany	Croatia
Bulgaria[b]	Belgium-Luxembourg	Germany	United States
Croatia	United States	Austria	Switzerland
Czech Republic[a]	Germany	Netherlands	Austria
Estonia	Sweden	Finland	United States
Hungary[a]	Germany	United States	Netherlands
Latvia	Denmark	United States	Russian Federation
Lithuania	Sweden	Finland	United States
Macedonia, FYR[a]	Germany	Austria	Greece
Moldova, Republic	Russian Federation	United States	Germany
Poland[a]	Netherlands	Germany	United States
Romania	Netherlands	Germany	France
Russian Federation[a]	United States	Cyprus	Germany
Slovakia	Austria	Germany	United Kingdom
Slovenia[b]	Austria	Croatia	Germany
Ukraine	United States	Netherlands	Germany

Source: UNCTAD, FDI/TNC database.

[a] Based on commitments.
[b] 1997.

Figure II.38. Central and Eastern Europe: industry composition of inward FDI stock, 1998[a]

(Percentage)

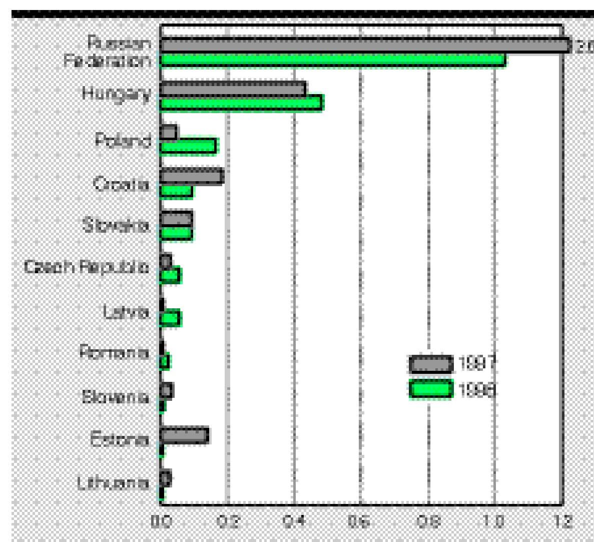


Source: UNCTAD, FDI/TNC database.

[a] Estimates.

Figure II.39. Central and Eastern Europe[a]: FDI outflows, 1997 and 1998[b]

(Billions of dollars)



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

[a] Central and Eastern Europe includes countries that are classified under developing Europe according to the United Nations classification.

[b] Ranked on the basis of the magnitude of 1998 FDI outflows.

Notes

1. There were two especially large cross-border M&As in 1998 (Daimler-Chrysler and BP-Amoco). It appears that they were financed by FDI (in the form of an exchange of stocks). If these transactions were excluded, equity capital in 1998 still increased by $11 billion (Bach, 1999).
2. Manufacturing affiliates of foreign TNCs accounted for 11.2 per cent of private sector employment in manufacturing in 1996, compared with 4.8 per cent in all sectors. Yet, a very uneven distribution of FDI across states prevailed in manufacturing, too. The employment share of foreign affiliates in manufacturing ranged from almost one fifth in Kentucky, South Carolina and New Jersey to 4-5 per cent in Idaho and Mississippi.
3. For example, EU FDI outflows to the United States and to all non-OECD host countries increased by 154 and 75 per cent, respectively, in 1997, compared with 27 per cent for outflows to EU partner countries (EUROSTAT, 1999).
4. According to EUROSTAT, extra-EU inflows of ECU 36 billion in 1997 were slightly below extra-EU inflows in 1995.
5. Note that inflow data reported by EU host countries and outflow data reported by EU investor countries may differ substantially in coverage. The reasons for this discrepancy are manifold, including an incorrect geographical allocation of FDI flows and different data collection systems in EU member countries. Some countries have collection systems based on partial inquiries using enterprise panels. Transactions below a certain minimum value are not always recorded as FDI flows. Loans provided by an affiliate to another affiliate of the same parent company are partly attributed to FDI outflows from the country of the parent company, rather than to outflows from the country where the affiliate resides which has provided the loan. Still more importantly, reinvested earnings as well as long-term and short-term loans are treated differently by EU member countries. For example, Germany has just revised FDI statistics by including short-term loans, while other EU countries have not yet done so. For a detailed discussion of the various reasons for discrepancies between inflow and outflow data, see EUROSTAT, 1999.

6 See, for example, the EU Commission's White Paper "Growth, competitiveness, unemployment", which was published in December 1993. As noted by the Commission in another report in 1993 (Commission of the European Communities, *European Economy*, No. 52, Brussels, 1993), the EU trade balance for high-technology products had worsened progressively; the growth rate of EU imports of high-technology products was nearly double the growth rate of the corresponding EU exports.

7 On a notification basis FDI outflows declined by 21 per cent and FDI inflows increased by 98 per cent in fiscal year 1998 (ending March 1999).

8 Several indicators point to low profitability. For example, in manufacturing the ratio of current profits to sales declined to 3.3 per cent in 1997 (Japan, Ministry of Finance, 1998). Low profits earned in the previous year affect investment expenditures in the following year. This continued in 1998 when current profits declined by 13 per cent for the firms listed in stock markets. *Nihon Keizai Shimbun*, 22 May 1999, p.1.

9 Negative growth rates of real GDP were registered in 1998 (-2.8 per cent). Industrial production for the fiscal year 1998 fell 7.1 per cent, its worst decline in 24 years (Michiyo Nakamoto, "Pressure grows in Tokyo for supplementary budget", *Financial Times*, 29 April 1999, p. 12).

10 Information provided by Recof (Tokyo).

11 This is based on the 15 major Japanese banks that received public funds from the Government of Japan for their restructuring. The number of foreign affiliates (including branches) was 393 in March 1999 (*Nihon Keizai Shimbun*, 9 March 1999, p. 7), compared with 669 at the end of 1995 (Japan, Ministry of Finance, 1997). This number is expected to be reduced further to 270 by March 2003.

12 *Nihon Keizai Shimbun*, 11 January 1999, p. 3. Because of this, FDI outflows in the financial sector are expected to decline. However, interestingly, both flows in this industry and their share in total Japanese outflows as reported by the Ministry of Finance increased in fiscal year 1998. There are statistical problems in the data reported by this Ministry, as they are based on a notification basis and do not take into account divestments. (These are the only data available providing industry breakdown of FDI flows.) Therefore, investments in Cayman Islands, for example, are recorded as positive, but closures or sell-offs of Japanese banking affiliates in the United States are not recorded in the statistics.

13 Based on a survey of 400 manufacturing affiliates conducted in mid-1998 (*Nihon Keizai Shimbun*, 1 September 1998, p. 11). Another survey by the Export-Import Bank of Japan also indicates that sales decreased in about 60 per cent of Japanese affiliates in that region (291 manufacturing affiliates surveyed in July-August 1998) (Nishiyama, Kushima and Noda, 1999).

14 *Nihon Keizai Shimbun*, 29 July 1998, p.11.

15 For instance, the international tobacco business of RJR Nabisco was acquired in 1999 by Japan tobacco for $7.8 billion — the largest cross-border M&A by a Japanese firm ever.

16 *Nihon Keizai Shimbun*, 29 July 1998, p.11.

17 This financial company is the largest foreign investor in Japan, controlling $12 billion worth of assets in Japan. (Gillian Tett, "GE Capital planning to expand in Japan", *Financial Times*, 23 February 1999, p. 17).

18 It is noteworthy that foreign affiliates in Japan have been more profitable than Japanese firms in general, even during the current economic recession. The ratio of current profits to total sales during the first half of the 1990s was 3-5 per cent for affiliates compared to 2-3 per cent for Japanese firms. One third of 705 foreign affiliates surveyed by JETRO in October 1998 expected to increase sales in 1998 (*Nihon Keizai Shimbun*, 11 December 1998, p. 11).

19 In order to give a comprehensive picture of FDI flows into and out of Africa, South Africa (otherwise classified among "other developed countries" in United Nations statistics) is included in the figures on FDI flows presented in this section. The data for South Africa can be found in the statistical annex under the heading "Other developed countries".

20 It should be noted that the figures for FDI flows into and out of Africa for recent years as published in this report differ from those reported in *WIR98*, due to changes in methodologies to compile and calculate the relevant data. (See also definitions and sources, Annex B.)

21 In some countries, such as Angola, a destabilization of the political situation contributed also to the decline in FDI inflows.

22 Liberia is traditionally one of the world's most important addresses for the registration of ships. However, although this influences the FDI statistics of the country, it does not represent *de facto* direct investment in Liberia.

23 For an explanation of the relatively large number of African countries with a high ratio of FDI inflows to gross fixed capital formation and GDP, see UNCTAD, 1998a, p.164.

24 These figures are based on unpublished data received from OECD. For a more detailed analysis of the home country distribution of FDI flows into Africa in recent years, see UNCTAD, 1998a.

25 Data from the South African Reserve Bank. Other sources (from private organizations such as IRRC and Business Map) also provide data on FDI, which can be different from the SARB data due to differences in

definition and methodologies.

[26] According to the Investors Responsibility Research Centre (IRRC): "if the sale of state assets are excluded from both years' tallies, inward FDI rose by more than 32 percent." (IRRC, 1999, p.1).

[27] Indeed, except for significant investments of 4 billion Rand by Petronas in the South African petroleum and refining company of Engen, there was no other major investment by Malaysian firms in South Africa in 1998. In fact, there were some divestments by Malaysian firms in 1998 (Business Map 1999, p. 2).

[28] The information regarding the distribution of FDI inflows into South Africa by industry and by home country is based on information from IRRC (1999) and Business Map (1999), private sources for FDI information. Information of this kind is not available from official sources, including the South African Reserve Bank.

[29] FDI outflow figures by host country are not available from the South African Reserve Bank.

[30] The survey took place between March and June 1999: 44 countries were surveyed, of which 30 answered. These were Algeria, Botswana, Burkina Faso, Cameroon, Cape Verde, Democratic Republic of the Congo, Côte d'Ivoire, Egypt, Ethiopia, The Gambia, Ghana, Kenya, Madagascar, Malawi, Mali, Mauritius, Morocco, Mozambique, Namibia, Niger, Rwanda, Senegal, Seychelles, South Africa, Sudan, Togo, Tunisia, Uganda, Zambia and Zimbabwe. A response was also received from the investment promotion agency of Zanzibar, which is part of the United Republic of Tanzania. The 30 countries listed above accounted for almost $16 billion of FDI inflows representing 64 per cent of total accumulated inflows between 1996 and 1998 into Africa.

[31] This result is perhaps not surprising, given the promotion function of these agencies (although they could have been less optimistic for Africa as a whole).

[32] Equatorial Guinea, owing to its recent success in attracting sizeable amounts of FDI largely due to its oil reserves, was the only "front runner" country that did not make it onto the list.

[33] The IPAs were asked to indicate "a) which of the factors listed below contribute positively or negatively to the future development of FDI into your country in the period 2000-2003 and b) the level of their importance". The rating scale to assess the importance of the factor was 1 (lower) to 4 (higher).

[34] A possible reason for this result might be low productivity levels which offset the advantage of low labour costs and may underline a need to emphasize education and skill development.

[35] The factor "extortion and bribery" also ranked high. However, since the value 3.5 for this item represents the average of the evaluations of only two countries the figure is less meaningful than the other figures presented in figure II.17b.

[36] In the Pacific, Vanuatu ranked top in terms of FDI inflows to gross fixed capital formation (figure II.20).

[37] For a full analysis of the effect of the Asian crisis on FDI flows, see UNCTAD, 1998b.

[38] FDI approvals in Viet Nam dropped by eight per cent to $4.1 billion in 1998, which included a $1.3 billion joint-venture oil refinery with the Russian Federation.

[39] In 1998, foreign investment projects (on an approval basis) in Iran amounted to $1.3 billion, 90 per cent of which were in the petroleum and petrochemical industries.

[40] For a detailed analysis, see UNCTAD, 1998a.

[41] Data provided by the Ministry of Finance and Economy. Actual divestment of FDI by Korean TNCs could be higher, as not all divestment abroad was recorded by the Ministry.

[42] Data from United States Department of Commerce (www.boa.doc.gov/bea/di/usdiacap.htm).

[43] This included flows to the Cayman Islands, which surged suddenly in 1998. Excluding Cayman Islands, the share of Japan in inflows to the region is less than five per cent on a notification basis.

[44] In 1995, United States FDI flows to Latin America and the Caribbean were $16 billion, as compared with $7 billion from the European Union. In 1997, these flows were respectively, $24 billion and almost $20 billion.

[45] Payment outflows due to dividend and profit remittances contribute to the current account deficit. For a discussion of the overall impact of FDI on balance of payments, see chapter VI.

[46] For the purpose of this analysis, this region is defined to include the following countries: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Former Yugoslav Republic of Macedonia, Hungary, Latvia, Lithuania, Poland, Republic of Moldova, Romania, Russian Federation, Slovakia, Slovenia, Ukraine, Yugoslavia. (The data for Croatia, Former Yugoslav Republic of Macedonia and Slovenia can be found in the annex under the heading "Developing Europe"). There are no official FDI data available for Yugoslavia. The Asian transition economies (Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) are analysed in the Central Asian section of this chapter.

[47] The 1997 FDI inflow figures of the Russian Federation were inflated by the sale of 25 per cent of Svyazinvest, the biggest telecommunications holding company, to a consortium of Russian offshore banks and foreign banks and investment funds (KPMG, 1998). Despite the presence of Russian banks in the consortium, and the lack of telecommunications management experience among the foreign partners, the transaction

was registered as FDI because the consortium had been registered abroad and acquired more than 10 per cent of a holding company. If the Svyazinvest transaction had not been registered under FDI in 1997, the 1998 decrease would have been 50 per cent, and not 65 per cent, as judged from the balance-of-payments data (UNCTAD, 1998a, p. 290).

48 Seventeen countries report data on the sources of FDI. None are available for Albania.