

United Nations Conference on Trade and Development

World Investment Report

2003 **FDI Policies for Development:
National and International
Perspectives**



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CHAPTER II

UNEVEN PERFORMANCE ACROSS REGIONS

Introduction

To sum up chapter I, FDI in 2002 was down again for both developed and developing countries. Flows to the United States, the top host country from 1978 to 2001, plunged to a 10-year low in 2002. But fairly robust FDI outflows from the United States helped sustain global FDI flows, though at levels well below their 2000 peak. FDI inflows to all three host developing regions—Africa, Asia and the Pacific and Latin America and the Caribbean—fell. Only CEE received higher inflows than in 2001.

Subregions and countries also showed considerable diversity in their vulnerability to the downturn, as did sectors and industries. Three things made a difference. How much countries sustained their economic performance and growth despite recession in major developed countries. How much they attracted resource-seeking and especially efficiency-seeking FDI. And how much national and international policy initiatives strengthened their positions as host countries.

In an FDI downturn policy changes favourable to FDI and agreements that address FDI issues assume greater importance. Combined with other determinants of FDI, they may help countries sustain or increase the level of FDI. National policy

changes were overwhelmingly in the direction of liberalization (table I.8). Internationally, agreements on FDI proliferated. Where they create bigger markets, in particular, they can be good for FDI.¹

For 2003 the prospects are stagnation at best for developed countries, Asia and the Pacific and Latin America and the Caribbean—but reasonably good for Africa and CEE. In 2004 and beyond, the prospects are promising for all regions.

This chapter discusses recent FDI trends and developments in the various regions. It also discusses international investment agreements (IIAs) involving countries in the different regions, exploring how they have influenced FDI flows. IIAs can influence TNC decision-making depending on their impact on factors determining the location of FDI (*WIR98*). Relevant is the emergence of regulatory frameworks for FDI that are more predictable, stable, transparent and secure. Particularly relevant is whether market size is increased or market access is improved, creating opportunities to tap larger markets and resources in the region and to specialize within corporate networks.

A. Developing countries

All developing regions—Africa, Asia and the Pacific, Latin America and the Caribbean—had lower FDI inflows.

The least developed countries (LDCs), a special group of 49 economies,² were not an exception with inflows declining by 7% to \$5.2 billion in 2002 (annex table B.1). Inflows to African LDCs fell by 3% in 2002, and those to LDCs in Asia and the Pacific declined by half, to \$0.3 billion in 2002. The only LDC in Latin America—Haiti—had higher inflows, particularly for textiles, due in part to its entry into CARICOM. The share of LDCs in global FDI flows remains less than 1% of the world total and 3.2% of the developing country total.

FDI flows to the largest LDC recipients—most of them oil-exporting countries, including

Angola, Equatorial Guinea and Sudan—also declined. Chad is an exceptional case with inflows growing from almost nothing in 2001 to \$0.9 billion in 2002 by attracting oil-related FDI. This country became the second largest recipient after Angola among LDCs. With more investment in petroleum, FDI flows to LDCs as a group are expected to rise in 2003.

1. Africa

Africa's FDI inflows declined to \$11 billion in 2002 after a surge to \$19 billion in 2001, mainly from two cross-border M&As. As a result, the region's share in global FDI inflows fell from 2.3% in 2001 to 1.7% in 2002, highlighting the small volume of FDI flows to the region. Many African

countries marginally sustained or increased their FDI inflows in 2002. Inflows to the region remained highly concentrated, with Algeria, Angola, Chad, Nigeria and Tunisia accounting for half of the total inflows. The distribution across sectors and industries remained largely unchanged.

The downturn in FDI flows could be short-lived, especially with stronger national efforts to promote FDI and ongoing trade and investment initiatives by the United States, the EU and Japan. In addition, some TNCs began new activities, notably in petroleum exploration and extraction. Much will depend, however, on the vigour of African countries in pursuing policies that stimulate domestic economic growth and encourage sustainable inflows of FDI.

a. FDI down by two-fifths

The most striking feature of the FDI downturn in Africa in 2002 is its size (41%), a good part of which was linked to the absence of large M&As comparable to those that took place in 2001. Cross-border M&As amounted to less than \$2 billion, compared with \$16 billion in 2001 (annex table B.7). If the large cross-border M&A deals in Morocco and South Africa in 2001 are excluded from FDI figures for that year, FDI inflows in 2002 actually increased by 8%. Unevenly distributed across the continent, FDI inflows amounted to only

8.9% of gross fixed capital formation (figure II.2), compared to 19.4% in 2001.

The downturn also reflects drops in outflows from the major home countries of FDI to Africa—the United States, France and the United Kingdom. United States imports from sub-Saharan Africa declined by more than 16% in 2002,³ reducing the interest of TNCs in Africa.

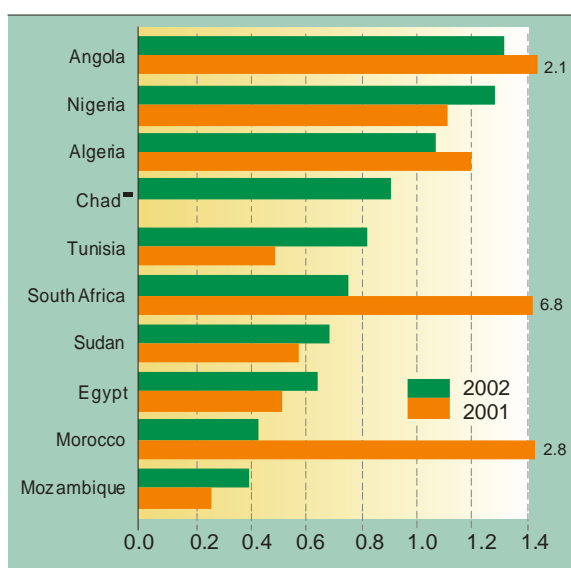
Until 2001, FDI was gaining in importance as a source of Africa's external development finance, reaching nearly two-thirds of total net resource flows in 2001, compared with 34% through official flows (figure II.3). Average FDI flows to the region in 1997–2001 were higher than either total official flows or the total of portfolio and commercial bank loans. Seen from this perspective, the downturn in FDI in 2002 was a major setback, even if short-lived.

In spite of the downturn, 30 countries out of Africa's 53 attracted higher inflows in 2002 than in 2001 (annex table B.1), largely through greenfield FDI, mainly in petroleum (Algeria, Angola, Chad, Equatorial Guinea, Sudan and Tunisia) and to a lesser extent in apparel (Botswana, Kenya, Lesotho and Mauritius). Angola, Nigeria, Algeria, Chad and Tunisia ranked, in that order, at the head of the top 10 FDI recipients (figure II.1). Chad registered the largest increase, from zero in 2001 to more than \$900 million in 2002.

The success stories contrast, however, with experiences of countries that lag behind. The Libyan Arab Jamahiriya (with negative inflows) ranked lowest (annex table B.1). Other low FDI recipients have relatively limited natural resource endowments. In four of them—Burundi, Comoros, Liberia and Somalia—efforts are still under way to recover from recent or on-going political instability and civil wars.

There was a flurry of petroleum exploration activities in the Gulf of Guinea, off the coast of West Africa and other areas of Africa, particularly in Angola, Chad, Equatorial Guinea and Sudan, as some TNCs—Exxon-Mobil (United States), TotalFinaElf (France) and Encana (Canada)—sought to diversify their holdings. Sustained peace in Angola could mean a further consolidation of such activities. In some countries, however, manufacturing attracted considerably more FDI than natural resources—as in South Africa. The automobile industry there, spawned by FDI, employs nearly 300,000 people and is the third largest industry.

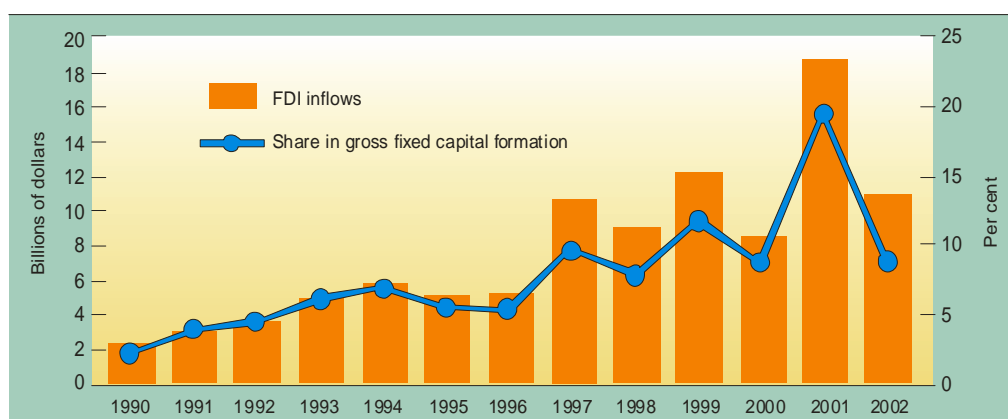
Figure II.1. Africa: FDI inflows, top 10 countries, 2001 and 2002^a
(Billions of dollars)



Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

- ^a Ranked on the basis of the magnitude of 2002 FDI flows.
^b In 2001, FDI inflows to Chad are zero.

Figure II.2. Africa: FDI inflows and their share in gross fixed capital formation, 1990–2002

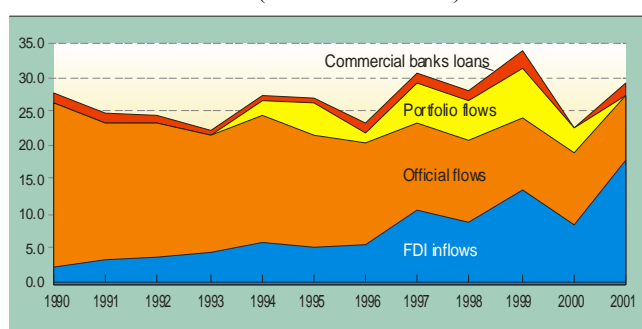


Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

Almost two-thirds of African IPAs indicated that their countries had not experienced a cancelling or scaling down of FDI projects or a divestment from existing projects according to UNCTAD's IPA survey (UNCTAD 2003a). More than 40% reported postponed projects, reflecting a "wait-and-see" attitude of some investors. About 30% said that they wanted to use additional incentives. Overall greater promotion and targeting are the prime responses to the more challenging FDI environment.

Aggregate FDI outflows from Africa were \$0.2 billion in 2002, compared with negative \$2.5 billion in 2001. South Africa, home to all three of the Africa-based TNCs on UNCTAD's list of the top 50 developing country TNCs, is the major source, though its outflows registered negative during 2001–2002 (i.e. more divestment than new investment) (annex table B.2). South African firms have traditionally invested abroad in mining and breweries, largely within the region, but some also invested in telecommunications in 2002.

Figure II.3. Total external resource flows^a to Africa, by type of flow, 1990–2001 (Billions of dollars)



Source: UNCTAD, based on World Bank, 2003a.

^a Defined as net liability transactions or original maturity of greater than one year.

Particularly noteworthy in the FDI activities by African companies in 2002 are:

- MTN and Vodacom SA⁴ both made significant inroads into the telecommunication industries of many African countries. Vodacom is South Africa's largest cellular phone operator, operating new networks in the Democratic Republic of Congo, Lesotho, Mozambique and the United Republic of Tanzania.⁵ Most of Vodacom's activities were organized through joint venture arrangements with local companies and businesspersons.
- South African Breweries bought a 64% stake in Miller Brewing (United States) for \$5.6 billion. After this acquisition, South Africa Breweries changed its name to SABMiller, which then acquired Birra Peroni (Italy) and Harbin Brewery (China) in 2003.
- South African Airways bought Air Tanzania, as part of its plan to build an African regional network.
- The Algerian national oil company SonaTrack participated in oil ventures in Egypt and Lebanon.
- Ashanti Goldfields from Ghana pressed ahead to bolster its regional presence in gold and platinum in South Africa. It was the leading gold producer in Ghana, Guinea, the United Republic of Tanzania and Zimbabwe.
- In 2003 Egypt's Orascom Telecom won the bid for Algeria's global system of mobile communication (GSM) at a cost of \$737 million. The company plans to invest \$500 million over the next five years.⁶

All these companies form a cohort of African firms acquiring an international portfolio of locational assets.

Box II.1. What Investment Policy Reviews show

Recently completed Investment Policy Reviews for African countries by UNCTAD show interesting developments in the regulation and promotion of FDI.^a

Standards of treatment and protection of foreign investors are no longer contentious issues. Good practice is the norm, even in countries without FDI laws. Indeed two countries have recently decided to formalize their commitment to good standards of treatment and protection by introducing FDI legislation for the first time. Moreover, interest is strong in expanding the network of BITs, including to Asian home countries. Some country groups are comfortable injecting common investment standards into their subregional agreements.

Countries continue to be reasonably open to FDI entry, with the authorities paying more attention to facilitating investment startup – “from red tape to red carpet” as one IPA describes it. Privatization with the participation of foreign firms is an important practical manifestation of openness. But such opening is slower than in other parts of the world, certainly in utilities and strategic industries.

One higher income country sought to tighten its FDI regime to fast-track local entrepreneurship. This highlights the growing concern about the impact of FDI on development on the one hand and the recognition of the need for active policy on fostering positive linkages between foreign affiliates and national entrepreneurs on the other.

All the countries, including the LDCs, are keen to attract FDI in manufacturing. The more

ambitious ones are also targeting FDI in service exports, including financial, business and professional services for their regions and international information and telecom opportunities.

While FDI-specific standards are now generally sound, there is still a highly patchy record in general regulatory and fiscal measures for business. Recent efforts to attract FDI in labour-intensive manufacturing for export and new opportunities for FDI in services have highlighted the following:

- First, typical fiscal regimes are not internationally competitive when countries seek FDI in export-oriented business. Most countries respond with piecemeal incentives in a process that can be prolonged to a point of becoming discriminatory and arbitrary.
- Second, good labour regulation, especially an effective industrial dispute resolution machinery, is lacking in many countries. Progress in this area is important in presenting an attractive profile for FDI in labour-intensive export manufacturing. Experience in meeting this challenge varies widely.
- Third, many countries still have outdated work and residence permit systems. The process of obtaining entry and work permits for expatriates is lengthy, cumbersome and non-transparent. This discourages FDI into new industries in export manufacturing and services which tend to depend heavily at the outset on expatriates in management and technical positions.

Source: UNCTAD.

^a Investment Policy Reviews have been completed for Botswana, Egypt, Ethiopia, Ghana, Lesotho, Mauritius, the United Republic of Tanzania and Uganda and are under way for Algeria, Benin and Zambia.

b. Policy developments—improving the investment climate

African countries have liberalized regulatory regimes for FDI, addressing investors' concerns, privatizing public enterprises and actively promoting investment (box II.1). In 2002 alone, 10 countries introduced 20 changes in their investment regimes, overwhelmingly in the direction of a more favourable investment climate.⁷ Many countries had previously abolished, or significantly reduced requirements for government participation in business ventures. Nigeria has moved away from mandatory joint ventures in petroleum and minerals. Ghana expanded the scope for FDI by reducing the number of industries closed to foreign investors. And some countries recently expedited investment approval procedures by developing one-stop investment centres (Egypt,

Kenya). Investment-related issues, such as technology transfer, are now subject to less restrictive compliance criteria, and the protection of intellectual property rights has improved in some countries.

African countries, while liberalizing their FDI policies, had also concluded 533 BITs (an average of 10 per country) and 365 DTTs (about 7 per country) by the end of 2002. The total number of BITs and DTTs is more than that in Latin America and the Caribbean, but fewer than that in Asia and CEE. During 2001 and 2002, 78 BITs and 15 DTTs were concluded (figure II.4). Progress towards creating free trade and investment areas is slow, although several agreements, mostly subregional, have been concluded (figure II.5). A majority of bilateral and regional agreements emphasize investment promotion through the

creation and improvement of frameworks. Judging from the experience of member countries, the impact of such agreements on FDI flows to their member countries has been limited. They have apparently not generated significant locational advantages for TNCs from within or outside the region. And they have not been accompanied by the establishment of regional FDI frameworks.

Among the schemes involving countries outside the region, the African Growth and Opportunity Act (AGOA) (although not a free trade agreement but rather a unilateral preference scheme) holds some promise for an expansion of trade and investment in the region.⁸ In some of the eligible countries, AGOA has increased exports to the United States in textiles and garments and FDI in such export-oriented production (United States, International Trade Administration, 2002). Much of the investment is by Asian TNCs in Kenya, Lesotho and Mauritius. In the two years since its inception AGOA helped stimulate FDI of \$12.8 million in Kenya and \$78 million in Mauritius—and create some 200,000 jobs in the apparel industry of the 38 beneficiary countries (United States, International Trade Administration, 2002). However, the quota and tariff advantages that corporations get from operating in AGOA countries apparently are not enough for most of them to overcome the locational disadvantages of most of the countries involved.⁹

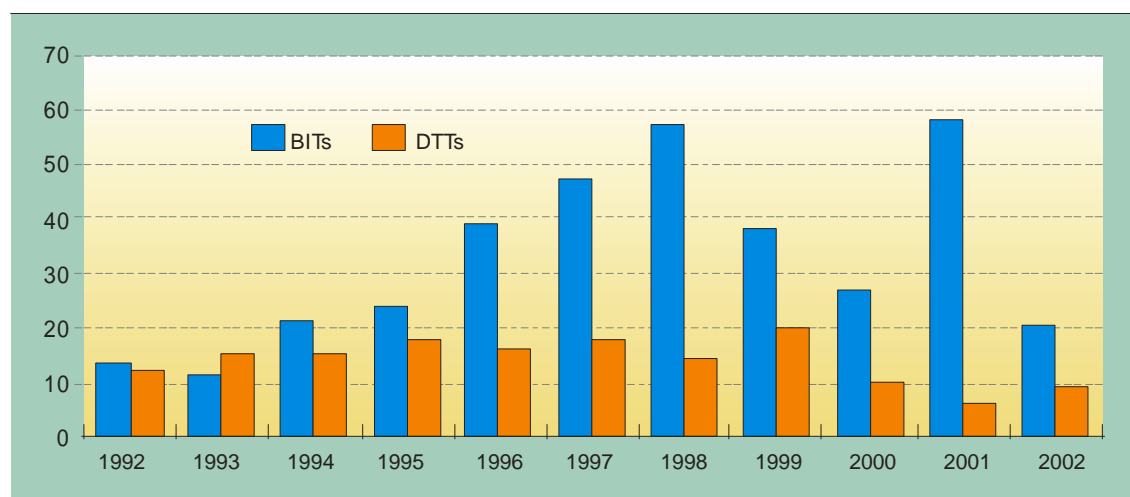
Given the importance of increasing market size and providing scale to attract FDI to Africa, efforts at regional integration continue to be important. The New Partnership for African Development (NEPAD)¹⁰ could be a catalyst in this respect, including infrastructure and energy investment among its priorities.

c. Prospects—quick recovery likely

The outlook for FDI flows to Africa in 2003 is promising. Three major factors—expanded exploration and extraction of natural resources (particularly petroleum), continued and enhanced implementation of regional and interregional free trade initiatives and a possible continuation of privatization programmes—are likely to lead to a moderate increase in total FDI inflows in 2003. Angola, Chad, Equatorial Guinea, Mauritania, Nigeria, Saõ Tomé and Príncipe and the Sudan are among the hopefuls for new FDI flows to the petroleum industry.¹¹ FDI in natural resources has well-known shortcomings as a force for development in host countries, notably limited linkages to domestic enterprises. But it is likely to be a major source of recovery for flows to Africa. Morocco, Nigeria and South Africa in particular may undertake further privatizations of major public enterprises.¹² Botswana, Kenya, Lesotho, Mozambique, Namibia, South Africa and Uganda can be expected to make gains as TNCs position themselves to benefit from the AGOA initiative.¹³

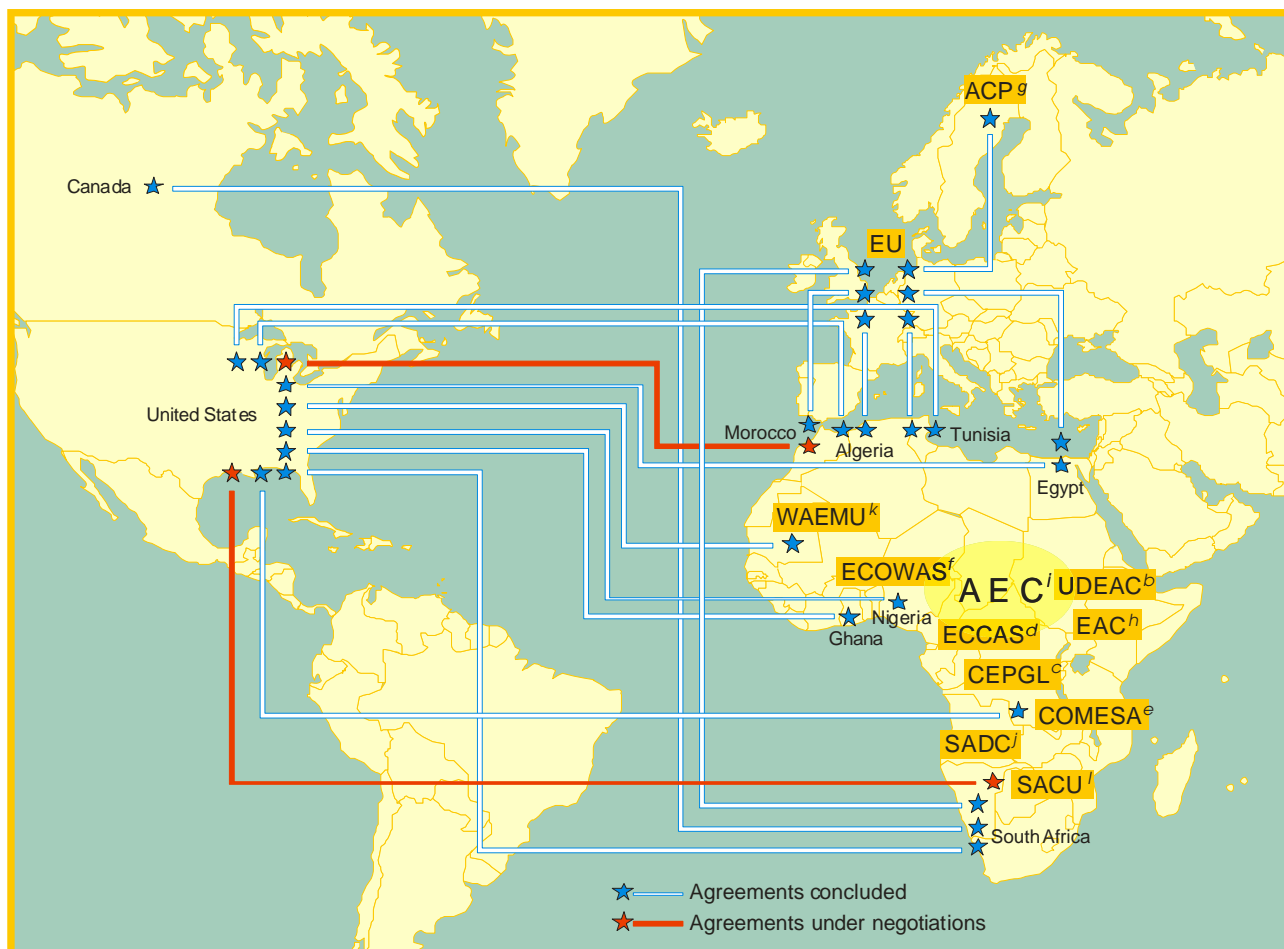
Investment prospects would further be enhanced by a better investment climate (figure II.6). More than 75% of IPAs in Africa expect an improvement in the investment climate in 2003–2004, 100% in 2004–2005. Tourism was mentioned most frequently as the most likely target industry. Telecommunications, mining and quarrying, as well as food and beverages and textiles, leather and clothing were also named. The traditional source countries—France, the United Kingdom and the United States—remain the most likely source countries for FDI into Africa for the period 2003–2005. Others are South Africa and China. African IPAs expect to receive most FDI in production,

Figure II.4. Africa: BITs and DTTs concluded, 1992–2002
(Number)



Source: UNCTAD, databases on BITs and DTTs.

Figure II.5. Africa: selected bilateral, regional and interregional agreements containing FDI provisions, concluded or under negotiation, 2003^a



Source: UNCTAD.

^a BITs and DTTs are not included.

^b UDEAC (Customs and Economic Union of Central Africa) refers to the following instruments: Common Convention on Investments in the UDEAC (1965); Joint Convention on the Freedom of Movement of Persons and the Right of Establishment in the UDEAC (1972); Multinational Companies Code in the UDEAC (1975). UDEAC comprises Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon.

^c CEPGL refers to the Investment Code of the Economic Community of the Great Lakes Countries. CEPGL comprises Burundi, Rwanda and the Democratic Republic of Congo.

^d ECCAS refers to the Treaty for the Establishment of the Economic Community of Central African States. ECCAS members include Chad, Congo, the Democratic Republic of Congo, Equatorial Guinea, Gabon, Rwanda, Sao Tome and Principe.

^e COMESA: Treaty Establishing the Common Market for Eastern and Southern Africa. It comprises Angola, Botswana, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Seychelles, Somalia, Swaziland, United Republic of Tanzania, Uganda, Zambia, Zimbabwe. A Charter on a Regime of Multinational Industrial Enterprises (MIEs) in the Preferential Trade Area for Eastern and Southern African States was signed in 1990. COMESA replaced the Preferential Trade Area for Eastern and Southern African States in December 1994. The signatories to the Charter are Angola, Comoros, Djibouti, Kenya, Lesotho, Malawi, Mozambique, Rwanda, Somalia, Sudan, United Republic of Tanzania, Uganda, Zambia, Zimbabwe.

^f ECOWAS: the Revised Treaty of the Economic Community of West African States. Its member states include Benin, Burkina Faso, Côte d'Ivoire, Gambia, Ghana, Guinea, Liberia, Mali, Niger, Senegal, Sierra Leone and Togo.

^g ACP: African, Caribbean and the Pacific Group of states. ACP signed an agreement, commonly known as the Cotonou agreement on 23 June 2000.

^h EAC: Treaty for the Establishment of the East African Community. EAC member States are Kenya, Uganda, United Republic of Tanzania.

ⁱ AEC: Treaty Establishing the African Economic Community.

^j SADC: Southern African Development Committee. Its member countries are: Angola, Botswana, the Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe. FISCO (Finance and Investment Sector Co-ordinating Unit of SADC) has been mandated to produce a Draft Finance and Investment Protocol for the SADC region.

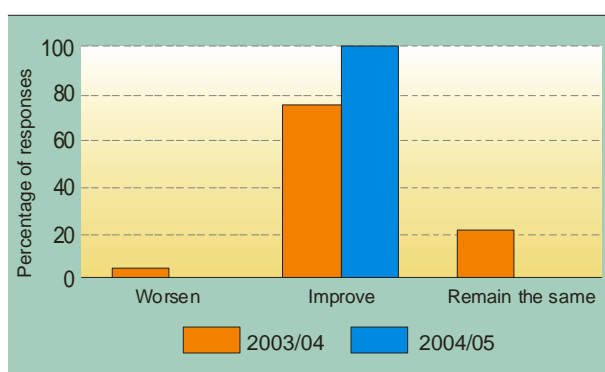
^k WAEMU: West African Economic and Monetary Union, its member States are currently: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.

^l SACU: Southern African Customs Union comprises Botswana, Lesotho, Namibia, South Africa and Swaziland.

distribution and sales, much less in high value-added corporate functions, such as R&D or regional headquarters (HQ) facilities. Not surprisingly, African IPAs expect most FDI in 2003–2005 to come as greenfield FDI. But some countries have scope for privatization M&As.

Bilateral, regional and interregional initiatives can also influence future FDI flows. Two initiatives by the EU—the EU-ACP Cotonou Agreement and the Everything-but-Arms Initiative—could have an effect on trade and investment in Africa.¹⁴ So could a 2001 initiative by Japan, establishing duty-free and quota-free preferences for LDCs on 99% of industrial

Figure II.6. Africa: FDI prospects,^a 2003-2005
(Per cent)



Source: UNCTAD.

^a The survey question was: “How do you perceive the prospects for FDI inflows to your country in the short- and medium-term, as compared to the last two years (2001-2002)?”.

products, including all textiles and clothing. AGOA II has relaxed the rules of origin restrictions in the apparel industry to the United States market for the “very poor” countries. However, an immediate factor constraining the potential benefits of AGOA is the economic slowdown and low demand in the United States market. The United States could further enhance the benefits of AGOA by supplementing the current arrangements with additional home country measures (see chapter VI).

The expiration of the Multifibre Arrangement (MFA) at the end of 2005 also poses challenges for African countries currently taking advantages of AGOA privileges in textile and garment exports—and thus FDI in export-oriented production. Its phasing out would put Africa’s fragile infant apparel firms in direct competition with major traditional textile and apparel exporters such as China, India, Pakistan and Viet Nam. But African countries eligible for AGOA will continue to enjoy tariff and quota advantages.

The results of these initiatives and UNCTAD’s recent investment policy reviews suggest that an African Investment Initiative could strengthen the continent’s supply capacity (box II.2). It would help African countries improve their national regulatory and institutional frameworks for FDI, support their promotion efforts, help in the dissemination of information on investment opportunities and facilitate linkages between foreign affiliates and domestic firms—all to strengthen a vibrant domestic enterprise sector.

Box. II.2. The need for an integrated approach to attract FDI to Africa and benefit from it: an African Investment Initiative

To attract FDI and benefit more from it requires the right conditions. An African Investment Initiative would help countries of the region in creating such conditions. The past few years have seen various initiatives that can help in this respect. It would be appropriate for interested intergovernmental and civil society organizations to coordinate, with NEPAD, the aspects of their work that deal with FDI—an African Investment Initiative.

Improving the national investment framework

Investment Policy Reviews can provide governments with a tool for assessing where they stand in attracting FDI and benefiting more from it. Such Reviews also incorporate a medium-to-long term perspective on how to respond to emerging regional and global opportunities. Other activities, such as identifying administrative barriers to investment and reviewing investment incentive regimes, are relevant as well.

Improving the international investment framework

African countries need to participate as effectively as possible in discussions and negotiations of international investment agreements—to ensure that their interests are properly reflected. This requires training of investment negotiators and background policy analysis, including in cooperation with African academia and faculty and institutions of higher learning, for the purpose of local capacity-building. The negotiation of BITs and DTTs is also relevant here, as is the negotiation of regional investment frameworks and assistance to African countries in investment discussions in WTO. Investment agreements are becoming increasingly important as they set the framework for national FDI policies.

Supporting national investment promotion efforts

African IPAs have joined the World Association of Investment Promotion Agencies, which offers training and capacity building

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Box. II.2. The need for an integrated approach to attract FDI to Africa and benefit from it: an African Investment Initiative (concluded)

opportunities to more than 160 IPAs, including through exposure to successful IPAs worldwide. This helps them develop their strategy and promotion plans, establish information systems and produce marketing materials. Other activities include project portfolio preparation and retention and expansion programmes.

Promoting information dissemination and public-private sector dialogue

Lack of information about investment opportunities in Africa is one factor that holds back the flow of FDI to the continent. Providing investment information is therefore crucial. Actions could include the preparation and dissemination of investment guides and the creation of web-based promotion materials. Also important is promoting a public-private sector dialogue, nationally and internationally, to draw directly on the expertise of corporate decision makers in interaction with senior government officials. For this purpose UNCTAD and the ICC jointly established an

Source: UNCTAD.

Investment Advisory Council, while Ethiopia, Ghana, Senegal and the United Republic of Tanzania have established such councils at the national level.

Facilitating business linkages

Linkages between foreign affiliates and domestic firms are the main avenues to disseminate the benefits of FDI to the domestic economy and help create a vibrant enterprise sector. Many TNCs have built up complex supply chains, involving competitive local SMEs. This has opened up new opportunities for many SMEs. But the vast majority of them, particularly in African LDCs, remain delinked from TNCs, missing out on potential gains of technological spillovers and access to markets, information and finance. Advice on the most appropriate policy framework for linkages, identifying opportunities available to local SMEs and foreign affiliates to increase business linkages and deepen them can increase the contribution of FDI to development.

2. Asia and the Pacific

Like the other developing regions, Asia and the Pacific was not spared by the downturn. The region, however, weathered the downturn better than most other regions, with only an 11% FDI decline. The decline was uneven by subregion, country and industry. Asia is one of the most rapidly liberalizing host regions for FDI, making more national policy changes in a direction favourable to investors in 2002 than any other region. Bilateral and regional arrangements involving countries in the region also proliferated. While the long-term prospects for an increase in FDI flows to the region remain promising, the short-term scenario continues to be uncertain.

a. FDI down again, but several countries receiving significantly higher flows

For the region as a whole, FDI flows declined for the second year in a row, down from \$107 billion in 2001 to \$95 billion in 2002. The decline affected all-subregions, except for Central Asia and South Asia. Still 26 out of the region's 57 economies saw higher FDI inflows.

Despite the downturn, however, the share of Asia and the Pacific—the world's largest developing region in terms of population and

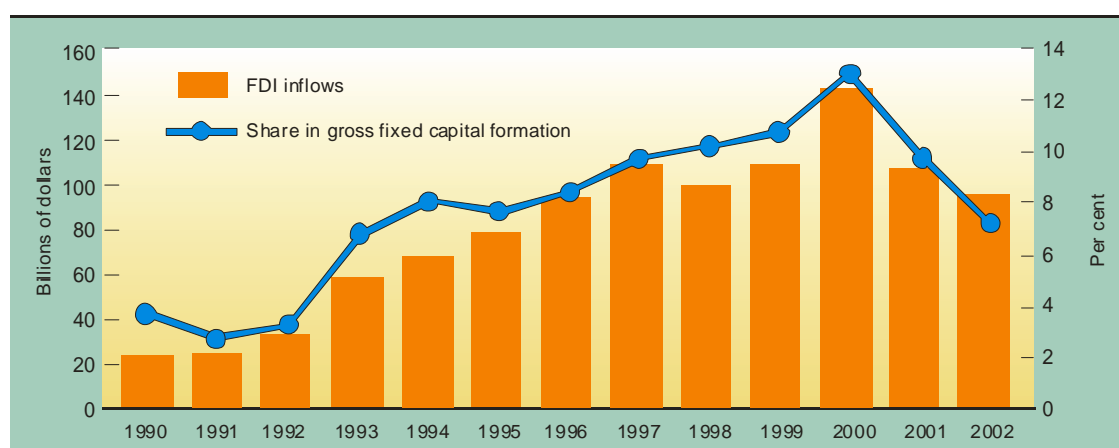
GDP—in global FDI flows rose to 14% in 2001–2002, compared with 10% during the FDI boom years of 1999–2000. The region's share of FDI flows to developing countries in 2002 also rose, to 59%, from 51% in 2001. The ratio of FDI flows in gross fixed capital formation declined from 10% in 2001 to 7% in 2002 (figure II.7), suggesting a more severe impact of the global economic slowdown on FDI than on domestic investment.

FDI flows continue to be concentrated in China, Hong Kong (China) and Singapore. The top 10 host economies took 93% of the region's total inflows in 2002 (figure II.8). The electronics industry was most affected by the downturn due to continued rationalization of production activities in the region and adjustments to weak global demand. Repayments of intra-company loans by foreign affiliates remained high in some countries. However, reinvested earnings rose,¹⁵ an important source of financing FDI during the downturn.

Some highlights for the subregions:

- FDI flows to North-East Asia¹⁶ dropped from \$78 billion in 2001 to \$70 billion in 2002. FDI flows to Hong Kong (China) fell by 42%, to Taiwan Province of China by 65% and to the Republic of Korea by 44%, partly because TNC production activities were relocated to lower cost locations, primarily China. The decline in FDI flows was also partly due to slow economic growth of these economies. The notable

Figure II.7. Asia and the Pacific: the share of FDI inflows in gross fixed capital formation, 1990–2002

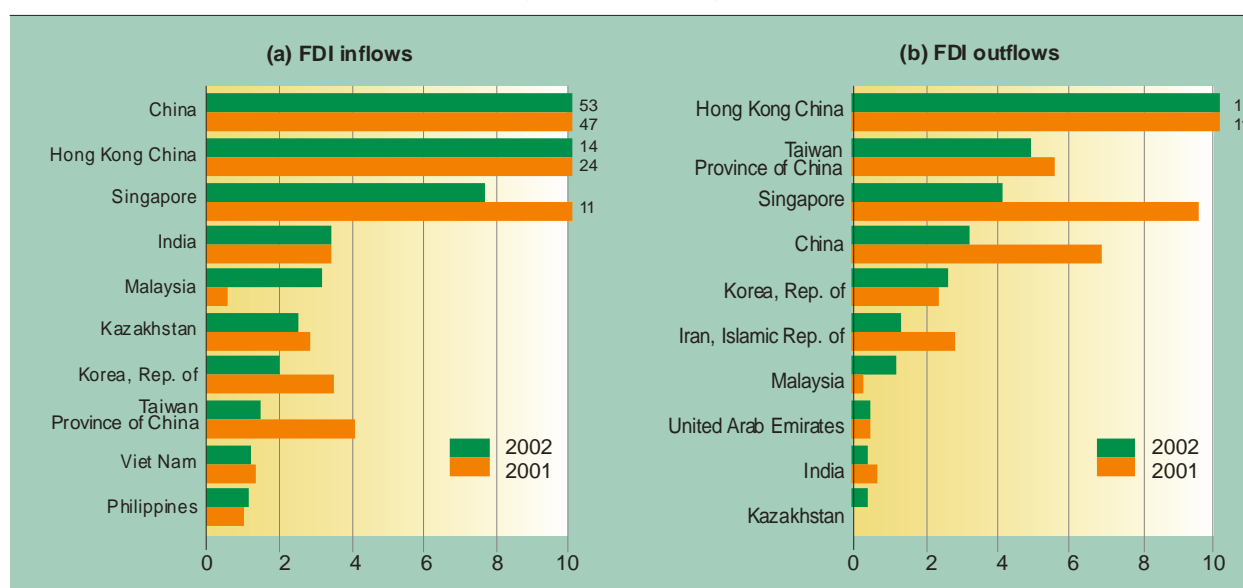


Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

exception was China, whose sustained economic growth and other advantages attracted increased inflows of FDI in 2002. FDI flows to Mongolia also increased.

- FDI flows to South-East Asia dropped from \$15 billion in 2001 to \$14 billion in 2002, though Brunei Darussalam, Lao People's Democratic Republic, Malaysia and the Philippines received larger flows than in 2001. Significant repayments of intra-company loans by foreign affiliates were a feature of the decline, as was the increased competition from China.
- FDI flows to South Asia increased from \$4.0 billion in 2001 to \$4.6 billion in 2002,¹⁷ due to higher flows to India, Pakistan and Sri Lanka.
- FDI flows to Bangladesh and other countries in the subregion declined. However, in the case of Bangladesh, FDI flows in 2002 would have been higher if investment in kind were included (box II.3).
- FDI flows to West Asia declined in 2002 to \$2.3 billion, from \$5.2 billion in 2001. Despite the recent efforts of some countries in this subregion to relax FDI restrictions, flows continue to be low, with geopolitical tensions being a major factor. Some countries have large oil reserves with low extraction costs, which help attract FDI to oil and gas activities, despite the difficult political and business environment. A number of countries (e.g. Bahrain, Kuwait) received

Figure II.8. Asia and the Pacific: FDI flows, top 10 economies, 2001 and 2002^a
(Billions of dollars)



Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

^a Ranked on the basis of the magnitude of 2002 FDI flows.

Box II.3. The FDI census in Bangladesh

The Bangladesh Board of Investment (BOI) conducted a census of foreign direct investors in February 2003 to gather comprehensive primary data on actual FDI inflows based on projects registered with BOI and the Bangladesh Export Processing Zones Authority.

Results:

- FDI inflows in 2002 were \$328 million (compared with \$58 million on a balance-of-payments basis reported by the Central Bank of Bangladesh). Half of it was financed by equity, 31% by reinvested earnings and 19% by intra-company loans.
- While FDI flows have traditionally been concentrated in the power and energy industries, 44% of the total FDI flows in 2002 went to the manufacturing sector.
- The major sources of investment in 2002 were Asia (45%), followed by Europe (32%) and

North America (17%). Norway was the single largest investor (19%), followed by the United States (17%), Singapore (14%) and Hong Kong (China) and Malaysia (9% each). Most of the FDI from Norway was in telecoms and from the United States in the services sector (e.g. power generation, oil and gas, liquefied petroleum gas bottling, medicare service). Investments from Asia, particularly South, East and South-East Asia, were concentrated in manufacturing.

- The major investors include AES and Unocal (United States), BASF (Germany), Cemex (Mexico), Holcim and Nestlé (Switzerland), Lafarge and Total FinaElf (France), Taiheyo (Japan), Telenor (Norway) and TMI (Malaysia).

This is an example of how careful FDI statistics need to be interpreted, given the different ways in which they are compiled.

Source: UNCTAD, based on information provided by Bangladesh Board of Investment.

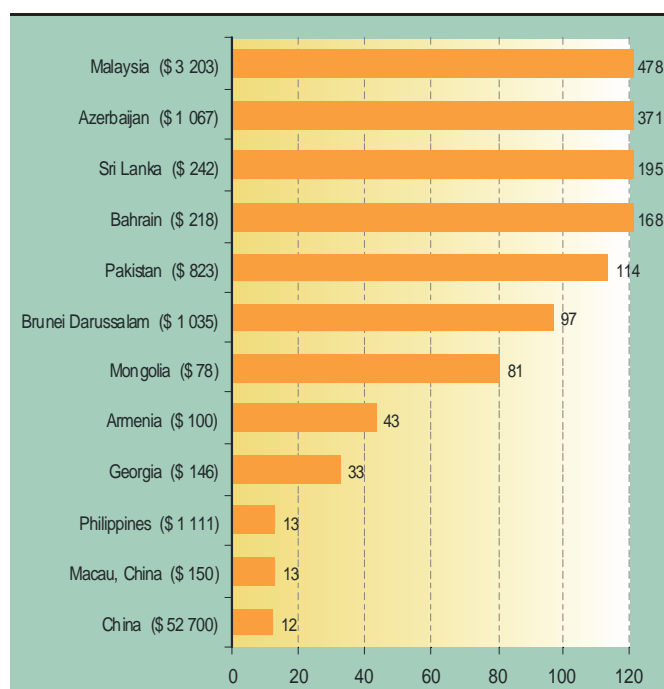
higher flows. Turkey, however, remained the main recipient.

- FDI flows to Central Asia rose in 2002 due to significant increases in FDI flows to Azerbaijan, from \$227 million in 2001 to \$1 billion. Kazakhstan received 9% less FDI in 2002 but remained the main recipient, with most going to oil and gas. FDI flows to Armenia and Georgia increased by more than 25%.
- The downturn also affected the Pacific islands economies, with FDI down from \$159 million in 2001 to \$140 million in 2002. They are disadvantaged by their size and distance from major markets. Fiji and Papua New Guinea remained the principal recipients.

Notwithstanding the general downturn, a number of countries improved their FDI performance, as these highlights suggest. In particular, Malaysia, Azerbaijan, Sri Lanka, Bahrain, Pakistan and a few others received significantly higher FDI flows in 2002 than in 2001 (figure II.9). FDI flows to China rose by 13% in 2002, to \$53 billion, a new record reinforcing China's position as the largest recipient of FDI inflows in the developing world. Indeed, China received more than three times as much as Brazil. China's large domestic market, strong economic growth, increasing export competitiveness and accession to the WTO have all increased investors' interest in locating operations in that country (WIR02).

Given its locational advantages, it is attractive for resource-seeking, efficiency-seeking and market-seeking FDI. That a large proportion of FDI in China comes from the overseas Chinese network

Figure II.9. Asia and the Pacific: host countries defying the downturn in 2002 (Per cent)



Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

Note: The figure presents percentage increase in FDI inflows in 2002 over 2001. Figures in parenthesis are absolute amounts of FDI inflows, in millions of dollars, for 2002.

and other TNCs less affected by the global economic slowdown, contributed to the increase in FDI flows to China.¹⁸

FDI flows to India rose to \$3.4 billion, sustaining it as the largest recipient in South Asia. The country's market potential, improved economic performance, growing competitiveness of information technology industries and impetus of recent liberalization are factors attracting more FDI into the country. Although India and China both received increased FDI flows, their performance has been strikingly different (box II.4).

Oil and mining do better than manufacturing and services. The primary sector—especially oil and mining—weathered the 2001–2002 downturn better than manufacturing and services did, despite geopolitical tensions and volatile oil prices. In the more developed economies—also more service-oriented—the share of FDI in services rose. In 2002 the share of the tertiary sector in total FDI inflows to the Republic of Korea increased by 13 percentage points and to Singapore by 0.8

percentage points. The share of tertiary sector FDI to Hong Kong (China) is expected to remain high in 2002.¹⁹ In other countries FDI in manufacturing fell but the sector gained in terms of share. In China manufacturing's share, already high, rose from 66% in 2001 to 70% in 2002. In the ASEAN subregion, it rose from 23% in 1999 to 45% in 2000 and 49% in 2001. FDI in the other subregions was dominated by investment in resource-based or oil and gas industries.

Intra-company loans down sharply. In terms of financial components of FDI, intra-company loans dropped sharply. For instance, intra-company loans in Hong Kong (China), the Republic of Korea and Thailand declined significantly in 2002 (annex table A.II.1). And foreign affiliates in Indonesia, Malaysia, Philippines and Singapore have been making significant repayments.²⁰

Large repayments of intra-company loans have been noticeable since 1999, particularly in countries affected by the 1997–1998 financial crisis. One reason might be exchange rate

Box II.4. China and India—what explains their different FDI performance?

China and India are the giants of the developing world. Both enjoy healthy rates of economic growth. But there are significant differences in their FDI performance. FDI flows to China grew from \$3.5 billion in 1990 to \$52.7 billion in 2002; if round-tripping is taken into account, China's FDI inflows could fall to, say, \$40 billion.^a Those to India rose from \$0.4 billion to \$5.5 billion during the same time period (box table II.4.1).^b

Even with these adjustments, China attracted seven times more FDI than India in 2002, 3.2% of its GDP compared with 1.1% for India.^c In UNCTAD's FDI Performance Index, China ranked 54th and India 122nd in 1999–2001.

FDI has contributed to the rapid growth of China's merchandise exports, at an annual rate of 15% between 1989 and 2001. In 1989 foreign affiliates accounted for less than 9% of total Chinese exports; by 2002 they provided half. In some high-tech industries in 2000 the share of foreign affiliates in total exports was as high as 91% in electronics circuits and 96% in mobile phones (*WIR02*, pp. 162–163). About two-thirds of FDI flows to China in 2000–2001 went to manufacturing.

In India, by contrast, FDI has been much less important in driving India's export growth, except in information technology. FDI in Indian manufacturing has been and remains domestic market-seeking. FDI accounted for only 3% of India's exports in the early 1990s (*WIR02*, pp. 154–

163). Even today, FDI is estimated to account for less than 10% of India's manufacturing exports (UNCTAD forthcoming a).

For China the lion's share of FDI inflows in 2000–2001 went to a broad range of manufacturing industries. For India most went to services, electronics and electrical equipment and engineering and computer industries.

What explains the differences? Basic determinants, development strategies and policies and overseas networks.

Basic determinants

On the basic economic determinants of inward FDI, China does better than India. China's total and per capita GDP are higher (box table II.4.1), making it more attractive for market-seeking FDI. Its higher literacy and education rates suggest that its labour is more skilled, making it more attractive to efficiency-seeking investors (World Bank 2003c, p. 234; UNDP 2002). China also has large natural resource endowments. In addition, China's physical infrastructure is more competitive, particularly in the coastal areas (CUTS 2003, Marubeni Corporation Economic Research Institute 2002). But, India may have an advantage in technical manpower, particularly in information technology. It also has better English language skills.

Some of the differences in competitive advantages of the two countries are illustrated by the composition of their inward FDI flows. In

/...

Box II.4. China and India—what explains their different FDI performance? (continued)

information and communication technology, China has become a key centre for hardware design and manufacturing by such companies as Acer, Ericsson, General Electric, Hitachi Semiconductors, Hyundai Electronics, Intel, LG Electronics, Microsoft, Mitac International Corporation, Motorola, NEC, Nokia, Philips, Samsung Electronics, Sony, Taiwan Semiconductor Manufacturing, Toshiba and other major electronics TNCs. India specializes in IT services, call centers, business back-office operations and R&D.

Rapid growth in China has increased the local demand for consumer durables and nondurables, such as home appliances, electronics equipment, automobiles, housing and leisure. This rapid growth in local demand, as well as competitive business environment and infrastructure, have attracted many market-seeking investors. It has also encouraged the growth of many local indigenous firms that support manufacturing.

Other determinants related to FDI attitudes, policies and procedures also explain why China does better in attracting FDI.

- China has “more business-oriented” and more FDI-friendly policies than India (AT Kearney 2001).
- China’s FDI procedures are easier, and decisions can be taken rapidly.

Box table II.4.1. China and India: selected FDI indicators, 1990, 2000-2002

Item	Country	1990	2000	2001	2002
FDI inflows (Million dollars)	China	3,487	40,772	46,846	52,700
	India	379	4,029	6,131	5,518
Inward FDI stock (Million dollars)	China	24 762	348 346	395 192	447 892
	India	1,961	29,876	36,007	41,525
Growth of FDI inflows (annual, %)	China	2.8	1.1	14.9	12.5
	India	-6.1	16.1	52.2	-10.0
FDI stock as percentage of GDP (%)	China	7.0	32.3	33.2	36.2
	India	0.6	6.5	7.4	8.3
FDI flows as percentage of gross fixed capital formation(%)	China	3.5	10.3	10.5	..
	India	0.5	4.0	5.8	..
FDI flows per capita (Dollars)	China	3.0	32.0	36.5	40.7
	India	0.4	4.0	6.0	5.3
Share of foreign affiliates in total exports (%)	China	12.6	47.9	50.0	..
	India	4.5
GDP (billion dollars) ^a	China	388	1,080	1 159.1	1 237.2
	India	311	463	484	502
Real GDP growth (%)	China	3.8	8.0	7.3	8.0
	India	6.0	5.4	4.2	4.9

Source: UNCTAD, FDI/TNC database; IMF, World Economic Outlook Database, April 2003.

^a At current prices.

Note: see note b of this box for explanation for the data on FDI flows and stocks of India. FDI flows and stocks data for India in 2000 and 2001 are based on fiscal year 2000/01 and 2001/02.

- China has more flexible labour laws, a better labour climate and better entry and exit procedures for business (CUTS 2003).

A recent business environment survey indicated that China is more attractive than India in the macroeconomic environment, market opportunities and policy towards FDI. India scored better on the political environment, taxes and financing (EIU 2003a). A confidence tracking survey in 2002 indicated that China was the top FDI destination, displacing the United States for the first time in the investment plans of the TNCs surveyed; India came 15th (AT Kearney 2002). A Federation of Indian Chambers of Commerce and Industry (FICCI) survey suggests that China has a better FDI policy framework, market growth, consumer purchasing power, rate of return, labour laws and tax regime than India (FICCI 2003).

Development strategies and policies

The different FDI performance of the two countries is also related to the timing, progress and content of FDI liberalization in the two countries and the development strategies pursued by them.

- China opened its doors to FDI in 1979 and has been progressively liberalizing its investment regime. India allowed FDI long before that but did not take comprehensive steps towards liberalization until 1991 (Nagaraj 2003).
- The two countries focused on different types of FDI and pursued different strategies for industrial development. India long followed an import-substitution policy and relied on domestic resource mobilization and domestic firms (Bhalla 2002; Sarma 2002), encouraging FDI only in higher-technology activities. Despite the progressive liberalization, imposition of joint venture requirements and restrictions on FDI in certain sectors, China has, since its opening, favoured FDI, especially export-oriented FDI, rather than domestic firms (Buckley forthcoming; IMF 2002). Such policies not only attracted FDI but led to round-tripping through funds channelled by domestic Chinese firms into Hong Kong (China), reinvested in China to avoid regulatory restrictions or obtain privileges given to foreign investors. In India, round-tripping, mainly through Mauritius, is much smaller and for tax reasons.

It has been suggested that domestic market imperfections associated with problems of outsourcing, regulations and local inputs have led to “excessive internalization” of production activities by TNCs in China. So part of the FDI, occurring because of the imperfections of the domestic market, is undertaken as a second best response by manufacturing TNCs to the Chinese environment (Buckley forthcoming).

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Box II.4. China and India—what explains their different FDI performance? (concluded)

For India the situation is somewhat different. A tradition of entrepreneurship has spawned a broad based domestic enterprise sector (Huang and Khanna 2003). This combines with the necessary legal and institutional infrastructure and a restrictive FDI policies followed until the 1990s. As a result, TNC participation in production has often taken externalized forms (such as licensing and other contractual arrangements). Even after a significant liberalization of FDI policies, internalization is not necessarily dominant. Consider information technology, industries where outsourcing to private Indian firms is efficient and there are quality domestic subcontractors.

China's accession to the WTO in 2001 has led to the introduction of more favourable FDI measures. With further liberalization in the services sector, China's investment environment may be further enhanced. For instance, China will allow 100% foreign equity ownership in such industries as leasing, storage and warehousing and wholesale and retail trade by 2004, advertising and multimodal transport services by 2005, insurance brokerage by 2006 and transportation of goods (railroad) by 2007. In retail trade, China has already opened and attracted FDI from nearly all the big-name department stores and supermarkets such as Auchan, Carrefour, Diary Farm, Ito Yokado, Jusco, Makro, Metro, Prisma, 7-Eleven and Wal-Mart (PriceWaterhouseCoopers 2002).

In India the Government is planning to open some more industries for FDI and further relax the foreign equity ownership ceiling (EIU 2003a). To identify approaches to increase FDI flows, the Planning Commission established a steering committee on FDI in August 2001. Following the Chinese model, India recently took steps to establish special economic zones. China's special economic zones have been more successful than Indian export processing zones in promoting trade and attracting FDI (Bhalla 2002).

Overseas networks

In addition to economic and policy-related factors, an important explanation for China's larger FDI flows lies in its position as the destination of choice for FDI by Chinese businesses and individuals overseas, especially in Asia. The role of the Chinese business networks abroad and their significant investment in mainland China contrasts with the much smaller Indian overseas networks and

investment in India (Bhalla 2002). Why? Overseas Chinese are more in number, tend to be more entrepreneurial, enjoy family connections (*guanxi*) in China and have the interest and financial capability to invest in China—and when they do, they receive red-carpet treatment. Overseas Indians are fewer, more of a professional group and, unlike the Chinese, often lack the family network connections and financial resources to invest in India.

Both China and India are good candidates for the relocation of labour-intensive activities by TNCs, a major factor in the growth of Chinese exports. In India, however, this has been primarily in services, notably information and communication technology. Indeed, almost all major United States and European information technology firms are in India, mostly in Bangalore. Companies such as American Express, British Airways, Conesco, Dell Computer and GE Capital have their back-office operations in India. Other companies—such as Amazon.com and Citigroup—outsource services to local or foreign companies already established in the country (AT Kearney 2003). Foreign companies dominate India's call centre industry, with a 60% share of the annual \$1.5 billion turnover.

Investor sentiment on China as a location for investment is improving (MIGA 2002; AT Kearney 2002; American Chamber of Commerce in China 2002). Nearly 80% of all Fortune 500 companies are in China (*WIR01*, p. 26), while 37% of the Fortune 500 outsource from India (NASSCOM 2001). Despite the improvement in India's policy environment, TNC investment interest remains lukewarm, with some exceptions, such as in information and communication technology (AT Kearney 2001).

The prospects for FDI flows to China and India are promising, assuming that both countries want to accord FDI a role in their development process — a sovereign decision. The large market size and potential, the skilled labour force and the low wage cost will remain key attractions. China will continue to be a magnet of FDI flows and India's biggest competitor. But, FDI flows to India are set to rise — helped by a vibrant domestic enterprise sector and if policy reforms continue and the Government is committed to the objective of attracting FDI flows to the country.

Source: UNCTAD.

- ^a FDI flows to China are generally considered to be over-reported due to the inclusion of round tripping (investment from locations abroad by investors from China) in China's FDI data, while those to India were under-reported due to the non-inclusion of reinvested earnings and intra-company loans in that country's data. Zhan (1995, pp. 91-92) estimated that round-tripping to China was less than 25%, the prevailing estimate at the time (Harrold and Lall 1993). However, with China's accession to the WTO in December 2001 and the removal of preferential treatment to foreign investors over domestic investors, round-tripping of Chinese FDI is likely to fall (World Bank 2003a, p. 102). The Bank of China Group indicated in an article that "... the market's general assessment is that the ratio (round-tripping to China) has declined from 30% to around 10–20% in recent years." ("Foreign direct investment in China", Hong Kong Trade and Development Cooperation, 1 January 2003 (<http://www.tdctrade.com/econforum/boc/boc030101.htm>)).
- ^b Based on the revised FDI data methodology, which includes the three components of FDI, India reported that FDI flows to the country increased from \$4.1 billion in fiscal year 2000/01 to \$6.1 billion in fiscal year 2001/02. This means that actual inflows were about 60% higher than those reported earlier. This ratio is applied to arrive at the 1990 and the 2002 data for India. (The data in the annex to this report are still old ones, as the new ones arrived after closure of the statistical work).
- ^c The figure for China after taking into account round-tripping (25% of FDI flows). The figure for India is based on the methodology mentioned in note b.

instability, inducing foreign affiliates to make early loan repayments to hedge against exchange rate risks. Other reasons relate to the improved financial position of Asian affiliates in the post-financial crisis situation and the fact that a great part of intra-company loans provided by parent companies to the Asian affiliates to overcome the 1997–1998 financial crisis are probably due for repayment. In addition, the declining profitability and tight financial conditions faced by parent companies and the need to strengthen their balance sheets could have led to early repayment.²¹

Reinvested earnings rose and remained a significant source of finance for FDI activities in several economies, including China, Hong Kong (China), Malaysia, the Philippines and Singapore.²² Good returns on FDI—in most cases higher than the developing country average (annex table A.II.2)—and a positive economic outlook helped mitigating the downturn.²³ Equity capital, the third component of FDI, also declined in most countries, particularly for the newly industrial economies and some ASEAN countries.

Outward FDI flows from Asia and the Pacific fell in 2002, by marginally more than inflows (annex table B.2). The Asian newly industrial economies, China and a few other ASEAN countries are notable sources,²⁴ concentrated on manufacturing and natural resources. Of the top 50 TNCs from developing countries in 2001, ranked by foreign assets, 33 of them were from Asia (annex table A.I.2).

Intra-regional investment in developing East Asia fell, but its share of total inflows to the subregion increased from 37% in 1999 to 40% in 2001, supported by relocations of investment, growing regional production networks and continuing regional integration efforts (table II.1). Intra-ASEAN FDI increased from 7% in 1999 to 17% in 2002, reflecting the continuing improvement in the private sector's recovery from 1997–1998 financial crisis, aided by regional integration (box II.5).

Table II.1. Intra-regional FDI flows in developing Asia, 1999-2001
(Millions of dollars)

Host economy	1999 Source economy					Sub-total of reporting host economy (A)	Total in reporting host economy (B)
	ASEAN	China	Hong Kong, China	Republic of Korea	Taiwan Province of China		
ASEAN	1 685	78	886	510	347	3 506	25 029
China	3 275 ^a	..	16 363	1 275	2 599	23 512	40 318
Hong Kong, China	759	4 981	..	231	171	6 142	24 581
Total above	5 719	5 059	17 249	2 016	3 117	33 160	89 928
Percentage of A/B						37%	
Host economy	2000 Source economy					Sub-total of reporting host economy (A)	Total in reporting host economy (B)
	ASEAN	China	Hong Kong, China	Republic of Korea	Taiwan Province of China		
ASEAN	1 259	58	1 045	153	580	3 095	18 625
China	2 838 ^a	..	15 500	1 490	2 296	22 124	40 715
Hong Kong, China	7 703	14 211	..	69	535	22 518	61 940
Total above	11 800	14 269	16 545	1 712	3 411	47 737	121 280
Percentage of A/B						39%	
Host economy	2001 Source economy					Sub-total of reporting host economy (A)	Total in reporting host economy (B)
	ASEAN	China	Hong Kong, China	Republic of Korea	Taiwan Province of China		
ASEAN	2 334	151	- 365	- 304	113	1 929	15 211
China	2 970 ^a	..	16 717	2 152	2 980	24 819	46 878
Hong Kong, China	1 930	4 934	..	100	518	7 482	23 776
Total above	7 234	5 085	16 352	1 948	3 611	34 230	85 865
Percentage of A/B						40%	

Source: UNCTAD, FDI/TNC database.

^a Covers Indonesia, Malaysia, Philippines, Singapore and Thailand.

Box II.5. Effects of regional agreements on FDI in Asia

Several studies at the firm level suggest that the ASEAN Free Trade Agreement (AFTA) has influenced TNCs' decisions to invest in the region, especially in the automotive and electronics industries (Baldwin 1997; Dobson and China 1997; Japan Research Institute Limited 2001). But it appears that some rationalization in the automotive industry has occurred as well, with implications for the distribution of flows (Farrell and Findlay 2001).

A cross-sectional regression analysis of United States outward FDI suggested that the major ASEAN host countries (Malaysia, the Philippines, Singapore and Thailand) received more FDI than the analysis predicted for 1994 (Lipsey 1999). This could imply positive effects of AFTA on FDI flows from the United States.

In another econometric study of United States FDI flows to the ASEAN-5 and 26 other countries, market size (GDP) was found to be positively related to FDI flows. And some evidence of a negative relationship between FDI and tariff rates was found over the entire 31-country sample (Parsons and Heinrich 2003). While the "AFTA effect" was ambiguous in this study, a more integrated market and lower duties on vital imported intermediate goods may have encouraged more market-seeking and efficiency-seeking FDI to the region.

FDI flows to the ASEAN subregion have increased steadily, particularly after the signing of AFTA and until the 1997–1998 Asian financial crisis (box figure II.5.1). In the South Asian Association for Regional Cooperation (SAARC) Preferential Trading Arrangement subregion, FDI has been increasing since the signing of the agreement in 1993.

Although these regional trading arrangements may be stimulating FDI, ASEAN has consistently attracted only about 5% of world FDI over the past 20 years. With so many trading arrangements being signed and at the same time new markets opening up to FDI (such as CEE and China), it is difficult to sift out the effects on FDI flows to the region from those for individual members.

Most of the recent regional arrangements in Asia tend towards free trade areas (AFTA, Singapore–United States, ASEAN–China, Republic of Korea–Chile) and regional investment cooperation (ASEAN Investment Area). These arrangements provide assurances of market access, involve a deeper tariff-cutting programme on a more extensive range of products,

Source: UNCTAD.

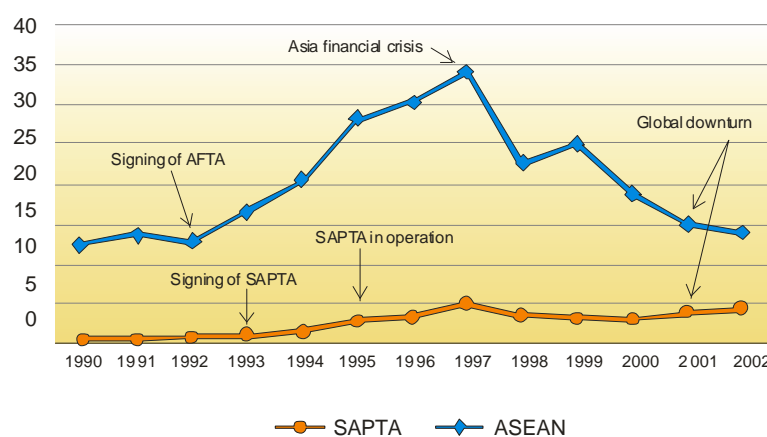
address non-tariff barriers, facilitate easier sourcing of production inputs and resources and cover investment matters. The attractiveness of these free trade agreements for FDI is enhanced by these elements, which could affect operations seeking markets, resources and efficiency (Heinrich and Konan 2001).

A recent JETRO survey of 1,519 Japanese manufacturers in Asia indicated that 50% of the respondents expect a Japan–ASEAN free trade area and 25% expect the ASEAN–China free trade area to benefit them. A large majority of the firms indicated that they would benefit from reduction of customs duties and simplification and harmonization of customs clearance procedures. And about 20% expect to benefit from the simplification of mutual recognition (JETRO 2003b).

This survey of Japanese manufacturers also found that AFTA and the proposed ASEAN–Japan free trade area are expected to increase the investment and networks of Japanese operations in ASEAN (JETRO 2003b). Another survey by the Japan Bank for International Cooperation shows that more than half of the Japanese manufacturing TNCs surveyed held the view that AFTA stimulates intraregional trade through corporate regional production networks (JBIC 2003).

Efficiency-seeking FDI is likely to rise as TNCs position themselves to take advantage of a regional division of labour and production upgrading through network operations. The main question for policymakers is not whether regional agreements and liberalization efforts attract more FDI. It is what kinds of investment a regional integration arrangement has the greatest capacity to generate for each member and for the region.

Box figure II.5.1. Asia and the Pacific: FDI flows to ASEAN and SAPTA,^a 1990–2002
(Billions of dollars)



Source: UNCTAD, FDI/TNC database.

^a SAARC Preferential Trading Arrangement (SAPTA).

b. Policy developments—more unilateral measures to improve the investment environment

Many countries introduced unilateral policy measures to further liberalize their FDI regimes. They relaxed limitations on foreign equity ownership, liberalized sectoral restrictions, streamlined approval procedures, granted incentives, relaxed foreign exchange controls and offered investment guarantees. For instance, China relaxed foreign shareholding limitations in the domestic airlines industry from 35% to 49%; the Shenzhen Municipal Government in China established a centre to handle and coordinate foreign investors' complaints; India announced in 2002 a plan to allow foreign companies to own up to 74% equity in print media business; the Republic of Korea offered new tax incentive to attract FDI; Lao People's Democratic Republic streamlined its investment application procedures; Malaysia announced incentives for operational headquarters and R&D centers; Thailand relaxed the conditions governing the location of promoted projects in the country; and Viet Nam further relaxed conditions

regarding foreign equity ownership in local private companies. ASEAN members are taking steps to promote FDI jointly to the region by holding investment fairs together and organising an ASEAN Business and Investment Summit in October 2003. Under the ASEAN Investment Area Agreement, the ASEAN countries have phased in the Temporary Exclusion List of manufacturing sectors on 1 January 2003, opening more industries and granting national treatment to ASEAN investors. Indonesia declared 2003 as the "Indonesia Investment Year", with a number of favourable policy changes to be introduced (box II.6). And investment promotion is receiving more attention: 64% of the Asian and Pacific IPAs surveyed indicated that they have intensified their promotion efforts in 2002 in response to the downturn (UNCTAD 2003a). Half the countries made more use of investment targeting, 25% reported additional incentives and 36% further liberalization.

Bilateral treaties have further strengthened the region's policy framework. By the end of 2002, countries in the Asia and Pacific region were party to 1,003 BITs (an average of 18 BITs per country for 57 economies) and 842 DTTs (an average of 15 DTTs per country)—more than any other developing region (figure II.10). Bilateral free trade agreements have also been increasing, with Singapore as the main hub and the EU and the United States as the main partner (figure II.11). They contain (at times substantial) investment provisions, underlining that investment has become a key consideration in economic cooperation.

For example, the Republic of Korea–Chile and the Singapore–United States free trade agreements contain a range of investment provisions. And the ASEAN–China arrangement contains provisions on investment liberalization, transparency and facilitation. In many negotiations ASEAN is taking the lead. By 2005 the Asia and Pacific region is likely to have a dense web of bilateral and regional free trade agreements—most of them likely to include investment provisions, a trend that differs conspicuously from earlier regional and bilateral arrangements.

Thus, countries in the region are taking steps—unilaterally, bilaterally and collectively—to enhance their investment policy frameworks and support their regional integration process. They are forging closer economic cooperation in an uncertain multilateral environment. They are promoting FDI flows to countries in the region generally, especially in the light of China's success. And they are strengthening trade and production linkages to enhance access to complementary resources and strengthen competitiveness.

Box II.6. Indonesia's Investment Year 2003

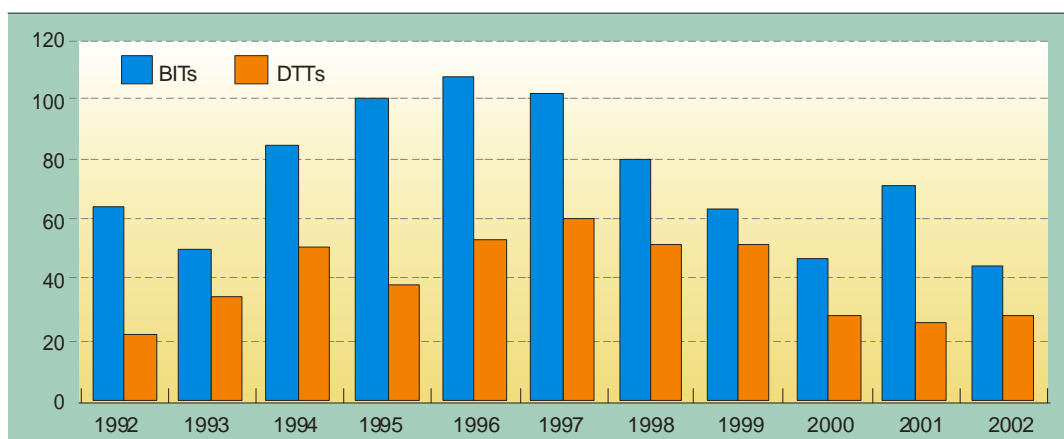
To promote FDI and increase investor confidence, the President of the Republic of Indonesia declared the "Indonesia Investment Year 2003". The new National Investment Team, chaired by the President, includes key cabinet ministers. An Investment Working Group, chaired by the Chairperson of the Investment Coordinating Board, provides technical support to the National Investment Team.

A "one roof service", supervised by the Investment Coordinating Board, will expedite investment approvals for all investors, existing and new, foreign and domestic. It will simplify procedures and improve the coordination of various agencies, including regional governments. In parallel, the Board will improve its pre- and post-investment services at the national and regional levels.

The Board has a detailed action plan to support Investment Year activities. Its objectives are to support institutional and legal changes for investment, improve investor relations and communications and promote foreign investment. Noting the importance of investment advocacy and the involvement of the general public in supporting investment efforts, the Government will improve communication and collaboration with investors, parliament and regional governments.

Source: UNCTAD.

Figure II.10. Asia and the Pacific: BITs and DTTs concluded, 1992-2002
(Number)



Source: UNCTAD, databases on BITs and DTTs.

Some countries that so far have largely remained outside the proliferating treaty network are beginning to join in. For example, Japan recently concluded a treaty with Singapore (box III.2) and is negotiating other bilateral agreements. And India is negotiating a free trade agreement with ASEAN. It is important to emphasize that bilateral and regional arrangements (with one exception, the ASEAN Investment Area) were not established for the primary purpose of attracting FDI. Their objective is broader: to increase trade flows, enhance regional economic integration, facilitate a division of labour and increase competitiveness—also improving the locational attractiveness of the members. Perhaps because of their broader focus, regional arrangements can be more effective instruments for attracting FDI than BITs and DTTs.

How do these arrangements influence FDI flows to the region? How do they strengthen the locational advantages of the region and its members? And how will TNCs adjust their investment strategies? Because most of the agreements are recent, it is difficult to assess their effects on FDI flows (box II.5, annex table A.II.3). One thing is clear, though: to the extent that they liberalize trade (and regardless of whether they address FDI or not), they encourage FDI (box II.7) and they facilitate the emergence of a regional division of labour and production in the framework of corporate regional production networks (box II.8).

c. Long-term prospects promising but short-term outlook uncertain

Prospects for a rise in FDI inflows in 2003 are slim, and the short term continues to be uncertain. Developments in West Asia and the

economic impact of the severe acute respiratory syndrome (SARS) add to this uncertainty.²⁵ Despite these factors and a possible increase in competition, the Asia and Pacific region will continue to be the largest FDI recipient among developing regions in 2003. This view is supported by studies by the World Bank (2003a, p.102) and the Institute of International Finance (2003).

Box II.7. The Indo-Lanka free trade agreement and FDI

Signed in December 1998, the Indo-Lanka Free Trade Agreement gives duty-free market access to India and Sri Lanka on a preferential basis. Covering 4,000 products, it foresaw a gradual reduction of import tariffs over three years for India and eight years for Sri Lanka.

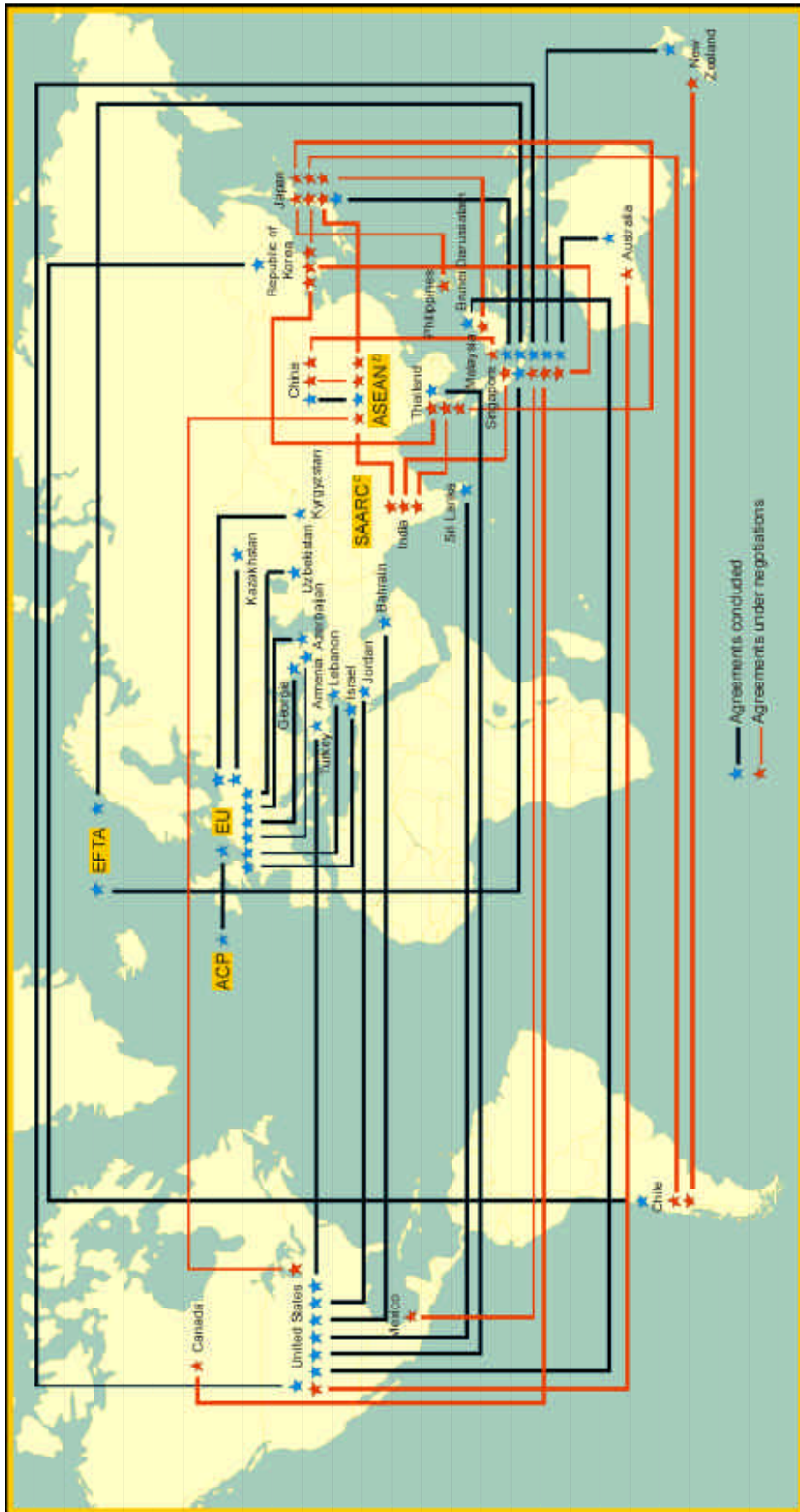
To qualify for duty concessions in either country, the rules of origin criteria spelled out value added at a minimum of 35% for eligible imports. For raw materials sourced from either country, the value-added component would be 25%.

The effect? Sri Lankan exports to India increased from \$71 million in 2001 to \$168 million in 2002. And India's exports to Sri Lanka increased from \$604 million in 2001 to \$831 million in 2002.

Although the agreement does not address investment, it has stimulated new FDI for rubber-based products, ceramics, electrical and electronic items, wood-based products, agricultural commodities and consumer durables. Because of the agreement, 37 projects are now in operation, with a total investment of \$145 million.

Source: UNCTAD.

Figure II.11. Asia and the Pacific: selected bilateral, regional and interregional agreements containing FDI provisions, concluded or under negotiation, 2003^a



Source: UNCTAD.

^a BITs and DTTs are not included.

^b Asean Free Trade Area (AFTA) and ASEAN Investment Area: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam.

^c South Asian Association for Regional Cooperation (SAARC): Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. First SAARC Meeting on Investment Promotion and Protection was held at New Delhi in September, 1997 in which a draft for SAARC Investment Promotion and Protection Treaty was circulated to all the SAARC Governments. The Second Meeting was scheduled to be held in New Delhi in June 1999. The subject was discussed in the 10th SAARC Committee on Economic Cooperation meeting held on 1st February, 1999 and 11th SAARC Committee on Economic Cooperation meeting in October 2002 at Kathmandu. SAARC is also negotiating for a South Asian Free Trade Area (SAFTA).

In the medium term, as the growth of the world economy resumes and the developing Asian region grows at expected rates of 6.3% in 2003 and 6.5% in 2004,²⁶ the prospects for FDI flows to the Asia and Pacific region remain good, particularly for automobiles and electrical and electronics products. In addition, weak global demand, shaken corporate confidence and adjustments in semiconductors and electronics are likely to improve in the near future.

The 28 IPAs responding to UNCTAD's IPA Survey indicated that one in five Asian countries had suffered from a scaling-down of investment projects or a divestment by TNCs in 2002 (UNCTAD 2003a). Just over half of the respondents claimed that planned investments had been postponed. Looking ahead, about two-thirds of the respondents expected improved FDI prospects for 2003–2004, and almost all even better prospects for 2004–2005 (figure II.12). The United States,

Box II.8. Regional integration and TNC production networks in ASEAN

ASEAN, through AFTA, provides a regional market with more than 500 million people, a combined GDP of \$560 billion in 2001 and an internal tariff rate of no more than 5%. ASEAN is also integrating through the ASEAN Investment Area, the ASEAN Framework Agreement on Services and infrastructure linkages. Regional production networks are not new in the region (Dobson and Chia 1997), but the recent integration is leading more TNCs to explore the creation of more such networks, particularly in the automobile and automotive components industries as well as the electronics industry (ASEAN Secretariat 2001):

- Japanese and other automakers are consolidating their production in the region and adopting regional production network strategies and plant specialization to service the AFTA market (Japan Research Institute Limited 2001).
- Honda Motor Company plans to streamline its production in ASEAN, with some models to be centralized in Thailand.
- Toyota has a network of operations linking different functions—such as regional HQ, assembling facilities, financing and training centres and parts suppliers—in different ASEAN countries.
- Nissan is setting up regional network structures in ASEAN to capitalize on the greater production efficiency made possible by AFTA. It plans to build a “Southeast Asian parts sourcing company” in Thailand, to source component parts in ASEAN and decide which models should be built in which plants in the region.
- Ford also has a regional strategy to service the ASEAN market and allow the various plants in the region to specialize. Rather than have two plants producing the same product in the two countries, Ford has its plant for pickup trucks in Thailand and that for passenger cars in the Philippines.
- Isuzu Motors Co. (Thailand), Isuzu Engine Manufacturing (Thailand) and Isuzu Mesin (Indonesia); Volvo (Malaysia) and Volvo

(Thailand) are producing and exchanging automotive completely-knocked-down packs through the affiliates in these countries.

- Samsung Corning (Malaysia) provides tube glass as a major input to Samsung Display's Malaysian factory for colour picture tubes, selling intermediate products to Samsung Electronics (Thailand) and affiliates in Indonesia and Viet Nam for colour televisions and in Malaysia for computer monitors.
- Samsung Electro-Mechanics (Thailand) supplies tuners, deflection yokes, and fly-back transformers to affiliates in Malaysia, Thailand and Viet Nam. It also supplies tuners to Indonesian operations for VCRs, oil capacitors to the Malaysian operation for microwave ovens and deflection yokes to Samsung Display Devices (Malaysia) for colour picture tubes.

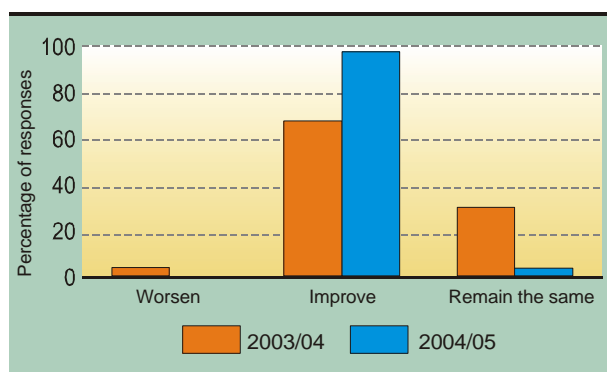
The ASEAN Industrial Cooperation scheme also encourages TNCs to establish regional production networks. For instance:

- Denso affiliates in Indonesia, Malaysia and Thailand exchange automotive components.
- Matsushita affiliates in Indonesia, Malaysia, Philippines and Thailand are part of a production network to exchange electronics parts and components.
- Nestlé's affiliates in Indonesia, Malaysia, Philippines and Thailand are part of a regional production network involving intra-firm trade in food processing.
- Sony Electronics (Singapore) and Sony (Viet Nam) produce and exchange electronics parts and components among themselves. Sony Display Devices (Singapore) and Sony Siam Industries (Thailand) are involved in a similar production arrangement, exchanging electronics parts and components.

Such production networks strengthen regional integration through production and supply linkages and the intra-firm sourcing of parts and components.

Source: UNCTAD, based on information from *Nihon Keizai Shimbun*, 31 December 2002; “Nissan sets up ASEAN sourcing HQ in Thailand”, *AutoAsia*, 27 February 2003; <http://www.auto-asia.com/viewcontent.asp?pk=8131>; *Jakarta Post*, 20 June 2002, p. 17; Jun 2001, p. 306; and information from the ASEAN Secretariat.

Figure II.12. FDI prospects^a in Asia, 2003-2005
(Per cent)



Source: UNCTAD.

^a The survey question was: "How do you perceive the prospects for FDI inflows to your country in the short- and medium-term, as compared to the last two years (2001-2002)?"

Japan and the United Kingdom are predicted to be the top investors in most of the countries (in that order). Interestingly, six IPAs cited China as being likely to be among the top three investors in their countries in 2003–2005, twice the number in 2001–2002. More countries (eight) expect to receive more R&D investment in 2003–2005 as compared to 2001–2002 (three). About one-third of the respondents expected more TNCs to locate "regional functions" to Asia, contributing to regional production networks—consistent with greater network investment in East and South-East Asia. TNCs are also predicted to shift from greenfield investments to M&As, unlike in other regions.

Prospects for different countries and groups of countries in the region will continue to vary. China will remain the largest recipient of FDI flows among the developing countries. Other countries in the region may adjust to this through increasing regional cooperation, moving up the value chain and improving competitiveness:

- India has the potential to attract significant FDI flows, depending on the course of policy reforms and privatization.
- Other South Asia countries will continue to attract modest FDI flows, with their locational advantages enhanced by the South Asian Free Trade Area, now being negotiated.
- Iraq and other countries in West Asia may experience a rapid increase in FDI flows, driven by FDI in oil and gas, depending on political developments, economic reforms and perceptions of security.
- Oil and gas will also dominate the picture in Central Asia. In addition, the reconstruction in Iraq²⁷ and Afghanistan could lead to an increase

in FDI flows in construction and infrastructure and perhaps beyond, depending on the privatization programme.

- The Pacific island economies will continue to receive a modest level of FDI flows in the near future. For the lower income countries of the Asia and Pacific region, the phasing out of some preferential arrangements may further weaken their competitive position in such industries as textiles.

Intra-regional investment between North-East and South-East Asia is likely to increase as more TNCs continue to relocate their efficiency-seeking FDI to lower cost locations and expand their market-seeking FDI to the rapidly expanding economies of the region. The more developed economies—China, Hong Kong (China), Malaysia, Republic of Korea, Singapore and Taiwan Province of China—will continue to be an important source of FDI for others in the region. And regional production networks will grow, partly because of the influence of bilateral and regional agreements. Overall, however, competition for FDI within Asia and with other regions will intensify.²⁸

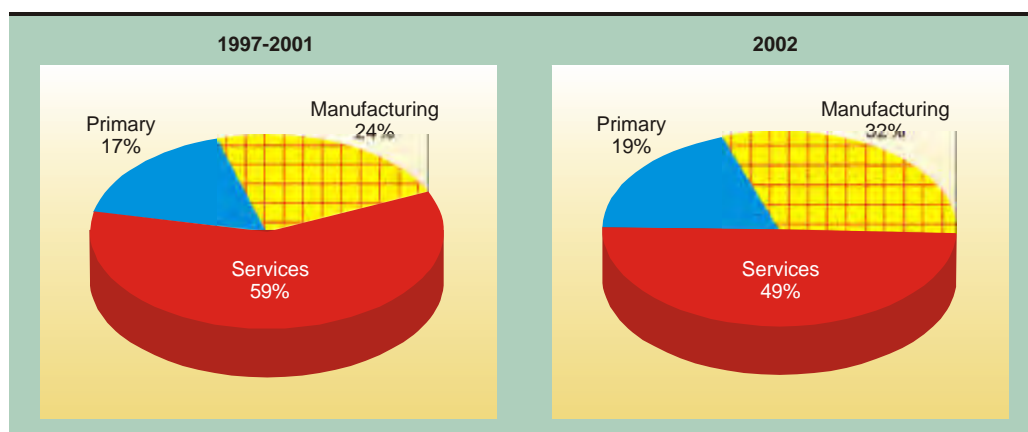
3. Latin America and the Caribbean

FDI inflows to Latin America and the Caribbean declined in 2002 for the third consecutive year, falling by a third to \$56 billion—the lowest since 1996. The decline was widespread across the region, mostly concentrated in services. Economic crises and political uncertainties made a difference, as did devaluations that affected market-seeking FDI. Governments are increasingly pursuing investment promotion policies that go beyond simply opening to foreign investment—by targeting investments in line with their development strategies. Bilateral and regional agreements are concluded in the hope that they will help attract investment to the region.

a. The downturn—concentrated in Argentina, Brazil and Chile

FDI inflows have been on a downward trend since 2000. The decline was concentrated in services (figure II.13), especially in the South American countries where TNCs had been attracted, before that, by the deregulation of telecom, utilities and banking, macroeconomic stability and prospects of a growing market in the second half of the 1990s. FDI flows into manufacturing were similar to those in 2001, as were flows into natural resources. The exception: Venezuela, where political instability affected flows to the oil industry. Due to a larger decline in FDI inflows than in domestic investment, FDI as a

Figure II.13: Latin America and the Caribbean: shares of primary, secondary and tertiary sectors in total FDI flows in selected countries,^a 1997–2001 and 2002



Source: UNCTAD, FDI/TNC database.

^a Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico and Venezuela.

percentage of gross fixed capital formation declined in 2001 and continued to do so in 2002 as well (figure II.14).

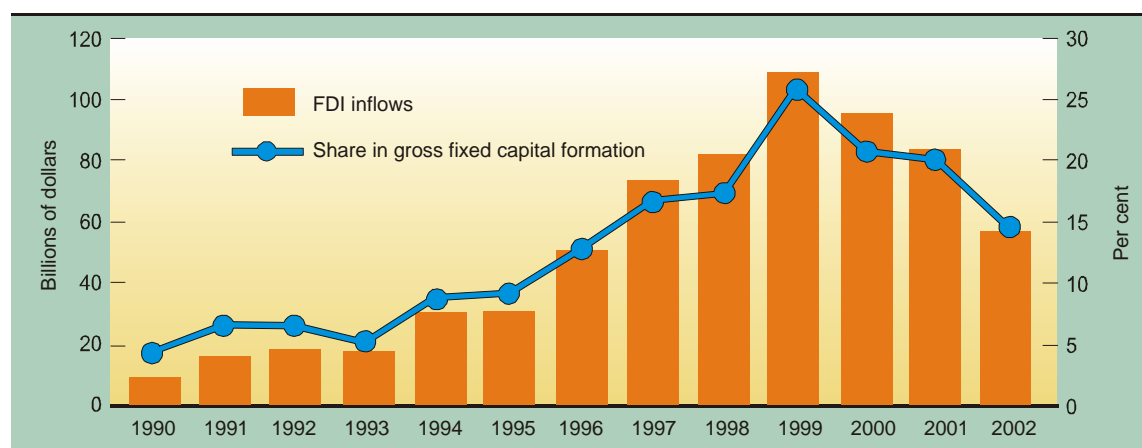
The decline in FDI was concentrated in Argentina, Brazil and Chile, where FDI into services was more important. The Andean Community, where natural resources are the main driver, was less affected. The largest host in 2002 was Brazil, followed by Mexico (figure II.15). Mexico's FDI inflows would have been 10% higher if the Banamex acquisition were excluded from 2001. FDI inflows into Costa Rica rose by 41%. But they were among the exceptions, with only 11 out of the region's 40 economies seeing an increase (annex table B.1).

GDP in the region fell by 0.1% in 2002 (IMF 2003a), and currency devaluations took place, especially in Argentina, Brazil and Venezuela, reducing markets substantially in dollar terms and

hitting the profitability of foreign affiliates in services. Devaluations also increased the debt burden (denominated in dollars) of these affiliates relative to their revenues (earned in local currency).²⁹

Privatization initiatives were postponed or cancelled due to a lack of political support or direct opposition, as in Ecuador, Paraguay and Peru. In some of the smaller markets, governments could not attract bidders for utilities slated for privatization. Foreign investment in electricity in Brazil and Mexico continued to be deterred by the effects of the devaluation in the first place and unfavourable regulations in the second. This attitude has coincided with a more cautious approach by the TNCs in the industries affected, such as telecom. So, privatization is not at present an important source of FDI in the region. An important exception in 2002 was the privatization of the third largest insurer in Mexico, Aseguradora

Figure II.14. Latin America and the Caribbean: FDI inflows and their share in gross fixed capital formation, 1990–2002



Source: UNCTAD, FDI/NC database (<http://www.unctad.org/fdistatistics>).

Hidalgo, acquired by MetLife (United States) for \$962 million, reflecting the interest of foreign companies in Mexico's financial services.

Even though the slowing United States economy halted the growth of manufacturing exports from Mexico and the Caribbean basin, FDI into export-oriented manufacturing was largely unchanged. Mexico's manufacturing exports did not recover from the drop in 2001 and were 2% below their level in 2000.³⁰ The decline was concentrated in consumer goods, while exports of components kept growing, suggesting that the integration of Mexican manufacturing into the North American production system by way of intra-firm trade remained largely unaffected.

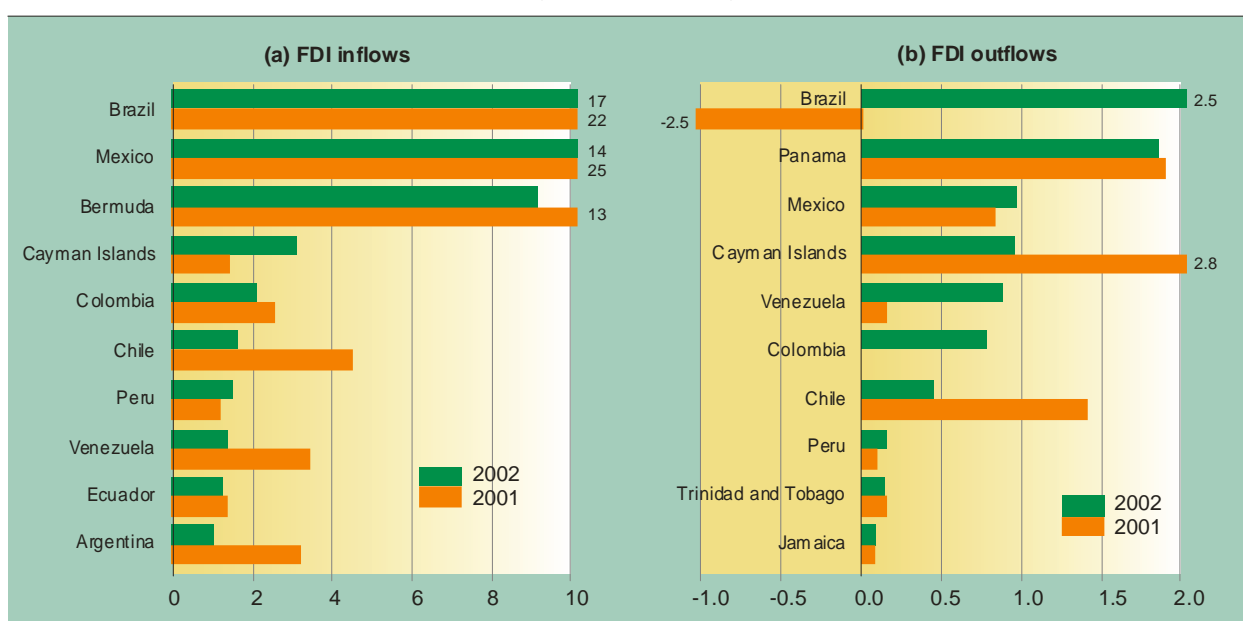
More than 200,000 jobs were lost in the *maquila* industries in Mexico 2000-2001, with no recovery from this loss in 2002, though value added was up by 11%,³¹ suggesting a shift from labour-intensive activities into higher value-added ones. Competition was evident from China and other lower cost countries as export platforms to the United States. According to the Comisión Nacional de la Industria Maquiladora de Exportación, 60% of the plants that closed in 2002 moved to Asia, the rest relocated to Central America.³² Electronics was affected most. Canon (Japan) relocated its production from Mexico to Thailand, Philips (Netherlands) to Viet Nam and China. Even so, the productivity of medium- and high-tech industries in Mexico and some other Latin American countries rivals that of their developed country counterparts,

and the prospects for FDI in new industries are promising, exemplified by the Ford manufacturing plant in Hermosillo.

Brazil's FDI inflows fell by 36%, but manufacturing received more, led by food, automobiles and chemicals. This trend began after the 1998 devaluation and continued amidst the economic uncertainty of the past two years. Brazil's automobile industry has suffered from weak demand in MERCOSUR, but the devaluation, combined with high FDI in some of the most modern plants in the world, increased the industry's competitiveness. Automobile exports rose by 45% in 2002 and are expected to go up another 20% in 2003, according to the manufacturers association.³³ They are now directed more towards NAFTA (52% of exports in 2002), benefiting from a recent agreement that reduces tariffs on trade in automobiles between Brazil and Mexico. Ford, Toyota and Volkswagen have all increased their investment in Brazil, to export outside MERCOSUR. Toyota has also announced a \$200 million project in Argentina, where the drastic depreciation brought costs down enough to consider exporting to the rest of Latin America (ECLAC 2003).

FDI inflows to Argentina in 2002 were only 10% of the average received during 1992-2001, when Argentina received 13% of the region's inflows. Despite the impact of the debt default crisis on TNCs in Argentina (see *WIR02*), very few of them left the country. However, there were large

Figure II.15. Latin America and the Caribbean: FDI flows, top 10 countries, 2001 and 2002^a (Billions of dollars)



Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

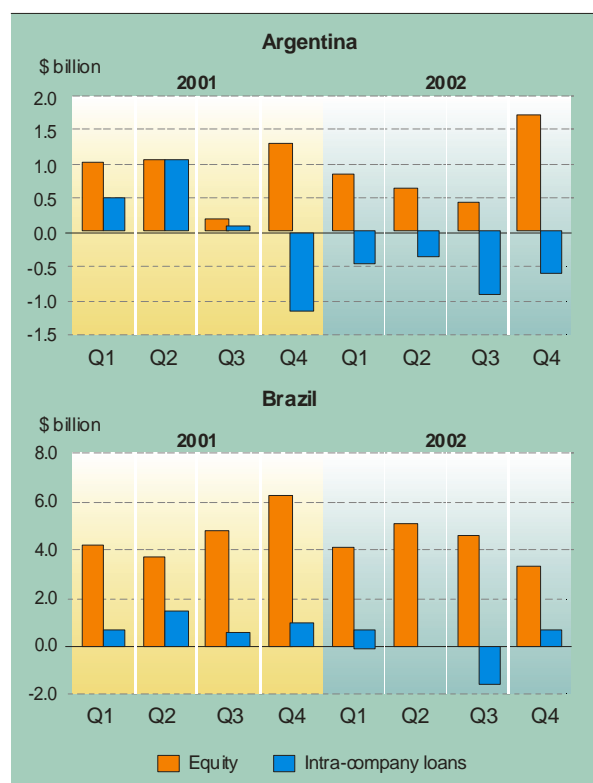
^a Ranked on the basis of the magnitude of 2002 FDI flows.

negative flows in the reinvested-earnings and intra-company loan components of FDI, revealing that established TNCs have been reducing their investments. The reaction was similar in Brazil, though smaller, as the country went through a period of financial instability and political uncertainty (De Barros 2002). TNCs reacted to the crisis and poor local prospects by cutting loans to their Brazilian affiliates, especially in telecoms, electricity and gas (figure II.16). The decline in intra-company loans accounted for the entire decline in FDI inflows in Brazil in 2002.³⁴

These economic factors as well as political uncertainties also affected domestic investment in Latin America and the Caribbean, which declined in 2001 and 2002. In 2002, total investment (both public and private) declined in most major economies, but MERCOSUR countries and Venezuela were particularly affected (ECLAC 2002).

Outward FDI from Latin American countries also declined in 2002 by 28%, to \$6 billion. Most Latin American TNCs are expanding within the region, which for Mexican companies includes the United States. But Argentine firms divested more than they invested abroad, to the tune of \$1 billion, as companies in that country sold assets abroad to help overcome the crisis at home. The

Figure II.16. FDI inflows into Brazil and Argentina, by type of financing, 2001-2002, by quarter



Source: UNCTAD, FDI/TNC database.

Argentinean crisis was also an opportunity to acquire Argentine assets more cheaply. Brazil's State-controlled Petrobras acquired a majority stake in Pérez Compac for \$1.1 billion in August 2002, the largest acquisition of the year in the region. América Móvil (Mexico) invested \$2.2 billion in acquiring companies in Argentina, Brazil and Ecuador, becoming a key player in the telecom industry of Latin America.

b. Policy developments—linking FDI to development strategies

Over the past decade, national FDI policies in Latin America and the Caribbean have emphasized liberalization and opening to FDI. There is now the perception that more emphasis should be placed on FDI policies that support an overall development strategy. Although openness to FDI is not being reversed, the enthusiasm for privatization has diminished. There is also growing awareness that more sophisticated policies need to be pursued to attract the right type of FDI and to benefit more from it. The survey of IPAs carried out by UNCTAD (box I.5) found that most countries in the region were planning to increase promotion and targeting efforts to attract FDI. Costa Rica has had the most important national FDI initiative going beyond liberalization and opening (*WIR02*). Chile recently developed such an initiative (box II.9). Proceeding along similar lines, the Mexican State-owned bank Bancomext launched an investment promotion service in 2003.

By the end of 2002, the cumulative number of BITs (413, with an average of 10 BITs per country for 40 economies) and DTTs (262, with an average of 7 DTTs per country for 40 economies) concluded by countries in the region was less than half that concluded by the economies

Box II.9. A new FDI strategy in Chile

Chile's high technology investment programme targets the software industry and services that are intensive users of information technology, such as call centres, support centres, shared services and back offices. It is attracting FDI to transform the country's production base in a direction consistent with the country's changing economic conditions and comparative advantage. The programme is promoting Chile as a place for high-tech investment (the President inaugurated the establishment of an office in Silicon Valley). So far, it has attracted regional technology centres and back offices for Air France, Banco Santander, Hewlett-Packard, Motorola and Unilever, among others.

Source: UNCTAD, based on information from www.hightechchile.com.

of South, East and South-East Asia, and the pace has slowed (figure II.17). But, the negotiation of bilateral free trade agreements—Chile and Mexico are particularly active—has picked up considerably, with most of them covering investment issues as well (figure II.18).

NAFTA and MERCOSUR are the most important regional agreements. But negotiations are under way for a Free Trade Area of the Americas (FTAA), meant to cover all states in the region (except Cuba)(box III.3). Its implications for FDI flows cannot be assessed at this time. For Mexico, there is concern that its current privileged access to the United States market may be diluted inside the FTAA, though companies based there will also gain access to other markets (Levy Yeyati et al. 2002). The agreement may make the regulatory framework for FDI in individual countries more transparent and simplify overlapping subregional and bilateral agreements.

The impact of these agreements on FDI is unclear. Countries have been changing their regulatory frameworks in favour of FDI unilaterally, so the effects of bilateral and regional agreements are hard to assess separately. Market access provided by trade or trade and investment agreements has increased FDI when the United States market became more accessible, but not under agreements among smaller economies, such as those in Central America and CARICOM. Regional agreements can in some instances enhance the locational advantages of countries, but Chile and Costa Rica have attracted FDI without the support of such agreements. Coverage is also critical. Compare the impact of NAFTA's rules of origin on the Mexican garment industry with that of the more restrictive production-sharing

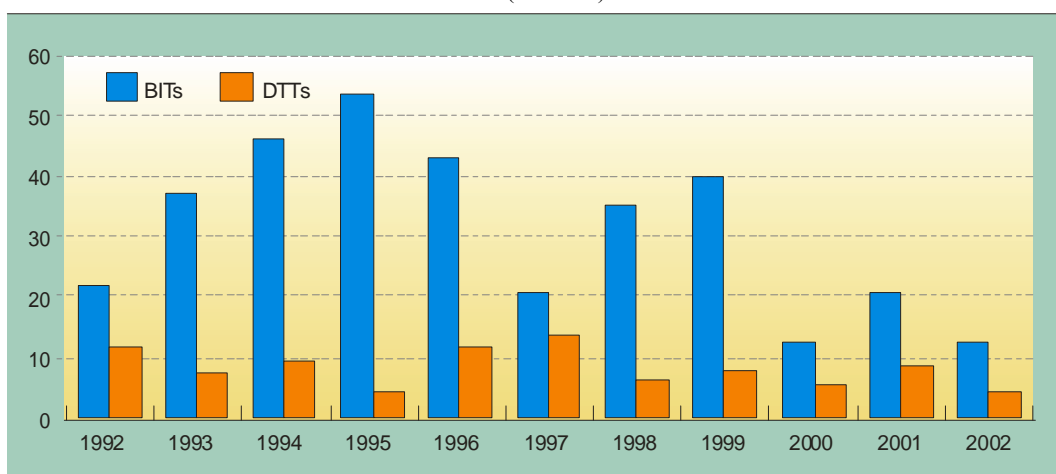
mechanism incorporated into the agreements between the United States and the Caribbean and Central American economies.

The proliferation of bilateral agreements complicates the assessment of regional ones. Mexico has signed bilateral agreements with Bolivia, Chile, Costa Rica, the EU member countries and Nicaragua, and is negotiating one with Japan (figure II.18). Chile has bilateral agreements with Canada, Mexico and the United States and associate member status with MERCOSUR.

Although FDI boomed in both Argentina and Brazil after the MERCOSUR agreement came into force in 1991, it was mainly because of macroeconomic stabilization and openness to foreign investors (including privatization) (Levy Yeyati et al. 2002). FDI into the smaller members of MERCOSUR (Paraguay and Uruguay) has not risen substantially, though there is some evidence that FDI is becoming more export-oriented, especially to other MERCOSUR members (López 2002).

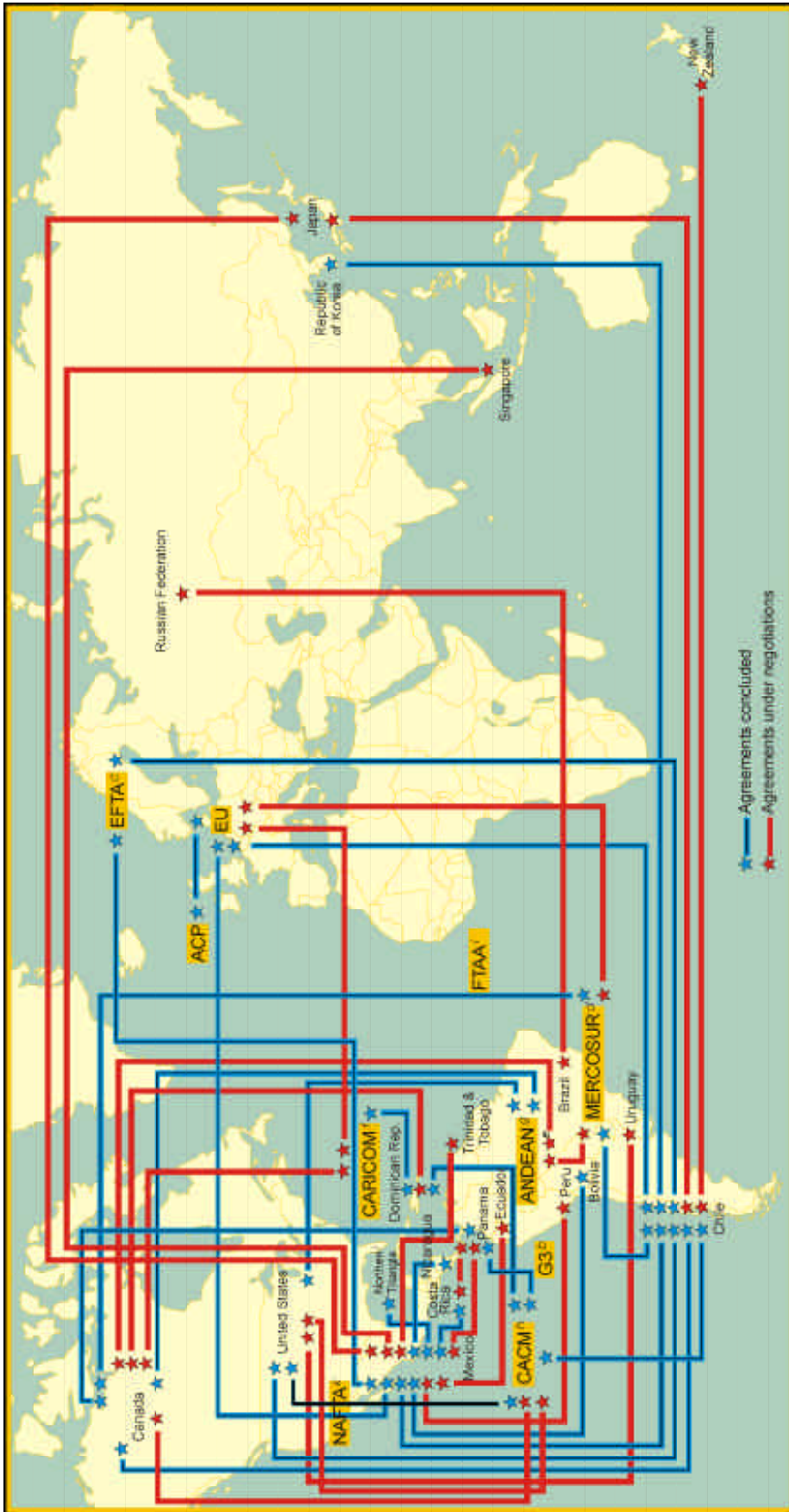
Mexico has received substantial FDI since NAFTA came into force, mainly from the United States, concentrated on the assembly of manufactured goods for the United States market (box II.10). The combination of better market access and locational advantages such as cheap labour attracted TNCs to locate manufacturing activities in Mexico, especially in areas close to the United States border. The integration of Mexico into the production system of the United States, already present with the *maquila*, was extended and deepened. NAFTA also consolidated policy reforms that started in the mid-1980s and opened the economy to foreign investors.

Figure II.17. Latin America and the Caribbean: BITs and DTTs concluded, 1992-2002
(Number)



Source: UNCTAD, databases on BITs and DTTs.

Figure II.18. Latin America and the Caribbean: selected bilateral, regional and interregional agreements containing FDI provisions, concluded or under negotiation, 2003^a



Source: UNCTAD.

- a BITs and DTTs are not included.
- b Group of Three (G3): Colombia, Mexico and Venezuela.
- c European Free Trade Association (EFTA): Iceland, Liechtenstein, Norway and Switzerland.
- d Southern Common Market (Mercosur): Argentina, Brazil, Paraguay and Uruguay.
- e A free trade agreement is under negotiation between the Andean countries and Canada.
- f Caribbean Community (CARICOM): Antigua&Barbuda, Barbados, Jamaica, St. Kitts and Nevis, Trinidad and Tobago, Belize, Dominica, Grenada, Montserrat, St. Lucia, Guyana, Haiti, Suriname, St. Vincent and the Grenadines and Bahamas.
- g Andean Community: Bolivia, Colombia, Ecuador, Peru and Venezuela.
- h Central American Common Market (CACM): El Salvador, Guatemala, Honduras, Nicaragua and Costa Rica.
- i Free Trade Area of the Americas (FTAA) (under negotiation): Antigua and Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, United States, Uruguay and Venezuela.
- j Northern Triangle: Guatemala, Honduras and El Salvador.
- k North American Free Trade Agreement (NAFTA): Canada, Mexico and the United States.

c. Prospects—not much change

UNCTAD estimates that 2003 FDI flows to the region are likely to remain similar to those in 2002.³⁵ Although the political and economic climate in the region is improving (except in Venezuela), the recovery is likely to be slow. The factors that deterred market-seeking FDI in 2002 are persisting in 2003—and will recover only

slowly. But TNCs will continue to be attracted by natural resources, especially if high oil prices persist. And efficiency-seeking FDI in Mexico and the Caribbean basin will likely remain at the same level in 2003. FDI will continue to flow into the manufacturing sector of Brazil and is likely to resume in Argentina. Only Colombia has an important privatization plan for the year, though implementation could be delayed.

Box II.10. NAFTA and FDI

Negotiated by Canada, Mexico and the United States, NAFTA came into force in January 1994, creating the first north-south regional integration agreement in the Western hemisphere. The Agreement opens the three economies to further cross-border trade in goods, services and intellectual property and to investment from one another in almost all industries. The final round of tariff cuts under NAFTA was on 1 January 2003, with some exceptions for agricultural products until 2008.

NAFTA caused a marked jump in intra-regional trade. North American intra-regional exports of goods and services stood at 56% of total exports from North America in 2002, up from 49% in 1996 and 34% in 1980 (Rugman and Brain 2003, pp. 5, 16). But the impact has been strongest in Canada and Mexico. In the late 1980s three-quarters of Canadian and Mexican trade was with the United States, and by 2002, more than 85%—with a similar pattern for Canadian and Mexican imports from the United States. But the pattern does not hold for the United States, whose trade with the two other economies over 1996–2001 was remarkably similar to that in 1980.

An increase in FDI flows to the three member countries has also been observed since the late 1980s, but it is unclear to what extent this was due to NAFTA. FDI flows, declining over 1988–1993, rose rapidly after 1994, peaking at \$383 billion in 2000, before falling back to \$64 billion in 2002. The gains appeared to come primarily from FDI into the United States, not to Canada or Mexico, however. The United States' share of North American FDI rose from 71% in 1994 to a peak at 88% in 1999, before falling back to 47% in 2002. The pattern is similar for North American FDI as a percentage of gross FDI inflows for all OECD countries—and as a percentage of worldwide inflows.

Still, Mexico benefited from increased inflows (MacDermott 2002; Andresen and Pereira 2002). But there is no evidence of increased intra-regional FDI intensity, particularly because Mexico's outward FDI flows to the United States were small over 1980–1998 (Globerman 2002).

Source: UNCTAD.

Intra-NAFTA FDI fell from 30% of the outward FDI stock in 1986 to 18% in 1999 (Eden and Li 2003). The Canadian share of United States outward stock appears to have been a key factor, down from 17% in 1989 to 10% in 2000 (Rugman and Brain 2003). NAFTA appears to have caused United States TNCs to close some plants in Canada and use United States exports to supply the Canadian market. Industries characterized by large economies of scale, low transportation costs and little product differentiation were expected to see such locational shufflings once tariffs were removed (Eaton and others 1994).

The most important industry in North America is automobiles and automotive components, accounting for between a third and a half of intra-regional trade, depending on how broadly the industries are defined. The Canadian and United States automobile industries had been integrated since the 1965 Auto Pact. NAFTA thus furthered the integration of the Mexican automobile industry into an already deeply integrated North American automotive industry (Weintraub and Sands 1998).

Comparing the position of the United States as an insider in NAFTA and an outsider to MERCOSUR, one study found a significant positive relationship between United States FDI and NAFTA, but no relationship between United States FDI and MERCOSUR (Bertrand and Madariaga 2002). Another study found that Central American countries (except Costa Rica) lagged behind Mexico after 1994 (Monge-Naranjo 2002). Most affected were textiles and apparel, accounting for most of the FDI flows to El Salvador, Guatemala and Honduras.

The definitive study of NAFTA's impact on FDI has yet to be done. The presumption is that NAFTA benefited its member economies in terms of international trade in goods and services, but less is known about its impact on FDI, for members and non-members. Better linking of micro-level locational strategies of individual firms to macro-level shifts in FDI flows and stocks is probably the key to solving this puzzle.

In the medium term, there is scope for increased flows, even if they do not reach the 1999 record level for a few years. Some industries are already dominated by TNCs, such as telecoms in South America and banking in Mexico, but cross-border M&As may resume as soon as the economic climate improves. Privatization is almost completed for some of the larger markets and most attractive assets, but investors might be attracted to smaller markets (Costa Rica or Ecuador) or to new industries (transport infrastructure).

Facing stiffer competition from China and elsewhere, most labour-intensive manufacturing has an uncertain future in Mexico and the Caribbean basin. But manufacturing in Mexico and to less extent in Costa Rica has reached levels of productivity and technological sophistication that make the threat of relocation to lower cost countries less imminent. A recent study estimated that 40%

of *maquiladora* plants in the Mexican state of Baja California can be classified as “third generation”, with intensive use of information technology and well-developed R&D capacities (Carrillo and Gerber 2003). The automobile industry, though facing excess global capacity, is expanding its plants in Mexico (ECLAC 2003). In MERCOSUR, TNCs might benefit from flexible exchange rates and the quality and excess capacity of plants, especially in the automobile industry—turning Argentina and Brazil into export platforms for the rest of the region and beyond.

With FDI flows likely to remain below their peak in the coming years, governments in Latin America will need to pay more attention to the way investment best helps their development objectives. The new emphasis on more sophisticated policy instruments for attracting and benefiting from FDI is likely to intensify.

B. Central and Eastern Europe

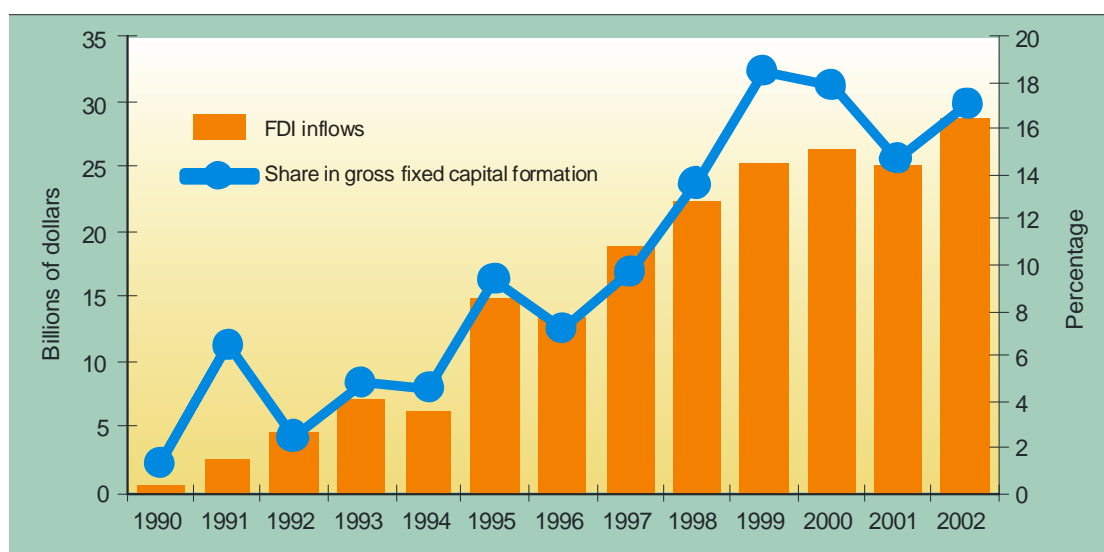
FDI inflows to CEE reached a new high of \$29 billion in 2002 (figure II.19), rising in 9 countries, falling in the other 10 (figure II.20; annex table B.1). Firms in several CEE countries, particularly those slated for accession to the EU, tended to shed activities based on unskilled labour and to expand higher value-added activities, taking advantage of the educated local labour force. That makes training and retraining important tools of employment policy.

The region’s EU-accession countries will have to harmonize their FDI regimes with EU regulations. The non-accession countries have to

update and modernize their FDI promotion to benefit from being a “new frontier” for efficiency-seeking FDI (UNCTAD 2003c).

The stability in FDI inflows in 2001–2002 can be attributed partly to the positive impact of the anticipated EU enlargement on investment, in both accession and non-accession CEE countries (for TNC strategies responding to EU enlargement, see also section C). This is a major asset for future FDI flows because the momentum should keep FDI flows strong once the current wave of large privatization deals is over in Czech Republic, Slovakia, Slovenia and to a less extent Poland.

Figure II.19. CEE: FDI inflows and their share in gross fixed capital formation, 1990–2002



Source: UNCTAD, FDI/NC database (<http://www.unctad.org/fdistatistics>).

1. Defying the global trend

The steady performance of FDI in CEE suggests that it is viewed as a stable and promising region for FDI, especially within the division of labour across the integrating European continent, improving the efficiency of operations in Europe as a whole.³⁶ FDI inflows have also benefited from a catch-up effect, with a ratio of FDI stocks to GDP in CEE moving from half the world average in 1995 to close to it in 2002 (table II.2).

Cross-border M&As, both privatization-related and others, were important for CEE's inflows in 2002, with the ten largest cross-border sales³⁷ amounting to \$12 billion in 2002 and the total reported exceeding \$16 billion. These data are, however, imperfect indicators of FDI-related developments, because the values of various cross-border deals remain undisclosed and some cross-border M&A sales do not have counterparts in the FDI inflow data.³⁸

Inflows rose in 9 countries and declined in 10 (figure II.20; annex table B.1). Growth was particularly strong for countries with privatization peaks (Czech Republic, Slovakia and Slovenia) and that had lagged behind in privatization (Belarus and Serbia and Montenegro).

FDI flows into the Czech Republic and Slovakia rose—driven by the takeovers of Transgas by German RWE and Slovensky Plynarensky Priemysel by Gazprom, Ruhrgas and Gaz de France—while those into Estonia, Hungary and

Poland declined. So the trends in 2002 were related to the lumpiness of privatization-related FDI, causing large upswings or downswings.

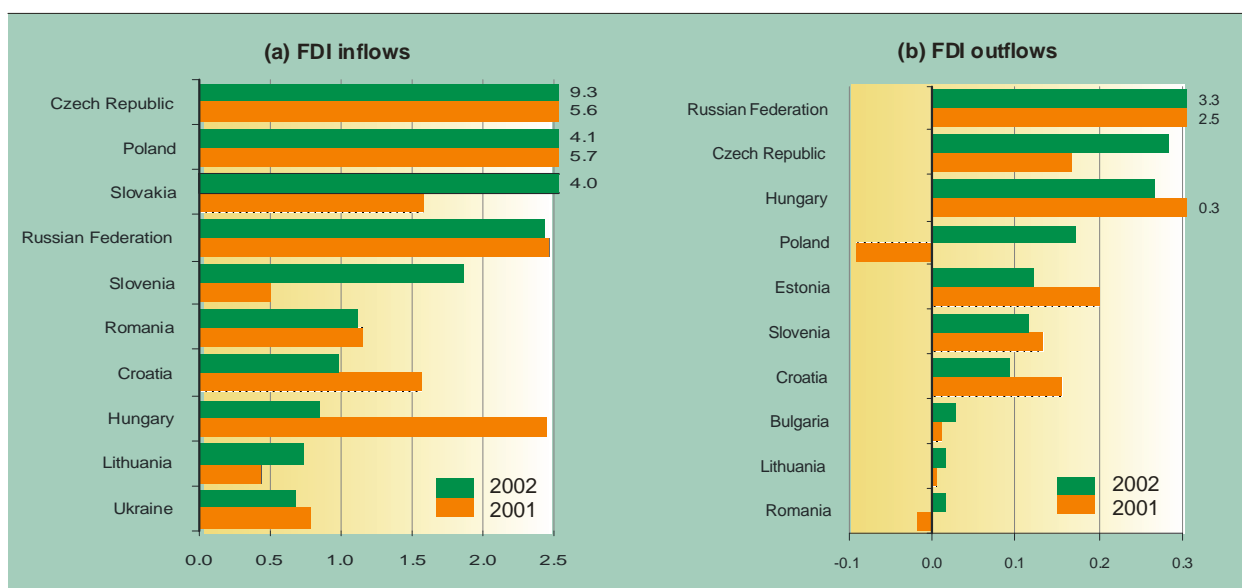
The anticipated positive impact of EU enlargement stimulated FDI inflows (see also section C). In other cases, a wait-and-see attitude by investors may explain the lower than expected level of FDI, as accession countries are adjusting their FDI regimes to the requirements of EU membership (e.g. Hungary).

As a result of the changing dynamics of FDI and the catching up of some latecomer countries, the traditional dominance of the Czech Republic, Hungary, Poland and the Russian Federation is starting to change, with only the Czech Republic still growing, while the other three countries declined. For various reasons discussed below, Hungary was only the eighth largest recipient in 2002.

The share of FDI inflows in gross fixed capital formation approached 18% in 2002 (figure II.19), with Bulgaria, the Czech Republic, TFYR Macedonia and the Republic of Moldova, the region's leaders over 1999–2001 (annex table B.5). Most of the high ratios reflect small national economies, except the Czech Republic, where a high ratio reflects massive privatization-related FDI inflows.

The automobile industry in CEE—a major recipient of FDI—is still on a growth path. The announcement of new projects in early 2003 in Slovakia (by PSA) and the Russian Federation (by

Figure II.20. CEE: FDI flows, top 10 countries, 2001 and 2002 ^a
(Billions of dollars)



Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

^a Ranked on the basis of the magnitude of 2002 FDI flows.

Renault) and the announcement of the expansion of existing projects (e.g. by Audi and Suzuki in Hungary) ensure that growth continues this year (table II.3).

By contrast, the electronics industry in CEE, both local and foreign, faces global overcapacity, sluggish demand and cost competition from East Asia, especially China. Electronics firms shed activities based on unskilled cheap labour and expanded activities based on higher skills. Hungary—as the middle income economy in the region with the “oldest” electronics foreign affiliates—is the first to face the pressure of restructuring towards higher value-added activities (figure II.21). Flextronics, IBM and Philips are undertaking both closures and capacity expansions—but in different product segments (table II.4).

In the middle income countries such as the Czech Republic, Hungary, Poland, Slovakia and Slovenia, inward FDI increasingly targets logistical centres and R&D. Paradoxically, the emergence of foreign affiliates in some knowledge-intensive corporate services—such as regional HQ, call centres and back offices—has not helped the

Table II.2. Catching up— inward FDI stock as a percentage of GDP in Central and Eastern Europe,^a 1995 and 2001
(Per cent)

Country/region	1995	2001
Estonia	14.4	65.9
Czech Republic	14.1	64.3
Moldova, Republic of	6.5	45.0
Slovakia	4.4	43.2
Hungary	26.7	38.2
Latvia	12.5	32.4
Lithuania	5.8	28.9
Croatia	2.5	28.4
Bulgaria	3.4	25.0
Poland	6.2	24.0
TFYR Macedonia	0.8	23.9
Slovenia	9.4	23.1
Albania	8.3	21.0
Romania	2.3	20.5
Serbia and Montenegro	2.7	20.1
Bosnia and Herzegovina	1.1	15.8
Ukraine	2.5	12.9
Belarus	0.5	8.7
Russian Federation	1.6	6.5
<i>Memorandum:</i>		
Central and Eastern Europe	5.3	20.9
World	10.3	22.5

Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

^a Ranked on the basis of the magnitude of 2001 Inward FDI stock as a percentage of gross domestic product.

Table II.3. CEE: a car assembly bonanza, 2003

Location	Manufacturer
Czech Republic	
• Kolin	Toyota/PSA (2005)
• Mlada Boleslav	Volkswagen/Skoda
Hungary	
• Esztergom	Suzuki (Swift, Wagon R+)
• Győr	Audi Hungaria Motor
Poland	
• Bielsko Biala	Fiat
• Gliwice	General Motors/Opel (Opel Agila)
• Lublin	Daewoo FSO ^a
• Poznan	Volkswagen (T4)
• Warsaw	Daewoo FSO
• Zeran	Daewoo (Lanos)
Romania	
• Craiova	Daewoo (Matiz) ^a
• Pitesti	Renault (Dacia Nova)
Russian Federation	
• Kaliningrad	BMW (3 series)
• Moscow	Renault (X-90) (2005)
• Togliatti	GM/AvtoVAZ joint venture (Niva 4x4)
• Vsevolozhsk	Ford (Focus)
Slovakia	
• Bratislava	Volkswagen (Tuareg, Polo, Golf 4x4, Variant 4x4, Bora 4x4)
• Trnava	PSA/Peugeot (2006)
Slovenia	
• Novo Mesto	Renault (Clio)

Source: UNCTAD, based on Figyelő 2003, and press reports.

^a Project discontinued/closed.

volume of FDI inflows because they can be established with small capital investments. The move to FDI based on higher labour skills makes the EU accession countries direct competitors with other emerging locations.

The Czech Republic, Estonia and Poland have to prepare for a time when privatizations are no longer a major source of FDI inflows. An increasing number of greenfield projects (including ones financed by reinvested earnings) may indicate that such projects can at least in part compensate for the end of privatization-related FDI inflows. In Estonia reinvested earnings accounted for 40% of FDI inflows in 2002. In the Czech Republic in 2002, 11 foreign affiliates³⁹ reported capacity expansion in the automotive supplier industry (CzechInvest 2003).

Judging from registered values, outward FDI (\$4 billion) recovered in 2002 but was still much lower than inward FDI. The Russian Federation accounted for the bulk of the outflows (figure II.19), with Yukos' acquisitions of Mazeikiu Nafta (Lithuania) and Transpetrol (Slovakia), as well as Eurochem's acquisition of the Lithuanian chemical firm Lifosa. Its outflows exceeded registered inflows at a relatively low GDP per capita. This may be explained by the difficult business environment at home and the aspirations of Russian natural-resource-based firms to become global players. The first four months of 2003 saw

31 outward FDI projects by Russian firms (up from 27 in the same period in 2002).⁴⁰ These projects are now going to the Commonwealth of Independent States (five of the top eight destinations), with Ukraine as the number one host. More than 60% of them were in energy (Gazprom, Zarubezhneft), followed by machinery (Sylovye Mashini).

2. FDI in the Russian Federation—taking off?

With its size and natural resources, the Russian Federation has the potential to attract resource-seeking, market-seeking and efficiency-seeking FDI. Until recently its inflows were below potential (annex table A.I.8). But there are distinct signs of greater investor interest.

In February 2003 British Petroleum announced its intention to acquire a 50% stake in a joint venture combining Tyumen Oil Company, the fourth biggest petroleum firm of the Russian Federation, with its affiliate Sidanco. (BP previously owned 25% of Sidanco.) Once fully materialized, this will be by far the largest FDI project in the Russian Federation since 1991—at \$6.5 billion, giving a major boost to the sluggish FDI inflows. The deal is worth more than twice the average inflows for 2000–2002 and a third more than the peak of \$4.9 billion in 1997 (figure II.22).

The growing number of greenfield FDI projects announced in the first four months of 2003 is another indication of a possible takeoff, with

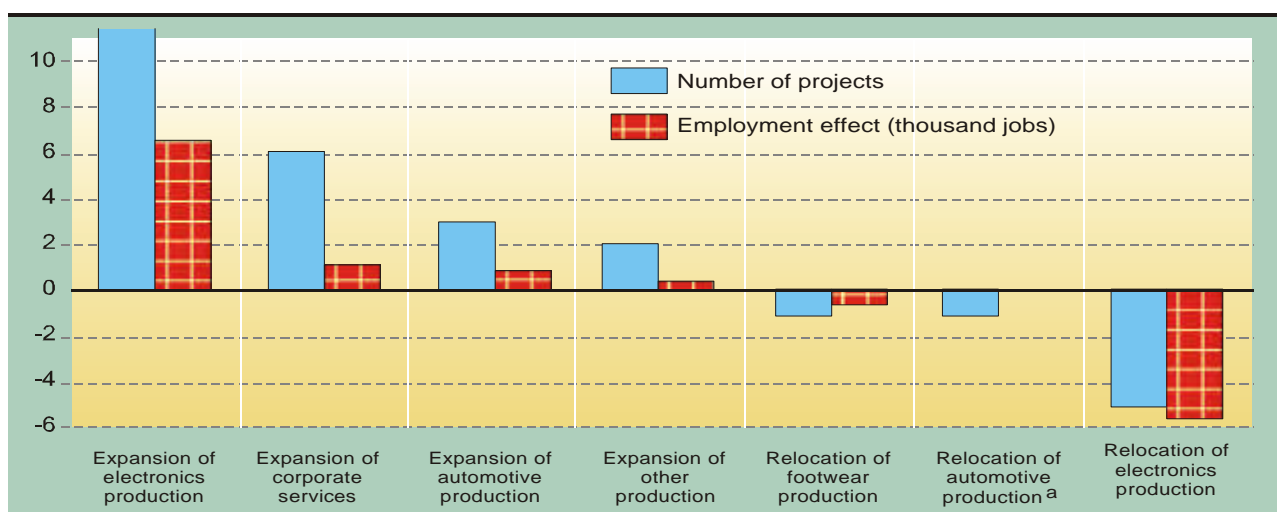
160 firms starting projects, for a value of \$9 billion, up from 77 and \$3 billion in the same period of 2002.⁴¹ The Russian Federation's 7% share in projects worldwide in 2003 made it the third most important location worldwide, after China and the United States.

Forecasting a rapid takeoff may be premature. The seeming takeoff in 1997 was followed by the Russian financial crisis in 1998, when FDI inflows plummeted (figure II.22). And in 2001 and 2002, outflows exceeded inflows, unusual for a lower middle income country.

The sustainability of FDI inflows higher than those in 2002 depends how the Russian Federation attracts FDI based on the full range of its competitive advantages. It has a sizable untapped potential (table II.5). The demonstrated potential for FDI in natural resources is significant—if foreign investors are allowed to take equity shares and are not confined to production sharing or other contractual arrangements short of ownership (figure II.23).

The Russian Federation has also been host to some major market-seeking investments, especially in food (Cadbury, Mars, Stollwerck), beverages (Baltika Brewery, Efes Brewery), tobacco (Philip Morris, Liggett) and telecoms (beside the contentious investment of Cyprus-based Mustcom Consortium into Svyazinvest, Deutsche Telekom's participation in mobile phone provider MTS is the most notable). But the scope for such investment has been limited by the low purchasing power of the Russian population.

Figure II.21. Expansion and reduction of capacity by foreign affiliates in Hungary—the “ins” and the “outs”, 2002–June 2003



Source: UNCTAD, based on annex table A.II.10.

^a Data for employment are not available.

Table II.4. Who competes with whom? ^a
Economies categorized by GDP per capita in 2000 (dollars)

Income group (Dollars)	EU accession countries	Other CEE	EU-15	Other developed countries	Selected developing economies as benchmarks
>20,000: high income			Luxembourg Denmark Sweden Ireland (+) United Kingdom (+) Finland Austria Netherlands Germany Belgium France	Japan Norway United States Switzerland Canada Australia (+)	Hong Kong, China (+) Singapore (+)
5,000-19,999: upper middle income	Cyprus Malta <i>Slovenia</i>		Italy (-) Spain Greece Portugal	Israel New Zealand	Taiwan Province of China Korea, Republic of Uruguay (+) Mexico (+)
2,000-4,999 middle income	<i>Czech Republic</i> <i>Hungary</i> <i>Poland</i> <i>Estonia</i> <i>Slovakia</i> <i>Lithuania</i> (+) <i>Turkey</i> ^b <i>Latvia</i> (+)	<i>Croatia</i>			Chile Malaysia Costa Rica Brazil Botswana South Africa Dominican Rep. (+) Peru (+)
500-1,999: low income	<i>Romania</i> ^c <i>Bulgaria</i> ^c	<i>TFYR Macedonia</i> <i>Russian Federation</i> (-) <i>Albania</i> <i>Bosnia and Herzegovina</i> <i>Belarus</i> (+) <i>Serbia and Montenegro</i> <i>Ukraine</i> (+)			Thailand Egypt Kazakhstan Morocco Philippines Turkmenistan China (+) Indonesia Azerbaijan Georgia Armenia (+)
<500: very low income		<i>Moldova, Republic of</i>			India Viet Nam Bangladesh Uzbekistan Uganda Kyrgyzstan Tajikistan

Source: UNCTAD, *Handbook of Statistics 2002 On-line*, <http://unctad.org/fdistatistics>.

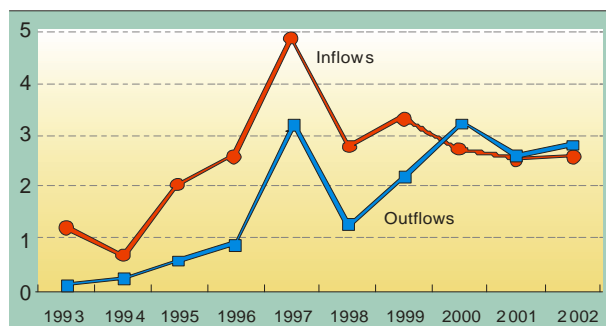
^a This table is based on Michalet's idea (Michalet, 1999) that each economy competes for FDI with other economies at a similar level of development only. CEE countries are shown in italics.

^b In a pre-accession stage. Candidate status for EU to be confirmed.

^c Envisaged to join EU in 2007.

Notes: (+) means a country moved upwards in categories from 1992 to 2000.
(-) means a country moved downwards in categories from 1992 to 2000.
Countries are listed in the order of GDP per capita.

Figure II.22. The Russian FDI roller coaster, 1993–2002
(Billion dollars)



Sources: UNCTAD FDI/TNC database (<http://www.unctad.org/fdistatistics>) and UNCTAD estimates.

Some technology-based, efficiency-seeking projects have been started recently, most of them in the automobile industry. The main examples are BMW's plant in Kaliningrad in 1999, Volvo Truck's assembly project in the Moscow region in 2001, General Motors' export-oriented joint venture in 2001 with AvtoVAZ to produce off-road vehicles, Ford's car factory opened in the Leningrad region in 2002 and Renault's car-manufacturing project in Moscow (table II.6).

Information collected in 2003 from 26 firms investing in the Russian Federation confirms natural-resource and market-seeking motives.⁴² More than half the respondents indicated a promising domestic market potential as a motive,

Table II.5. Inward FDI stock as a percentage of GDP, selected economies, 2001

Rank in world	Economy	Per cent
45	Viet Nam	48.4
51	South Africa	44.0
52	Brazil	43.6
58	Nigeria	41.6
61	Indonesia	39.5
70	China	33.2
81	Argentina	28.3
93	Thailand	24.6
103	Mexico	22.7
100	Poland	22.3
107	Egypt	22.1
136	Philippines	14.7
147	Turkey	12.0
149	Taiwan Province of China	11.4
163	Korea, Republic of	11.2
161	Pakistan	9.9
172	Russian Federation	7.0
175	India	4.7

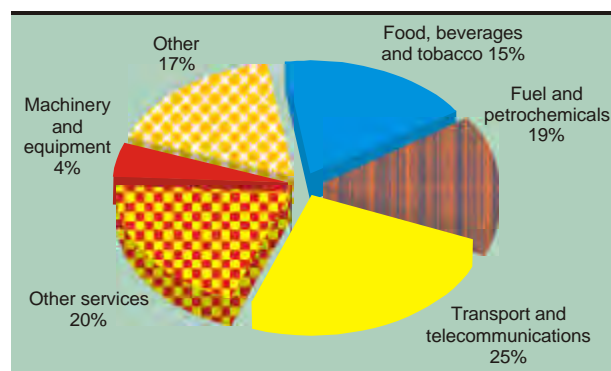
Source: UNCTAD Handbook of Statistics On-line 2002, <http://unctad.org/statistics>; and UNCTAD FDI/TNC database online, <http://unctad.org/fdistatistics>.

with proximity to regional markets mentioned second. A closer look at the projects started in January–April 2003 confirms that the greatest prospects are still in natural resources, followed at a distance by electronics, automobiles and R&D.

The Russian Federation could multiply its inward FDI stock in a short period. But, if the aim were to match China in its FDI stock per capita, it would need to quadruple the flows received in 2000. And if the aim were to match Poland, it would need to triple its FDI stock.

3. The challenge of EU enlargement

EU-accession countries have to harmonize their FDI regimes with EU regulations, with the twin aims of conforming to EU regulations and maximizing the benefits from EU instruments, such as regional development funds. Examples of nonconforming FDI instruments are Slovakia's special incentives for foreign investors and Hungary's 10-year tax holidays granted only to large investors. Both countries changed their investment incentives in 2002 to conform to EU rules, while seeking to provide a framework no less favourable for investors. In their search for international competitiveness under EU membership, some accession countries are also lowering their corporate taxes. By 2004 these taxes will be significantly below the average of current EU members, although still higher than those of some FDI front runners such as Ireland (table II.7).

Figure II.23. Russian Federation: industry composition of inward FDI stock, 2002 (Per cent)

Source: UNCTAD, based on data provided by the State Committee of the Russian Federation on Statistics.

Accession countries have to learn how to make the best use of facilities now available to them for promoting investment, such as EU regional development funds (which are more limited than those for actual EU members).⁴³ The accession countries also have to develop the institutional framework to administer and properly channel the variety of funds available from European Community sources for assisting economic development. Originally designed for high income countries, these funds require sophisticated administrative capabilities. Reaching similar levels of public administration in the short time left until accession will test human and financial resources.

For several countries, particularly the non-accession countries, the task is to modernize FDI promotion policies and measures. Only by doing so can they get the most from efficiency-seeking FDI.

UNCTAD's survey of IPAs confirms that promotion efforts (named by 53%) and targeting (60%) are the preferred policy responses. Only a third of the respondents reported additional incentives.

Since the early 1990s, CEE countries have been very active in signing BITs and DTTs, having concluded more than 700 BITs and more than 600 DTTs by the end of 2002 (figure II.24). The region's share in the global universe of BITs (33%) and DTTs (27%) was much higher than its share in United Nations members (10%). Almost half the BITs signed in 2002 were with developing countries (13 of 29), especially those in Asia and the Pacific (10 BITs). CEE countries are thus completing the geographical coverage of their BIT network, having first signed treaties with neighbours or with

developed countries. Most DTTs were signed with developed countries.

Additionally, all bilateral and regional agreements concluded by CEE countries with the EU (figure II.25) contain investment clauses, reflecting the priorities of international economic relations of both parties. Of the 19 countries of the region, all but 4 (Albania, Belarus, Bosnia and Herzegovina and Serbia and Montenegro) have signed such agreements. The investment-related clauses cover a wide range of issues, reflecting the depth of economic integration between the two parties. All offer guarantees for transfer, protection of intellectual property rights and State-State dispute settlement mechanisms. Most also provide for the liberalization of admission and establishment, national treatment, prohibition of some performance requirements going beyond the TRIMs Agreement and investment promotion clauses.

At the regional level, EU enlargement is the most important policy development affecting FDI inflows to CEE. It also affects FDI in non-accession

countries, but in a different manner. All accession countries but Bulgaria and Romania are upper middle income or high income (Slovenia) countries. All non-accession countries but Croatia are lower middle income countries (table II.4). This leads to an increase in FDI in services and higher corporate functions in accession countries, attracted from current EU members and third countries (table II.8). EU enlargement also offers opportunities to non-accession countries, because assembly-type manufacturing may shift to them from higher cost accession countries (table II.8). With the restructuring of middle income countries, labour-intensive FDI may move to lower-cost locations, in CEE or in Asia.

New EU member countries may become major sources of skill-intensive assets, combining their advanced education with competitive production costs. The legal regime of the EU provides the necessary framework for the free movement of persons, goods and capital within the region, in offering national treatment and in aiming for competitive equality within the grouping. In

Table II.6. Key greenfield FDI projects started in the Russian Federation, January-April 2003

Investor	Home country	Value (\$ million)	Project description	Main motivation
Royal Dutch Shell	Netherlands/ United Kingdom	5 500	Investment into the second phase of a Sakhalin oil and gas project	Natural resources
TotalFinaElf	France	2 500	Exploration and development of the Vankorsky oil field	Natural resources
Pfleiderer	Germany	647	Investment into chipboard production in Novograd	Efficiency/exports
Segura Consulting Assoc., Ferrovia and Caixa Bank	Spain	319	Hotel and office complex in Moscow	Market seeking
Renault	France	250	2000-job passenger car plant in Moscow	Market seeking/ efficiency
Philip Morris	United States	240	Cigarette factory in St. Petersburg	Market seeking
Baltic Beverages seeking	Denmark	50	Brewery in Khabarovsk exporting to China	Exports/market
Krka	Slovenia	20	R&D centre for new generic pharmaceuticals	Strategic assets
Tex Development	United Kingdom	12	Expansion of clothing production to be exported to Europe and China	Efficiency/exports
Outocoumpu	Finland	4.5	Auto components plant in Kurgan exporting to Europe	Efficiency/exports
Bank Austria	Austria	..	R&D team in Moscow to improve back-office system	Strategic assets
Nuclear Solutions	United States	..	R&D centre in Moscow to evaluate viability of various technologies	Strategic assets

Source: LOCOmonitor, OCO Consulting.

Table II.7. Making corporate taxes attractive in the Visegrad-4 countries: rates^a announced by June 2003 for the rest of the year and 2004
(Per cent)

Country	2003	2004
Czech Republic	31	24 ^b
Hungary ^c	18	18
Poland	27	19
Slovakia	25	19
<i>Memorandum items:</i>		
EU average	32	..
Ireland	12.5	..

Source: "Adólicit Közép-Európában", *Magyar Hírlap Online* (Budapest), 30 June 2003, <http://www.magyarhirlap.hu/cikk.php?cikk=68662>.

^a Excluding local/municipal taxes.

^b Gradual reduction until early 2006.

^c In addition, Hungary levies a "trade tax", although this is often waived for major investment projects.

this integrating European continent, market size and market growth will increasingly denote the enlarged EU as a whole, providing benefits mostly to new member countries, particularly those with limited domestic purchasing power.

Liberalization in non-accession countries may be more limited. But their trade agreements with EU (preferential or association agreements) may affect market size, one of the key determinants of FDI. And the use of the European cumulation area in the EU rules of origin can add to the flexibility in organizing production across the continent. Trade agreements with non-accession countries will also facilitate access to natural resources, with the most important resources outside the enlarged EU, notably in the Russian Federation.

The emerging specialization of FDI between the accession and non-accession countries does not yet follow a "flying-geese" pattern.⁴⁴ Labour-intensive activities relocated from accession countries now go more to developing Asia (especially China) than to lower income CEE countries. And the low outflows of FDI from accession countries limit the scope for restructuring to non-accession countries.

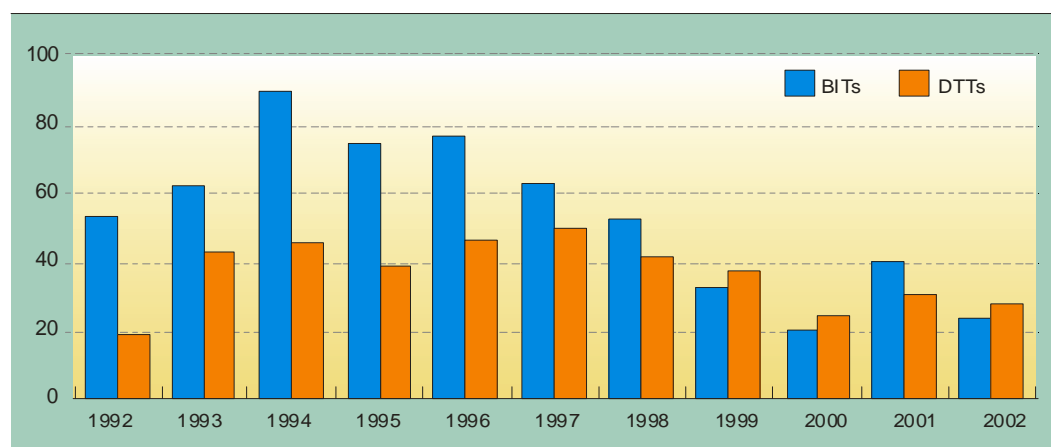
4. Prospects—mostly sunny

Led by the surge in flows to the Russian Federation, and fuelled by the momentum of EU enlargement, UNCTAD expects the region's FDI flows to rise somewhat in 2003 to close to \$30 billion.⁴⁵ The surge of FDI in the Russian Federation seems more fragile in the medium or long term than the spur of EU enlargement. But in the short term both are helping overcome the completion of privatizations and the slowdown of GDP growth expected in the Czech Republic, Hungary, the Russian Federation and Slovakia.

Realizing the potential of natural-resource-seeking FDI largely depends on the willingness of governments to allow foreign ownership in natural resources. Much depends also on whether local private companies are ready to take foreigners as minority, or eventually, majority shareholders in their ventures.

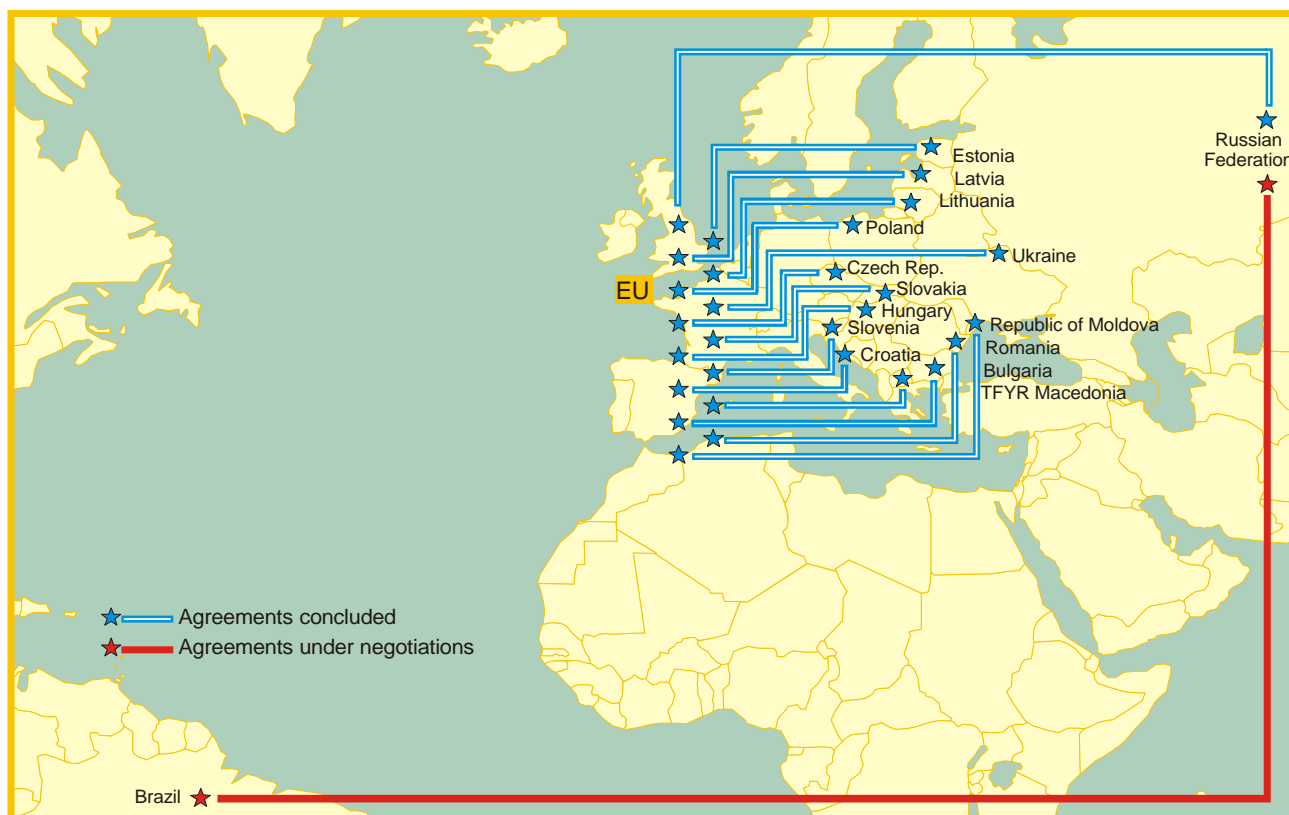
For market-seeking investment, prospects depend mostly on the speed of economic recovery in the Russian Federation and the rise in disposable income. The improvement of the general business environment and progress with intellectual property protection in such industries as pharmaceuticals could also boost FDI inflows.

Figure II.24. CEE: BITs and DTTs concluded, 1992-2002
(Number)



Source: UNCTAD, databases on BITs and DTTs.

Figure II.25. CEE: selected bilateral, regional and interregional agreements containing FDI provisions, concluded or under negotiation, 2003^a



Source: UNCTAD.

^a BITs and DTTs are not included.

Table II.8. Matrix of specialization between accession and non-accession countries of CEE, 2003

Countries	FDI patterns	FDI policies and measures
Accession countries	Upgrading of FDI activities	How best to adjust FDI promotion to EU instruments (regional and cohesion funds etc.)
Non-accession countries	"New frontier" for efficiency-seeking FDI	How to adjust policies/measures to the status of new frontier, question of business environment

Source: UNCTAD.

For efficiency-seeking FDI the Russian Federation has the biggest untapped potential. With its technological capabilities and skilled workforce, it could become a major international engineering hub. Under local ownership alone, however, most Russian industries have failed to connect with the technology and knowledge flows of the world economy. (It is less an issue of connecting to the world economy proper, as many of the large Russian firms are already major international players, but they do not always benefit from state-of-the-art technology flows.) Changing that depends partly on measures to improve the business

environment, the stability of the economy and the rule of law. But that may not be enough. The country also needs to upgrade its investment promotion efforts.

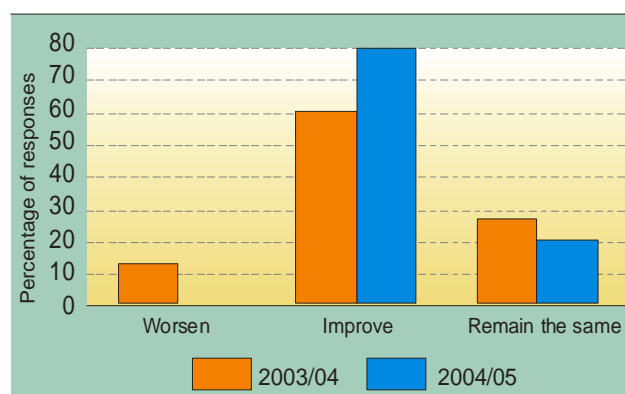
The momentum provided by EU enlargement is expected to remain strong in the medium term. The process of reorganizing economic activities across the integrating European continent is still in an early stage. Access to additional financial resources by the accession countries, though less than originally thought, can still attract economic activities to new EU members. EU enlargement can also stimulate outward FDI flows from accession countries, with non-accession countries possibly among the prime targets.

Results from UNCTAD's survey of 15 IPAs in CEE countries indicate optimism about the prospects for FDI in the coming two to three years (figure II.26). Nearly two-thirds of the respondents expected better FDI prospects in the short run (2003-2004), and four-fifths by 2004-2005. Given the region's record of steady FDI inflows,

that optimism may be too pessimistic. Surprisingly, the IPAs in CEE appear to be slightly less optimistic than their counterparts from developing countries, which have had declines in inflows. Perhaps explaining this mismatch are the composition of the samples and the cultural differences of IPA officers in different regions.

A majority of respondents (53%) reported recent increases in FDI projects. On the difficulties, most (54%) refer to postponements of projects previously planned but not yet realized. Fewer respondents reported major setbacks in cancellations (40%), scalings-down (24%) or divestments (23%). Confirming the trends documented for Hungary, IPAs expect a gradual shift towards higher value-added FDI, especially for R&D projects. Among developing country regions, only the Asian IPAs predicted a similar shift in their FDI. Reflecting the end of privatization in the Czech Republic and Poland, CEE agencies expected a shift in the mode of entry towards greenfield projects for the period to 2005.

Figure II.26. CEE: forecast mostly sunny,^a 2003–2005
(Per cent)



Source: UNCTAD.

^a The survey question was: "How do you perceive the prospects for FDI inflows to your country in the short- and medium-term, as compared to the last two years (2001-2002)?"

C. Developed countries

FDI inflows to developed countries in 2002 declined by 22%, to \$460 billion, from \$590 billion in 2001.⁴⁶ Despite the second year of decline, they remained above the average for 1996–1999. The United Kingdom and the United States accounted for half of the decline in the countries with reduced inflows in 2002. All three economic sectors (primary, manufacturing and services) suffered declines, but such industries as finance and business services activities saw higher FDI inflows. The major factors? A continuing slowdown in corporate investment, caused by weak economic conditions and reduced profit prospects, a pause in the consolidation in some industries and declining stock prices were the major factors behind the fall in FDI flows that occurred in parallel with, and largely in the form of, a decline in cross-border M&As. Large repayments of intra-company loans were the main element in reduced net FDI flows for some major host countries. IPAs in developed countries reported major setbacks in their efforts to attract FDI, including divestments or the scaling down of planned projects.

1. FDI down, as cross-border M&As dwindle

FDI inflows to developed countries declined for the second year in a row, with the share of developed countries in world FDI inflows remaining almost the same as in the previous year (more than 70%) (annex table B.1). If inflows are

adjusted to exclude transshipped investment in Luxembourg (box II.11), that share would decline by a further 15 percentage points. What lays behind the continuing downturn? The slow recovery of the United States and other host economies affected profit prospects, making companies more cautious about FDI, especially the market-seeking type. The significant expansion or consolidation in some industries, including cross-border M&As, reduced the opportunities for FDI. Declining stock markets and the need for cost-cutting measures constrained the financial capacity of corporations to engage in FDI.

Intra-company loans⁴⁷ declined sharply for several countries: of the 19 countries that report components of inward FDI, intra-company loans turned negative in 4 and declined in 6 countries in 2002. That offset increases or added to decreases in reinvested earnings and equity, the other components of FDI (annex table A.II.5). Interest rate differentials between countries might have been one factor in this (see chapter I). Another was the fall in cross-border M&As. And a third could be recalibrations of debt-to-equity ratios by recalling loans (see chapter I).

Despite the overall decline, about a third of developed countries experienced an increase in FDI inflows in 2002 (9 countries out of 26). The top FDI recipients were Luxembourg, France and Germany (figure II.27).⁴⁸ The United States—the largest recipient in 2001—did not make it to the region's top three in 2002. FDI inflows also fell

Box II.11. What made Luxembourg the world's largest FDI recipient and investor in 2002?

In 2002 Luxembourg^a was the world's largest outward investor and largest FDI recipient, accounting for about 19% (\$126 billion) of world inflows and 24% (\$154 billion) of outflows—and a more than a third of the combined EU inflows and outflows. The country's share of EU GDP is only 0.2%. Compared with domestic investment of \$4.4 billion in 2002, its FDI is impressive.

What explains these numbers?

Interestingly, Luxembourg's FDI inflows and outflows are relatively close in value, concentrated in manufacturing and services (box table II.11.1). A significant part of inflows and outflows in the first quarter of 2002 can be explained by large cross-border M&As that took place to establish the steel group Arcelor, formed by Arbed (Luxembourg), Aceralia (Spain) and Usinor (France) in late 2001 and headquartered in Luxembourg.

Inflows and outflows in roughly the same period could reflect a transfer of funds between affiliates within the same group located in different countries—or a channelling of funds to acquire companies in different countries through a holding company established in Luxembourg to take advantage of favourable intra-firm financing conditions.^b Luxembourg offers favourable

conditions for holding companies and for corporate HQ, such as certain tax exemptions (EIU 2003b). In 2000 a transaction along these lines in telecom (the Vodafone-Mannesmann deal) resulted also in significant FDI inflows to and outflows from Belgium and Luxembourg, making it the second most important investor and FDI recipient worldwide.

Equity, intra-company loans and reinvested earnings of firms are recorded as FDI if they are considered to be for the purpose of acquiring long-term interest in an enterprise abroad; this applies also in the case of special purpose entities such as holding companies (IMF 1993, paragraphs 365, 372-373). The latter might however be involved in transfer of funds to foreign affiliates in one economy for further transfer as FDI elsewhere. In 2002 such transshipped investment, or funds invested in the country for further transfer as FDI elsewhere, is estimated at about 80% of the inflows to and outflows of FDI from Luxembourg, according to the Luxembourg Central Bank. Such flows, which take place to some extent in other countries as well, have little economic impact on the countries involved. This highlights the fact that FDI statistics need to be interpreted carefully, with sufficient attention paid to the underlying methodology.

Box table II.11.1. FDI flows to and from Luxembourg, by component, 2002
(Millions of Euro)

Period	Outflows						
	Total	Equity		Reinvested earnings		Intra-company loans	
		Financial industries	Other industries	Financial industries	Other industries	Financial industries	Other industries
1st quarter	-45 446	30	-25 593	- 20	- 88	4	-19 778
2nd quarter	-23 385	96	-7 003	- 20	- 88	- 9	-16 361
3rd quarter	133	- 49	-5 165	- 20	- 88	0	5 456
4th quarter	-95 011	712	-86 950	- 20	- 88	139	-8 805
2002	-163 710	789	-124 711	- 81	- 353	134	-39 488
Period	Inflows						
	Total	Equity		Reinvested earnings		Intra-company loans	
		Financial industries	Other industries	Financial industries	Other industries	Financial industries	Other industries
1st quarter	34 072	244	21 353	322	316	- 4	11 842
2nd quarter	7 315	- 51	6 293	322	316	5	429
3rd quarter	4 423	80	5 920	322	316	- 3	-2 213
4th quarter	87 709	- 23	84 359	322	316	- 3	2 738
2002	133 520	250	117 925	1 289	1 264	- 5	12 796

Source: UNCTAD, based on data from BCL/STATEC.

Note: Up to 2001, data on FDI flows for the Belgium-Luxembourg Economic Union (BLEU) were reported by the National Bank of Belgium. Data on Luxembourg are not available separately before 2002.

Source: UNCTAD.

^a The Belgium-Luxembourg Economic Union, formed in 1921 primarily as a monetary union, came to an end in 2002, with the coming into force of the Euro as a common currency for several EU member countries (including Belgium and Luxembourg). Until 2002, only aggregate Union data had been reported and it is difficult to compare 2002 FDI flows for Luxembourg with those for previous years.

^b In a country's balance-of-payments statistics, all transactions between residents and non-residents are recorded (concept of residence, IMF 1993, paragraphs 57-58). This concept is not based on legal criteria or nationality but the transactor's centre of economic interest. In FDI statistics, as part of the financial account in the balance-of-payments statistics, transactions with the first foreign counterpart (as opposed to the ultimate beneficial owner, or debtor/creditor principle) are recorded. As a result, the initial source or the final destination of FDI flows might be different from the immediate partner to the transaction, in particular, in the case of special purpose entities (such as holding companies and regional HQ).

significantly (relative to the size of the country's inflows) in Greece and Austria (with the divestment of Telecom Italia). FDI inflows as a ratio of gross fixed capital formation in developed countries fell to 12 % on average, compared with 13% in 2001 (figure II.28). Inward FDI stock as a ratio of GDP reached on average 19%, compared with 18% in 2001 (annex table B.5 and B.6).

IPAs in the majority of developed countries faced difficulties in their efforts to attract FDI (UNCTAD 2003a). A majority of the IPAs reported cancellation or postponement of FDI projects, as well as divestment (45% of respondents) or a scaling down of planned projects (40%).

The 80% decline in inward FDI flows for the United States in 2002 accounted for 55% of the decline in developed countries with reduced inflows in 2002 (figure II.27). FDI from the EU into the United States plummeted, with fewer cross-border M&As:⁴⁹ major sources of FDI in the United States in 2002 were France, the United Kingdom, Japan and Australia, in that order (figure II.29). By industry, the largest declines in the United States were financial services (figure II.30) as well as computer-related services and chemicals. With the United States current account deficit at \$481 billion, the \$100 billion decline in inward FDI makes financing the balance-of-payments deficit more difficult.

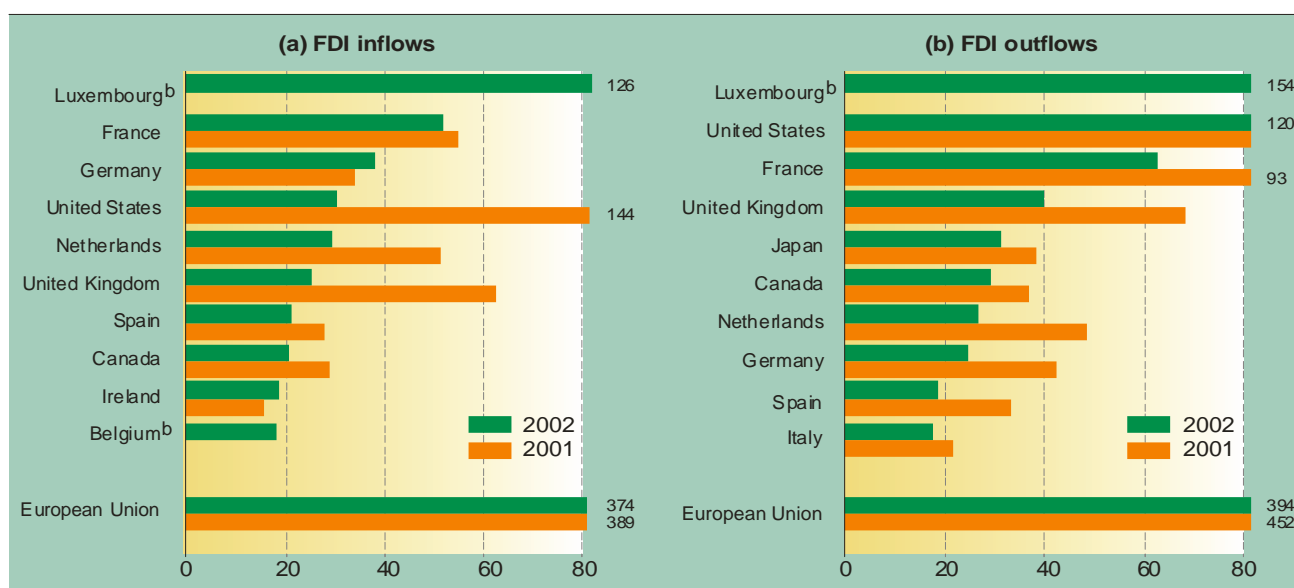
Inflows to the EU declined by 4%. But if Luxembourg's transshipped investment is excluded, inflows would decline by 30%. The decline in EU

flows stemmed, like that in the United States, largely from reasons related to the economic downturn and, in that context, the decline in cross-border M&As. In 2001, 49% of EU outflows remained within the EU; that share rose to 66% in 2002 (ECB 2003a).⁵⁰ The largest decline was in the United Kingdom (60%). Inflows increased in Luxembourg, Finland (mainly due to large transactions, such as the merger of Sonera (Finland) and Telia (Sweden)), Ireland (partly due to the acquisition of Jefferson Smurfit Group) and Germany (reflecting increased intra-company loans by foreign TNCs to their affiliates in Germany, as well as some large acquisitions, such as AOL (United States) acquiring additional stakes in AOL Europe) (annex table A.I.9). As economic activities have become more services-oriented in the EU, the services sector continues to attract a rising share of FDI flows to the EU (annex table A.I.4).

FDI inflows to other Western European countries also fell in 2002. Those to Norway declined dramatically, while inflows to Iceland and to Switzerland rose (in the latter, by 5% and as in the past, related mainly to services).

Flows into other developed countries were uneven. In Japan, FDI inflows increased (by 50%), mainly for the acquisition of Japanese financial companies by United States firms. Inflows from the EU almost doubled, mainly in automobiles and financial services. FDI inflows into Australia almost tripled—to a record high. Those to New Zealand were the lowest since the early 1980s, with large divestments by investors from the

Figure II.27. Developed countries: FDI flows, top 10 countries, 2001 and 2002 ^a
(Billions of dollars)

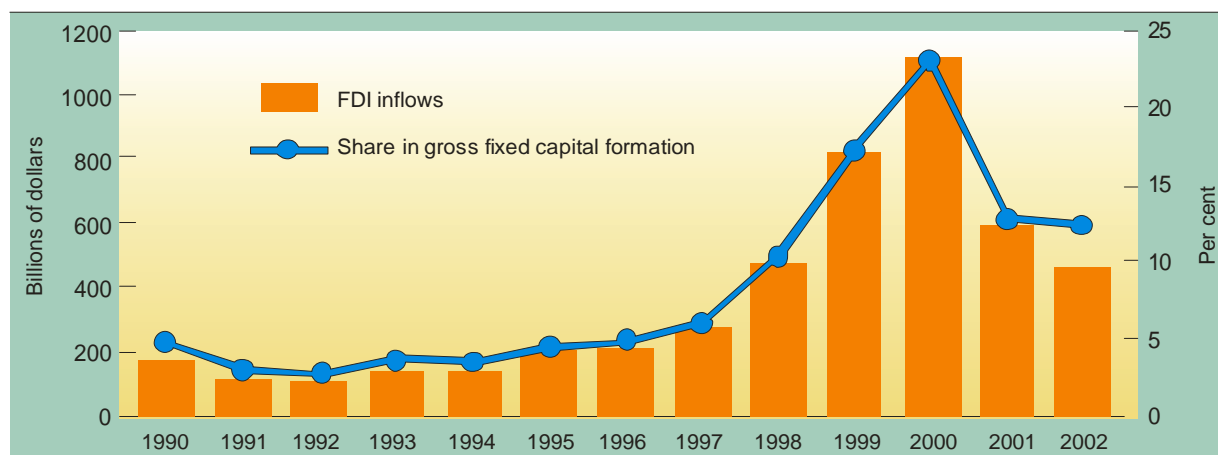


Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

^a Ranked on the basis of the magnitude of 2002 FDI flows.

^b In 2001, data for Belgium and Luxembourg are not separately available.

Figure II.28. Developed countries: FDI inflows and their share in gross fixed capital formation, 1990-2002



Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

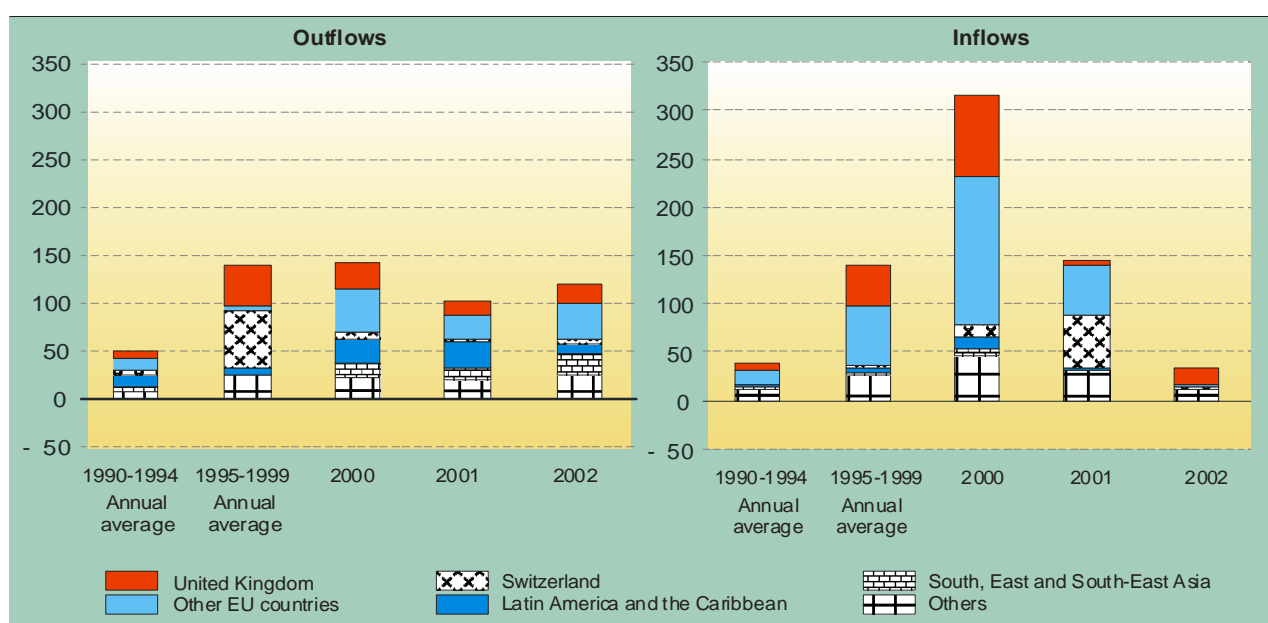
Note: The 2002 data for gross fixed capital formation are estimates.

Netherlands, the United Kingdom and the United States. And despite a decline in 2002 as compared with 2001, inflows to Canada were similar to those in 1998–1999.

An important aspect of the inward FDI performance of most of these countries was the uneven performance in cross-border M&As. The total value of cross-border M&As in the developed countries fell by 37% in 2002, from \$496 billion to \$311 billion (annex table B.7), with their number down from 4,482 to 3,234.⁵¹ As the M&A boom

came to a halt in 2000, cross-border equity flows fell, especially among developed countries. But inflows of equity investments to developed countries in 2002 were still above the 1996–1999 average. The decline in the value of cross-border M&As can be attributed, in part, to the reduction in investment abroad by TNCs for the reasons already mentioned. It can also be seen as a correction of the exceptional surge in M&As that paralleled high FDI flows into developed countries during 1999–2000.⁵²

Figure II.29. United States: FDI flows, by major partner, 1990-2002
(Billions of dollars)



Source: UNCTAD, FDI/TNC database, based on the United States Department of Commerce, Bureau of Economic Analysis (www.bea.doc.gov), data retrieved in June 2003.

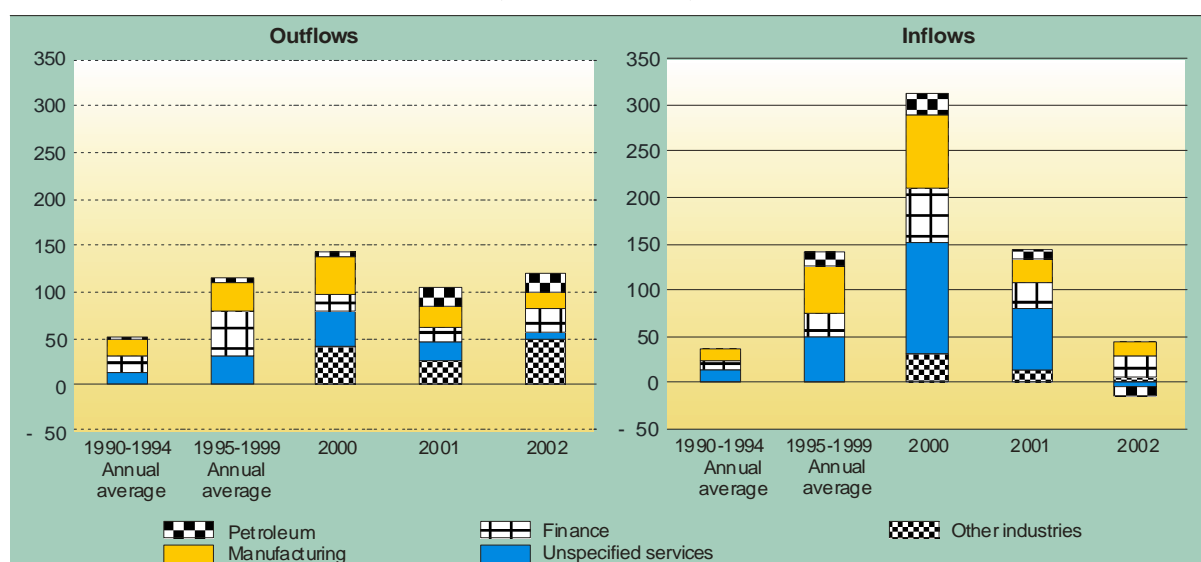
Cross-border M&As in utilities (electricity, gas and water) reached a record high in 2002, with the acquisition of Innogy Holdings (United Kingdom) by RWE (Germany) for \$7.4 billion and that of PowerGen (United Kingdom) by E.on (Germany) for another \$7.4 billion (annex table A.I.9). Several large companies reduced their activities in some fields while expanding operations in their core competencies. Aventis (France) sold its agrochemicals unit. Novartis (Switzerland) sold its food and beverage business to Associated British Foods. Cadbury Schweppes (United Kingdom) acquired Adams, a confectionary subsidiary of Pfizer (United States), and Squirt (Mexico). TNCs also strengthened their operations in more stable or growing markets (South-East Asia, CEE), to reduce costs or slow a decline in turnover. Deals of \$1 billion or more included the acquisitions by developed country firms of Daewoo Motor (Republic of Korea), Hyundai Merchant-Car Carrier (Republic of Korea), Pannon GSM (Hungary) and Transgas (Czech Republic) (annex table A.I.9).⁵³

FDI *outflows* from developed countries dropped by 9%, from \$661 billion to \$600 billion. Japan overtook Germany (box II.12) among the top home countries for FDI, ranking fifth after Luxembourg, the United States, France and the United Kingdom (figure II.27). Outflows from 8 out of 25 countries rose, with Norway, Sweden and Austria registering the largest increases. About one-

third of outflows from Austria—which almost tripled—went to the CEE. Outflows from the United States rose by about 15% in 2002; but outflows to developing countries fell by about one-fifth, particularly to Latin America (figure II.29). Companies from the United States have not invested much in the CEE. In contrast, EU companies were investing more in CEE and China, as were those from some other developed countries, such as Switzerland.⁵⁴ The Netherlands and Sweden increased their outflows to other EU members, with those from Sweden almost doubling, thanks in part to the Telia-Sonera transaction noted. Foreign affiliates of other developed country TNCs seeking access to the EU market were often located in the periphery (Ireland, Portugal and Spain) in the early 1990s, for tax reasons or lower labour costs (Barry 2003; Nunnenkamp 2001). But they were shifting to locations in countries scheduled to join the EU in 2004 (UNCTAD 2003c, see also section B of this chapter).⁵⁵

For other developed countries, there were few changes: for FDI outflows from Japan, the largest host country was again the United States, up by about 10% over the previous year. Flows to developing Asia also increased (by 8%), while those to the EU almost halved, mainly due to a decline of 80% in flows to the United Kingdom. Canada further diversified its outflows geographically. Companies from Australia and New

Figure II.30. United States: FDI flows, by major sector and industry, 1990-2002
(Billions of dollars)



Source: UNCTAD, FDI/TNC database, based on the United States Department of Commerce, Bureau of Economic Analysis (www.bea.doc.gov), data retrieved in June 2003.

Note: Data for average 1990-1994 and average 1995-1999 are not fully comparable to those for 2000-2002 as the coverage of industries/sectors are not the same. For 1990-1994 and 1995-1999, petroleum includes mining, quarrying and petroleum in the primary sector and coke, petroleum and nuclear fuel in the secondary sector; manufacturing covers the secondary sector except coke, petroleum and nuclear fuel; unspecified services relate to the tertiary sector except finance; and other industries include industries not specified elsewhere. In 2000-2002, petroleum refers to chemicals for inflows and mining, and for chemicals for outflows; manufacturing excludes chemicals; unspecified services include wholesale and retail trade, information, real estate, rental and leasing and professional, scientific, and technical services for inflows and utilities, wholesale trade, information, professional, scientific and technical services and other services for outflows; and other industries include industries not specified elsewhere.

Box II.12. What reverse flows mean for Germany's FDI statistics

Between April and June 2002, German FDI outflows were only €1.6 billion, compared with €36 billion in the same period the previous year. Part of this decline can be explained by the more cautious approach of German TNCs during the global economic slowdown. But the numbers also conceal important acquisitions of equity shareholdings by German companies abroad, amounting to €21 billion, largely offset by loans by German affiliates abroad to their parent companies in Germany (perhaps for the same reasons that foreign affiliates in the United States repaid loans to their European parent firms). These credit transactions, designated reverse flows, reduced Germany's outward FDI (box figure II.12.1).

The IMF recommends including cross-border financial loans and trade credits between affiliated enterprises under intra-company loans (or other capital). With loans classified according to the directional principle a German parent company granting a loan to its affiliate abroad increases German outward FDI. And a German parent receiving a loan by one of its affiliates abroad decreases German outward FDI, because it is considered a reverse flow. Not all countries have adopted this recommended principle.

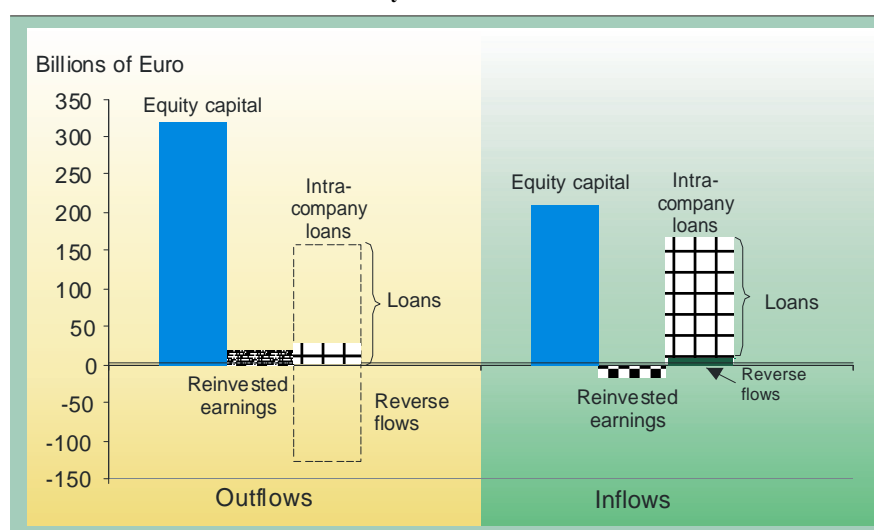
These loans can take different forms, such as funds raised from securities issued by German affiliates abroad on international financial markets

Source: UNCTAD, based on Deutsche Bundesbank, 2002.

and subsequently passed on to the parent firm in Germany. They also reflect different economic circumstances. From January 1996 (when Germany started to report FDI data according to the directional principle) until June 2002, reverse flows represented an important component of outward flows (€128 billion, as compared to equity capital of €318 billion). But their sudden significance in the first half of 2002 is striking (box figure II.12.1).

Aggregate FDI figures thus do not reflect the complexity of underlying economic transactions.

Box figure II.12.1. Germany: cumulative FDI flows, by component, January 1996-June 2002



Source: UNCTAD, based on Deutsche Bundesbank, 2002.

Note: Loans refer to credits from German investors (outflows) and credits to foreign investors in Germany (inflows). Reverse flows refer to net borrowing by German parent companies from their affiliates abroad (outflows) and foreign parents from their affiliates in Germany (inflows).

To assess the impacts on host and home economies, it is important to analyse each component of FDI and to apply uniformly the recommended standards for compiling FDI statistics.

Zealand continued to concentrate on investment in their subregion.

Most outward investment was in services.⁵⁶ Although outward FDI in skill-intensive manufacturing activities (automobiles, pharmaceuticals) was on the rise in several countries, it generally fell in manufacturing because of weak growth prospects and low profit margins. Exceptions include outflows from Austria and Norway.

2. Policy developments—continuing liberalization

Developed countries have been liberalizing their FDI rules and concluding bilateral and regional agreements since the 1950s. In a flurry of such activity 12 developed countries made changes to their FDI regimes in 2001 and 19 did so in 2002, with 45 regulatory changes in 2002 alone. More than 95% of the new national policy

measures were more favourable to FDI. They involved tax incentives (as in Belgium, Canada and Ireland), guarantees (as in Belgium, Ireland and New Zealand), the removal or relaxation of restrictions on entry (as in Japan and Norway) and the establishment of IPAs or one-stop information centres (as in the Netherlands and Portugal).

The proliferation of BITs and DTTs continued, with 1,169 BITs (49 BITs per country on average) and 1,663 DTTs (64 DTTs per country on average) concluded by the end of 2002, a year in which developed countries signed 44 BITs and 42 DTTs (figure II.31). Primary partners for both types of treaties were countries in Asia and the Pacific, followed by CEE for BITs and the EU countries for DTTs. Bilateral and regional instruments involving investment-related provisions also increased, with the largest number concluded by EU countries, followed by the United States and Canada. The EU countries have shown a preference for entering into agreements with CEE and Mediterranean countries (figure II.32), and the United States for doing so with African and Asian ones (figure II.33). Japan is a late starter, with an agreement with Singapore in 2003—its only FTA so far—covering trade, FDI and other economic matters (box III.2). Japan is also negotiating with Malaysia, Mexico, the Philippines and Thailand, and negotiations with the Republic of Korea may start in 2003 (figure II.11). Almost all of these agreements cover the principal issues normally contained in international investment agreements.

IPAs in developed countries increased their promotion efforts, with targeting among the most frequent policy responses, according to UNCTAD's IPA survey. Remarkably, none of the agencies suggested that they offered additional incentives,

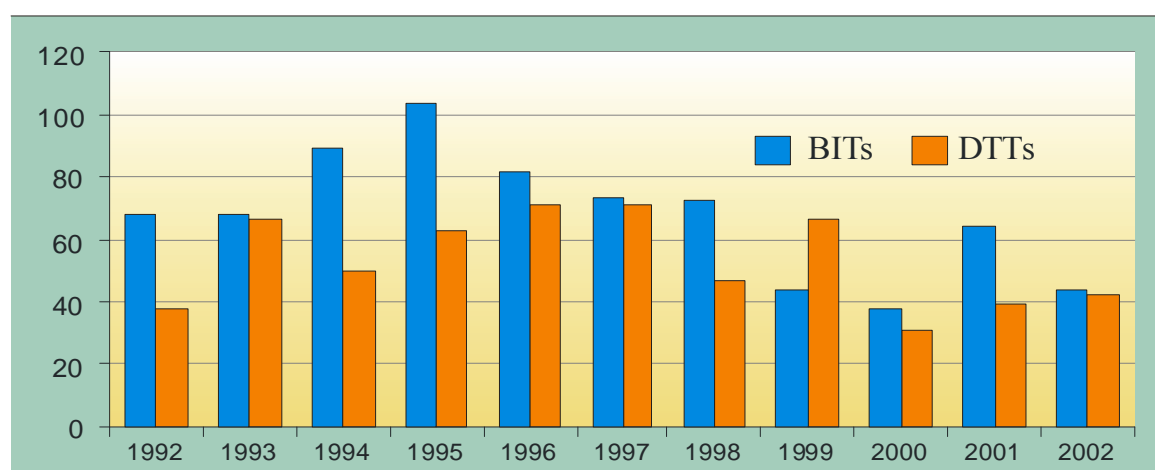
unlike developing countries many of which increased their incentive packages. Japan launched a most comprehensive programme in April 2003 to double the stock of inward FDI in five years (box II.13).

3. Prospects—hinging on economic recovery

UNCTAD expects FDI inflows to increase in some countries in 2003, but the developed countries as a group are not likely to exceed their performance in 2002, even though several surveys expect FDI to recover in 2003 (World Bank 2003a; EIU 2003a).⁵⁷ What will happen depends on the economic recovery, especially in developed countries, and on the success of efforts to strengthen investors' confidence. Low profitability, falling equity prices, concerns about corporate debt and cautious commercial bank lending (as well as investors' evaluation of future demand growth) might all dampen prospects for increased FDI (UNDESA and UNCTAD 2003; World Bank 2003a). To weather adverse conditions, TNCs are continuing to restructure, concentrate on core competencies, relocate to lower-cost locations and tap emerging markets. That will reduce investment in some markets and increase it in others.

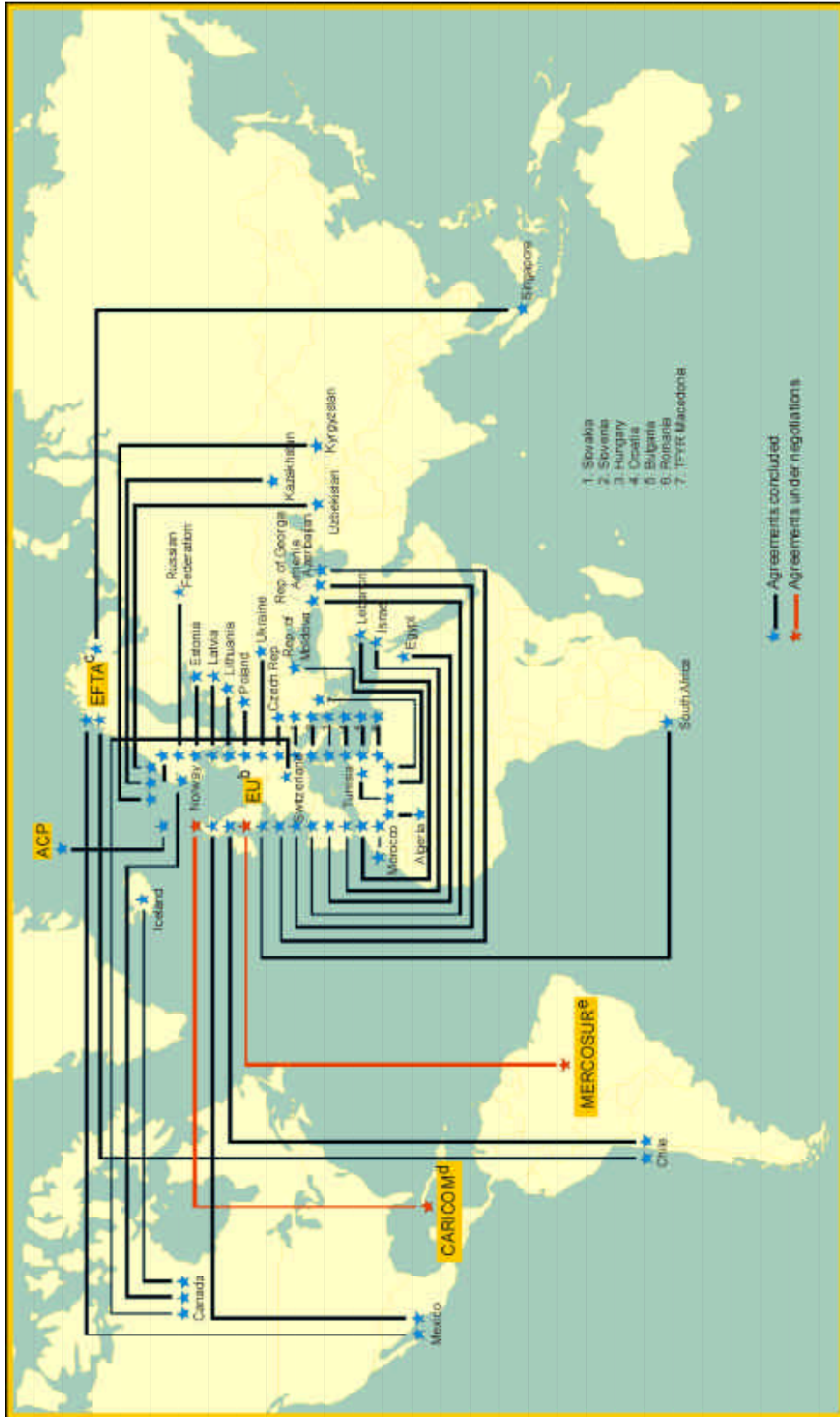
For the EU and the United States, prospects for economic growth continue to be modest in 2003. Germany and Japan—both with higher FDI inflows in 2002—have declined in attractiveness, according to some surveys (IMD 2003; AT Kearney 2002). In Japan, Citigroup and other foreign financial companies plan large divestments in 2003.⁵⁸ In Switzerland—which expects little GDP growth in 2003 and only about 1% in 2004—a

Figure II.31. Developed countries: BITs and DTTs concluded, 1992-2002
(Number)



Source: UNCTAD, databases on BITs and DTTs.

Figure II.32. Western Europe: selected bilateral, regional and interregional agreements containing FDI provisions, concluded or under negotiation, 2003^a



Source: UNCTAD.

^a BITs and DTTs are not included.

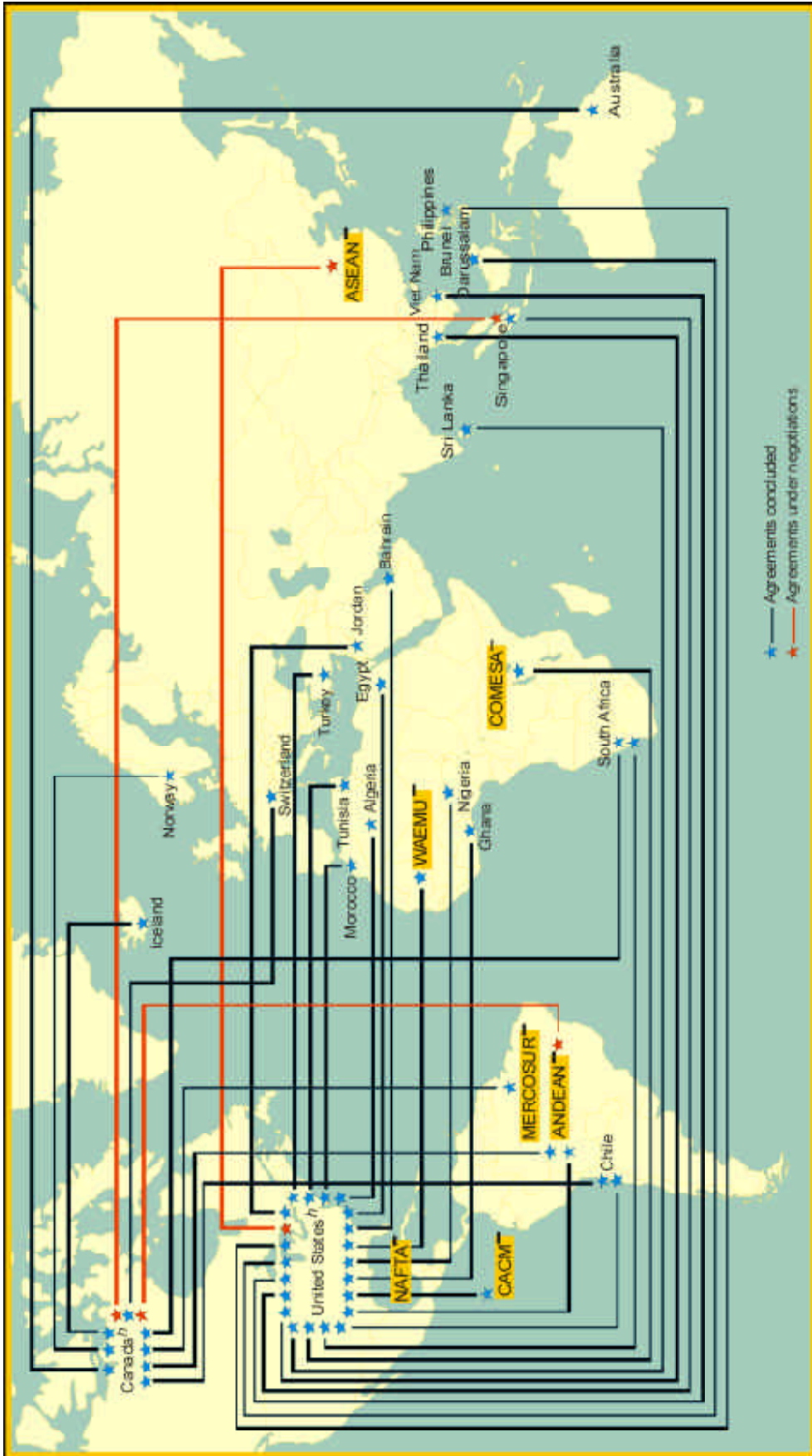
^b European Union (EU): Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and United Kingdom.

^c European Free Trade Association (EFTA): Iceland, Liechtenstein, Norway and Switzerland.

^d Caribbean Community (CARICOM): Antigua&Barbuda, Barbados, Jamaica, St. Kitts and Nevis, Trinidad and Tobago, Belize, Dominica, Grenada, Montserrat, St Lucia, Guyana, Haiti, Suriname, St. Vincent and the Grenadines and Bahamas.

^e Southern Common Market (Mercosur): Argentina, Brazil, Paraguay and Uruguay.

Figure II.33. Canada and the United States: selected bilateral, regional and interregional agreements containing FDI provisions, concluded or under negotiation, 2003^a



Source: UNCTAD.

- a BITs and DTTs are not included.
- b North American Free Trade Agreement (NAFTA): Canada, Mexico and the United States.
- c Central American Common Market (CACM): El Salvador, Guatemala, Honduras, Nicaragua and Costa Rica.
- d Southern Common Market (Mercosur): Argentina, Brazil, Paraguay and Uruguay.
- e West African Economic and Monetary Union (WAEMU), its member States are currently: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.
- f Treaty Establishing the Common Market for Eastern and Southern Africa (COMESA) comprises Angola, Botswana, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Seychelles, Somalia, Swaziland, United Republic of Tanzania, Uganda, Zambia, Zimbabwe.
- g Asean Free Trade Area (AFTA) and ASEAN Investment Area: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam.
- h Canada is negotiating agreements with CARICOM; the Dominican Republic; the Central American countries and Singapore. Similarly, the United States is negotiating agreements with Australia, Mexico and Uruguay.
- i ANDEAN community: Bolivia, Columbia, Ecuador, Peru and Venezuela.

recent FDI survey expected a further slowdown of FDI in manufacturing in 2003 and a moderate increase in FDI in services (KOF 2003). So the likelihood of developed countries attracting more FDI in 2003 is low.

TNCs from the developed countries will continue to invest in EU-accession countries. They might also pay more attention to growing and lower-cost markets, such as other CEE countries, Central Asian countries and some developing economies, similar to the 1980s when countries at the EU periphery joined the Common Market. Services requiring large investments (telecom, media, banking and so on) are expected to account for a significant share of the EU's FDI in these regions. Automobile manufacturing, computer-related activities, medical devices and biotechnology are likely to remain important recipients.

Cross-border M&As continue to be important, but there are signs of a shift towards greenfield projects.⁵⁹ The value of cross-border M&As in the United States in the first half of 2003 was slightly above that in the first half of 2002 (by 3%). This suggests that TNCs continue to follow more cautious growth strategies, with declining profits and less financing available for additional M&As, and expansion might remain limited. But

there are exceptions.⁶⁰ In the pharmaceutical industry, while the value of deals is expected to remain low (risk aversion to mega deals), the number of transactions is expected to remain high, supported partly by pressure for consolidation in the European biotech industry and accelerated consolidation in Asia (PwC 2003b). Several (mainly smaller) deals are expected in medical devices, motivated by strategic considerations.⁶¹

Developed country IPAs see prospects in their region as rather bright for 2003-2004, but they are much more cautious than their counterparts from developing regions. About 45% expect FDI for their region to improve in 2003-2004 (63% in developing countries), while only 15% forecast a deterioration and 40% expect no change. Optimism rises for the longer term, with 58% of respondents expecting an improvement in 2004-2005 (93% in developing countries) (figure II.34).

Corroborating these findings is a survey of German firms by the Deutsche Industrie- und Handelskammertag (DIHK 2003).⁶² About a quarter of investors from Germany plan to continue investing abroad in 2003-2005—while about 15% plan divestments. The survey revealed that the main motives for planned outward FDI in 2003-2005 were high costs of skilled labour (45%) and high taxes (37%) in Germany. Planned investments

Box II.13. Measures to promote inward FDI in Japan

In his general policy speech on 31 January 2003, the Prime Minister of Japan^a announced the country's goal to increase FDI through 74 measures in five specific areas: disseminating information, improving the business environment, reforming the administration, improving employment and living conditions, and upgrading national and local government support systems. The measures include (Japan Investment Council 2003):

- Conducting economic research to analyze the benefits of FDI for Japan and the perceived obstacles to inward FDI.
- Examining the possibility of financing cross-border M&As through the exchange of stock.
- Establishing a "one-stop" information centre in JETRO to serve as the focal point for foreign companies intending to invest in Japan, providing a variety of information relating to FDI in Japan (e. g. about the

investment climate, laws and regulations). This initiative is based on (and reinforces) existing measures such as the portal site of the Investment in Japan Information Centre (IJIC)^b and JIC.

- Improving the quality of technology-oriented university graduate business schools and professional business schools—to improve management, technology and language skills.
- Supporting regional activities to attract TNCs in five local areas.

National authorities implementing these measures include the Office of the Prime Minister's Cabinet, JETRO, the Ministry of Economy, Trade and Industry and the Ministry of Finance. The Expert Committee of Japan Investment Council will monitor the implementation, provide periodic reports and conduct further policy planning.

Source: UNCTAD, based on Japan, Ministry of Economy, Trade and Industry (www.meti.go.jp); JETRO (www.jetro.go.jp); JIC (www5.cao.go.jp); and Investment in Japan Information Centre (www.investment-japan.net).

^a "Foreign direct investment in Japan will bring new technology and innovative management methods, and will also lead to greater employment opportunities...We will take measures to present Japan as an attractive destination for foreign firms in the aim of doubling the cumulative amount of investment in five years", General Policy Speech by Prime Minister Junichiro Koizumi to the 156th Session of the Diet, 31 January 2003 (http://www.kantei.go.jp/foreign/koizumispeech/2003/01/31sisei_e.html).

^b IJIC was established in July 2000 to provide support to potential investors, mainly through information on business opportunities and legal issues.

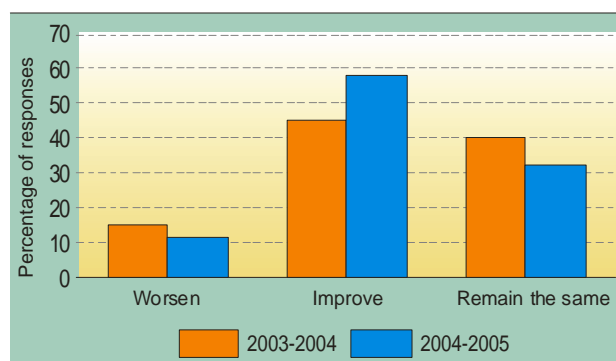
mainly include manufacturing projects but increasingly extend to the services sector (such as R&D and administrative and HQ functions). Preferred locations include the accession countries in CEE, but also the EU and some Asian economies, particularly China.

UNCTAD's IPA survey suggests that the United States will be the most important source of FDI during 2003–2005, followed at a distance by Germany, France, Japan and the United Kingdom. IPAs expect that FDI will be distributed fairly evenly across all economic sectors—but pharmaceuticals and chemicals (including biotechnology) and services (particularly telecom) are expected to receive more attention from investors.

Notes

- 1 For an analysis of the links between regional integration schemes (including trade agreements) and FDI, see *WIR98*, pp. 117–125; UN-TCMD 1993, pp. 8–14. They have been described as being part of the “new regionalism”; see Ethier 2001; Iglesias 2002; Eden and Li 2003. See also chapter III.
- 2 For the definition of LDCs see UNCTAD 2002b. For profiles of each LDC regarding FDI, see UNCTAD 2003b.
- 3 “U.S.–African trade profile”, United States Department of Commerce (www.agoa.gov), March 2003.
- 4 Both MTN and Vodacom SA have non-South African shareholders.
- 5 EIU's country profile of the United Republic of Tanzania (*source*: www.db.eiu.com/report_full.asp).
- 6 Information from ORASCOM press release, dated 24 September 2002 (www.orascomtelecom.com/docs/news/press.asp).
- 7 Information from the UNCTAD database on changes in national laws.
- 8 As of April 2003, African countries eligible for preferential treatment under AGOA were: Benin, Botswana, Cameroon, Cape Verde, Central African Republic, Chad, Republic of Congo, Côte d'Ivoire, Democratic Republic of Congo, Djibouti, Eritrea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, São Tomé and Príncipe, Senegal, Seychelles, Sierra Leone, South Africa, Swaziland, Uganda, the United Republic of Tanzania and Zambia.
- 9 Caribbean countries, in particular, enjoy cheaper transport costs.
- 10 NEPAD was concluded in 2001 by African leaders as a vision to extricate the region from the malaise of underdevelopment and exclusion in a globalizing world.
- 11 EIU Country Profiles (http://db.eiu.com/report_full.asp).
- 12 Data from *allAfrica* (www.allafrica.com) and the *Financial Express*.
- 13 Information from EIU's *Country Profiles* of Botswana, Kenya, Lesotho, Mozambique, Namibia, South Africa and Uganda (http://db.eiu.com/report_full.asp).
- 14 During 2003–2008, the European Investment Bank is expected to channel €3.9 billion to ACP projects

Figure II.34. Developed countries: FDI prospects,^a 2003–2005
(Per cent)



Source: UNCTAD.

^a The survey question was: “How do you perceive the prospects for FDI inflows to your country in the short- and medium-term, as compared to the last two years (2001–2002)?”.

- 15 that promote business or to public sector projects operated on a private sector footing. (€1.7 billion will be from the Bank's own resources and €2.2 billion from a new investment facility.) These funds are provided by EU member States to encourage private sector development (in particular SMEs), support the local savings markets and facilitate FDI.
- 16 Based on eight countries that reported the three FDI components.
- 17 Comprising China, Democratic People's Republic of Korea, Hong Kong (China), Macau (China), Mongolia, the Republic of Korea and Taiwan Province of China.
- 18 India has revised its FDI data (see box II.4). The new data were released on 30 June 2003, after the closing of the data collection for *WIR03*.
- 19 In 2001 FDI from Hong Kong (China), Macau (China), Singapore and Taiwan Province of China accounted for about 47% of the total FDI flows to China. Part of this investment, however, is by foreign affiliates in these economies, especially in the cases of Hong Kong (China) and Singapore.
- 20 The tertiary sector accounted for about 99% of the total FDI flows to Hong Kong (China) in 2000 and 2001.
- 21 Repayments of intra-company loans by Asian affiliates in some countries exceeded disbursements of intra-company loans from parent companies to their Asian affiliates.
- 22 Many TNCs now seem to be making good profits in China, and a few companies have turned to their foreign affiliates in China to support parent companies that have hit hard times (“Made in China, bought in China: multinational inroads”, *The New York Times*, 5 January 2003).
- 23 In China, Hong Kong (China), Malaysia and Singapore, reinvested earnings accounted for more than a third of the value of FDI flows in 1999–2002 (annex table A.II.1).
- 24 A JETRO survey of 1,519 Japanese manufacturers in Asia in 2002 indicated that 71% of the firms expected to post an operating profit in 2002 (up two percentage points from the previous survey by JETRO) (JETRO 2003b) and 51% expected 2002 profits to improve over 2001 (23% expected no change). Samsung saw its profits in China soar to 70% in 2001 to \$228 million, after years of making

- losses operating there (“How Samsung plugged into China: it’s finally making gains by selling high-end products”, *Business Week*, 4 March 2002 (http://www.businessweek.com/magazine/content/02_09/b3772138.htm).
- 24 See UNCTAD press release on “China: an emerging home country for TNCs”, 2003.
- 25 Economies affected by SARS (such as China and Hong Kong (China)) may have declining FDI flows in 2003—as investments are postponed—contributing to a weaker regional FDI inflows performance. The ASEAN region will also be affected, but to a lesser extent.
- 26 Based on real GDP growth as reported in IMF 2003a.
- 27 See “Global firms scramble for Iraq work”, *BBC News*, 12 June 2003 (<http://www.bbc.co.uk/2/hi/business/2983054.stm>).
- 28 The World Bank (2003a, p.101) forecast that FDI flows to Asia and the Pacific will increase marginally in 2003.
- 29 Half the \$45 billion in external debt owed by companies in Argentina is estimated to belong to foreign affiliates (ECLAC 2003).
- 30 Data from INEGI (www.inegi.gob.mx).
- 31 Data from INEGI (www.inegi.gob.mx).
- 32 EIU, *Business Latin America*, 24 February 2003.
- 33 EIU, *Business Latin America*, 24 March 2003.
- 34 In fact, some foreign affiliates established to serve local or regional markets had to start exporting to other markets to pay off their loans in Brazil. Managers at Ford, General Motors and Volkswagen expressed this view in interviews conducted by Mariano Laplane.
- 35 World Bank and EIU studies forecast a slight decrease in FDI flows for 2003, with a slow recovery afterwards (World Bank 2003a; EIU 2003a).
- 36 For example, for Flextronics, the existence of R&D in Austria and Germany makes sense only if complemented by some manufacturing operations in CEE (especially Hungary and to some degree in Poland); if production were to move to other continents, so would R&D (Figyelö 2002).
- 37 The gas utility Transgas (Czech Republic) was sold to RWE (Germany); the gas utility Slovensky Plynarensky Priemysel (Slovakia) to Gazprom (Russian Federation), Ruhrgas (Germany) and Gaz de France (France); KPN’s (Netherlands), Sonera’s (Finland) and Tele Danmark’s (Denmark) shares in mobile telecom provider Pannon GSM (Hungary) were taken over by Telenor (Norway); the pharmaceutical firm Lek (Slovenia) was acquired by Novartis (Switzerland); the bank Ceska Sporitelna (Czech Republic) by Erste Bank (Austria); the informatics firm GTS Central Europe (Poland) was taken over by KPN (Netherlands); the Kredyt Bank (Poland) was sold to KBC Bank (Netherlands); Zagrebacka Banka (Croatia) to UniCredito Italiano (Italy) and Allianz (Germany); the beer producer Bravo International (Russian Federation) to Heineken (Netherlands) and the Nova Ljubljanska Banka (Slovenia) to KBC Bank (Belgium).
- 38 This is why the cross-border M&A sales of Hungary in 2002 were significantly higher than FDI inflows. For a discussion of the data on cross-border M&As and its correspondence with FDI flows, see *WIR00*, pp. 105-106.
- 39 Automotive Lightning, Federal Mogul, F.X. Meiller, HP Pelzer, Rieter, Ronal, SAI Automotive, TI Automotive, Toyota Gosei and VDO.
- 40 Data on FDI projects are from OCO Consulting.
- 41 According to data on FDI projects collected by OCO Consulting.
- 42 According to a survey carried out by OCO Consulting among investors.
- 43 After accession in 2004 new EU member countries will be entitled to 25% of the Common Agricultural Policy funds and 30% of the regional development funds available to current EU members. Subsequently, those shares will increase by 10% per annum till they reach the level of 100% around 2014.
- 44 The basic idea of the “flying-geese” paradigm, developed for the case of TNC-led growth by K. Kojima (1973), is that, as host countries industrialize and go through industrial upgrading and learning in an open-economy context, the type of FDI flowing from home countries changes in character towards higher skills; in turn, simpler activities will gradually flow out from relatively advanced host countries to newcomer host countries. This process reinforces the basis for, and the benefits from, trade. For a detailed discussion, see *WIR95*, pp. 258-260.
- 45 This estimate is higher than that of the World Bank, which forecast FDI inflows of \$30 billion for its “Europe and Central Asia” region that includes CEE and Turkey (World Bank 2003a, p. 101).
- 46 The decline could be as large as 39% (an estimated \$230 billion) if transshipped investment to and from Luxembourg are excluded. The term “transshipped investment” is used here to refer to investment in foreign affiliates in Luxembourg that subsequently invest abroad. For details, see box II.11.
- 47 Intra-company loans are one of the three components of FDI, as recommended by international guidelines, consisting of short- and long-term loans and trade credits between affiliated enterprises, as well as financial leasing (IMF 1993).
- 48 Data for Belgium and Luxembourg before 2002 are not separately available.
- 49 In 2001 about 95% of FDI inflows to the United States were from the EU and Switzerland. The value of cross-border M&As by EU companies in the United States declined by 52% in 2002 (UNCTAD, cross-border M&A database; see also chapter I).
- 50 However, in some countries, the share of intra-EU inflows declined: in Sweden from 80% in 2001 to 66% in 2002, in Denmark from 60% to 38% and in Ireland from 99% to 95%.
- 51 UNCTAD, cross-border M&A database.
- 52 For conceptual issues related to cross-border M&As and their valuation in FDI statistics, see *WIR00*.
- 53 See footnote 37 for the largest M&A sales of CEE. For motivations of M&As, see *WIR00*.
- 54 For example, the acquisition by Novartis (Switzerland) of Lek (Slovenia) for \$0.9 billion was among the largest cross-border M&As undertaken in the CEE region in 2002.
- 55 Because “EU enlargement is not a zero sum game in which the new member states will compete against current incumbents for a fixed pool of FDI” (Barry 2003, p.189), it remains to be seen how much current EU members have to fear a deviation of FDI towards the accession countries.
- 56 More than a third of the cross-border provision of services is undertaken through the establishment of foreign affiliates in the host economy (mode three of the GATS classification, accounting for a share of about 38% of total services delivered by the four modes of supply described in GATS (WTO 1995; Karsenty 1999). In major host developed countries, turnover in services by foreign affiliates accounted

for between 9% and 30% of the national total (UNCTAD, FDI/TNC database).

⁵⁷ During the first quarter, or the first four months of 2003, inflows for two of the top five FDI recipients (in 2002), the Netherlands and the United States, increased by 122%, and 200%, respectively, over the same period of 2002. On the other hand, FDI inflows during January-April to France declined by 26%, to Germany by 61% and to Japan by 37%.

⁵⁸ *Nihon Keizai Shimbun*, 16 March 2003.

⁵⁹ Participants in UNCTAD's IPA survey expect greenfield investment to play an important role as a mode for FDI.

⁶⁰ Announcements include, for example, the acquisitions of Wella (Germany) by Procter & Gamble (United

States) for \$6.1 billion, Sunoco's plasticizer business in Neville Islands (United States) by BASF (Germany) for an undisclosed amount and Alstom's (France) industrial turbines business by Siemens (Germany) for \$1.2 billion.

⁶¹ Recent examples are the offers by Zimmer (United States) and Smith & Nephew (United Kingdom) for the Swiss medical devices company Centerpulse (formerly Sulzer Medica): both companies have made an offer in the range of \$3 billion ("Ein schön inszeniertes Theater", *Neue Züricher Zeitung*, 25 May 2003).

⁶² The survey, carried out in January 2003, covered about 10,000 German companies, mainly in manufacturing.