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2005 Transnational Corporations and the Internationalization of R&D

CHAPTER I

GLOBAL TRENDS: FDI FLOWS RESUME GROWTH

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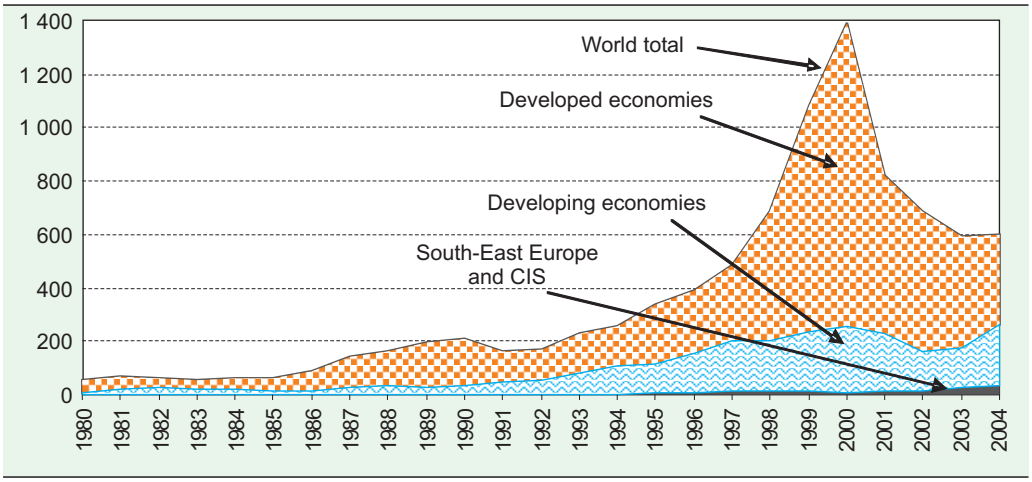
A. Signs of recovery

Global FDI inflows rose modestly in 2004 following large declines in their value in 2001 (41%), 2002 (13%) and 2003 (12%). At $648 billion in 2004, they were 2% higher than in 2003. This growth reflected increased flows to developing countries as well as to South-East Europe and the Commonwealth of Independent States (CIS) (figure I.1), which more than offset the decline (for the fourth year in a row) in flows to developed countries. The difference between inflows to developed countries and developing countries shrank to $147 billion – a significant narrowing of the gap compared with previous years.[1] The United States was the largest recipient in 2004, ahead of the United Kingdom and China as well as Luxembourg,[2] the top FDI recipients in 2003.

Cross-border mergers and acquisitions (M&As) – key modes of global FDI since the late 1980s – started to pick up in 2004 following three years of decline. Greenfield FDI continued to rise for a third consecutive year, strengthening the likelihood of a reversal of the global downward trend in flows. Data on the financing components of FDI show that the overall magnitude and trends of FDI in both developed and developing countries are determined to a significant extent by equity investment. However, fluctuations in other components can occasionally influence annual FDI flows to individual countries as in the case of Germany in 2004. The degree of transnationality – a measure of the relative economic importance of foreign affiliates in total economic activity – continued to rise for host economies as international production maintained growth.

Figure I.1. FDI inflows, global and by groups of economies, 1980-2004
(Billions of dollars)



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

1. Overall analysis

a. FDI inflows and outflows

Global inflows of FDI rose in 2004 for the first time in four years. Notwithstanding statistical problems in FDI data collection and reporting that make comparisons of FDI between countries and regions difficult (box I.1), a number of observations can be made regarding FDI flows by region and sector.

Developed countries – a category now defined to include also the 10 new European Union (EU) countries (box I.2) – saw FDI inflows

Box I.1. Problems with FDI data

The analysis of FDI trends in Part One of *WIR* is largely based on FDI flow data collected from national balance-of-payments statistics. Values of FDI flows in national currencies are converted to United States dollars to calculate global FDI flows and compare FDI inflows to and outflows from different countries and country groups. Balance-of-payments data on FDI flows[a] are available for most countries for many years with a short time lag.[b] But there are some problems with these data that have to be kept in mind when interpreting them. Many countries still deviate one way or another from the recommendations of the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) in their collection, definition and reporting of FDI data (IMF/OECD 2004).

FDI is an investment involving a lasting interest by a home-economy entity in an enterprise in a host economy. For data collection purposes, FDI has been defined as involving an equity stake of 10% or more in a foreign enterprise. FDI has three components: equity capital, intra-company loans and reinvested earnings. Different countries have different recording practices relating to these three components. Some countries deviate from the suggested 10% threshold value for foreign equity ownership. Most countries report long-term intra-company loans, but not all countries record short-term loans and trade credits (annex B, Definitions and sources). Some countries are still not able to report reinvested earnings, as the data are not easily available from company reports or balance-of-payments surveys; those that report often do so with a considerable time lag. Out of 34 developed economies, only Greece did not report reinvested earnings at all in 2003, and 78% of developing countries reported such data that year.

Differences in how countries measure and report FDI complicate the interpretation of FDI trends for the following reasons:

- Bilateral discrepancies between FDI flows as reported by home and host countries can be quite large. The following table on FDI flows to China as reported by China (the host) and by a number of the investing (home) countries highlights this problem (box table I.1.1). Thus global FDI inflows and outflows differ. In 2004 for example, global FDI outflows were 13% higher than global FDI inflows. This imbalance is due to various factors such as: different methods of data collection by host and home countries, different data coverage of FDI (i.e. all three components of FDI may not be included), different time periods used for recording FDI transactions, and different

Box table I.1.1. FDI flows to China as reported by China and by the investing economy
(Millions of dollars)

Economy	2000		2001		2002	
	As reported by China	As reported by investing economy	As reported by China	As reported by investing country	As reported by China	As reported by investing economy
France	853	324	533	166	576	563
Germany	1 041	819	1 213	976	928	887
Hong Kong, China	15 500	46 361	16 717	8 496	17 861	15 938
Japan	2 916	937	4 348	2 161	4 190	2 608
Malaysia	203	40	263	82	368	81
Netherlands	790	56	776	388	572	156
Thailand	204	9	194	11	188	16
United Kingdom	1 164	620	1 052	953	896	1 135
United States	4 384	1 817	4 433	1 912	5 424	924

Source: UNCTAD FDI/TNC database (www.unctad.org/fdistatistics).

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Box I.1. Problems with FDI data (concluded)

treatment of round-trip investments and of FDI in special-purpose entities.

- As recording practices change over time, time series data on FDI flows have structural breaks. For example, Japanese data on FDI flows started to include reinvested earnings (in addition to the other components) only in 1996, the same year German FDI flows began to cover short-term, intra-company loans.

Furthermore, to facilitate a comparative analysis of worldwide FDI, data on flows in various currencies are converted into a single currency, the United States dollar, and growth rates of dollar-denominated FDI flows may diverge from growth rates of FDI flows in national currencies.[c] In 2004 for instance, the United States dollar depreciated against most currencies of the developed countries. Therefore the 9% decline in the dollar value of FDI inflows into developed countries using constant exchange rates was smaller than the decline in FDI inflows calculated with current exchange rates. Similarly, as FDI flows are expressed in nominal or current prices of a country, the conversion of these flows into constant prices yields different results (box table I.1.2).

Box table I.1.2. FDI inflows to developed countries in various prices, 1980-2004
(Billions of dollars and per cent)

Year	In current exchange rates and prices[a]	Percentage change	In constant exchange rates[b]	Percentage change	In real prices [c]	Percentage change
1980	46.6	39.0	55.8	81.1	46.4	13.3
1981	45.9	-1.6	49.9	-10.7	45.3	-2.3
1982	31.8	-30.6	30.9	-38.0	32.6	-28.1
1983	32.9	3.6	30.6	-1.1	35.1	7.8
1984	40.6	23.2	35.5	16.1	44.0	25.1
1985	42.5	4.6	35.9	1.1	46.7	6.3
1986	70.1	65.0	70.5	96.4	75.6	61.9
1987	115.6	64.9	129.1	83.1	113.8	50.6
1988	133.6	15.6	158.5	22.7	125.7	10.4
1989	163.3	22.2	187.5	18.3	151.4	20.5
1990	172.1	5.4	206.4	10.1	146.8	-3.1
1991	117.1	-32.0	141.2	-31.6	101.6	-30.8
1992	112.6	-3.9	138.9	-1.6	101.6	0.0
1993	144.0	27.9	171.8	23.7	138.6	36.4
1994	151.8	5.4	183.5	6.8	142.3	2.7
1995	218.7	44.1	273.5	49.1	186.3	30.9
1996	234.9	7.4	281.7	3.0	203.2	9.0
1997	284.0	20.9	317.3	12.6	261.8	28.8
1998	503.9	77.4	525.6	65.7	491.6	87.8
1999	849.1	68.5	891.1	69.5	844.8	71.9
2000	1 134.3	33.6	1 134.3	27.3	1 134.3	34.3
2001	596.3	-47.4	555.1	-51.1	618.6	-45.5
2002	547.8	-8.1	512.0	-7.8	568.2	-8.1
2003	442.2	-19.3	451.1	-11.9	416.0	-26.8
2004	380.0	-14.1	410.3	-9.0	331.4	-20.3

Source: UNCTAD.

[a] FDI inflows to developed countries calculated by converting FDI inflows in national currencies and in current prices into dollar values on the basis of the annual average exchange rate of the respective currencies against the dollar.

[b] Calculated by using the real effective exchange rate of the United States dollar (base year 2000).

[c] FDI inflows to developed countries calculated by using the import price indices of industrialized countries with 2000 as the base year (as reported by the IMF), as a proxy for constant prices.

Source: UNCTAD.

[a] The IMF's *Balance of Payments Manual* (fifth edition, 1993) and the *OECD Benchmark Definition of Foreign Direct Investment* (third edition, 1995) provide agreed guidelines for compiling FDI flows. Both of them are now being revised. New methodologies and definitions of FDI are scheduled to be released in 2008.

[b] In the case of FDI stock, reliable data are available for considerably fewer countries because they are normally based on company surveys.

[c] For example, if the currency of country A devalues by 10% against the dollar while FDI inflows in national currency are constant, then FDI inflows into country A expressed in dollar terms would drop by 10%.

fall by another 14% (to $380 billion) in 2004, despite economic recovery in many countries and subregions, returning investor confidence and improved corporate earnings (chapter II). After the significant fall of 2001-2003, the further decline brought FDI inflows to developed countries to just 30% of their peak level of $1.1 trillion in 2000. The decline was particularly marked in the EU, where FDI fell by 36% to reach its lowest level since 1996. This decline was concentrated in a few members. Denmark, Germany, the Netherlands and Sweden alone accounted for 86% of the total decline that was spread over 10 countries. Other developed countries in Western Europe (particularly Norway, Switzerland) also experienced a fall (of

Box I.2. Changes in geographical groupings used in *WIR05*

Major changes in the classification of groups of economies have been introduced in the *World Investment Report* beginning this year following the reclassification of some countries by the United Nations Statistical Office (UNSO). The EU now has 25 members, including the 10 countries that became new members on 1 May 2004. Eight countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) have been reclassified from Central and Eastern Europe (CEE) to EU, and Cyprus from West Asia to EU. Malta has now been reclassified from "other developed countries" to EU. These ten countries are now included among the "developed countries". All references to the EU in *WIR05* refer to the new classification (i.e. the EU following the accession of the new members); growth rates have been calculated on the basis of adjusted series unless stated otherwise. For the purpose of analysis in *WIR05*, EU-15 refers to the group of countries that were members of the EU before 2004 and EU-10 to the 10 new EU members.

After the reclassification of the eight EU-accession countries as developed countries instead of CEE, the rest of the CEE countries, along with countries formerly in the group Central Asia (under developing countries) are now classified by UNSO under South-East Europe in a new grouping comprising South-East Europe and the Commonwealth of Independent States (CIS) (box table I.2.1). The CIS was created in December 1991 and includes all of the republics that were part of the former USSR, except the Baltic States.

In addition to the reclassifications mentioned above, the nomenclature used for the developing Pacific Island countries classified in previous WIRs under the Pacific subregion of the Asia-Pacific region is changed to "Oceania" in order to bring WIR usage in line with that of other UNCTAD publications. The country composition of the subregion and region remains the same as in previous WIRs.

Box table I.2.1. Reclassification of country groupings in *WIR05*

	New classification		
	New EU countries (classified under "developed countries")	South-East Europe (SEE) and Commonwealth of Independent States (CIS)	
Old classification		SEE	CIS
Former Central and Eastern Europe			
Albania		Albania	
Belarus			Belarus
Bosnia and Herzegovina		Bosnia and Herzegovina	
Bulgaria		Bulgaria	
Croatia		Croatia	
Czech Republic	Czech Republic		
Estonia	Estonia		
Hungary	Hungary		
Latvia	Latvia		
Lithuania	Lithuania		
Republic of Moldova			Republic of Moldova
Poland	Poland		
Romania		Romania	
Russian Federation			Russian Federation
Serbia and Montenegro		Serbia and Montenegro	
Slovakia	Slovakia		
Slovenia	Slovenia		
TFYR Macedonia		TFYR Macedonia	
Ukraine			Ukraine
Central Asia (Developing countries)			
Armenia			Armenia
Azerbaijan			Azerbaijan
Georgia			Georgia
Kazakhstan			Kazakhstan
Kyrgyzstan			Kyrgyzstan
Tajikistan			Tajikistan
Turkmenistan			Turkmenistan

Source: UNCTAD.

66%) in their combined inflows. Conversely, FDI flows to the United States rose for the first time since 2000, to more than three times their 2003 level; however, they too were at about one-third of their peak level of 2000. The United Kingdom was another developed country that received large FDI inflows in 2004 – nearly four times their 2003 level. Flows to Australia, Japan and New Zealand also rose.

In contrast to developed-country inflows, flows to *developing countries* rose by 40% (to $233 billion) in 2004. As a result, their share in world FDI inflows reached 36% – the highest since 1997. While flows to Africa remained virtually unchanged, all other regions and subregions experienced a significant increase:

- *Africa* attracted constant but relatively high levels of FDI inflows at $18 billion, following an increase of 39% in 2003.
- Inbound FDI to the *Asia-Oceania region* reached $148 billion, up from $101 billion.[3]
- FDI flows to *Latin America and the Caribbean* rose by 44% (to $68 billion) after four years of consecutive decline.

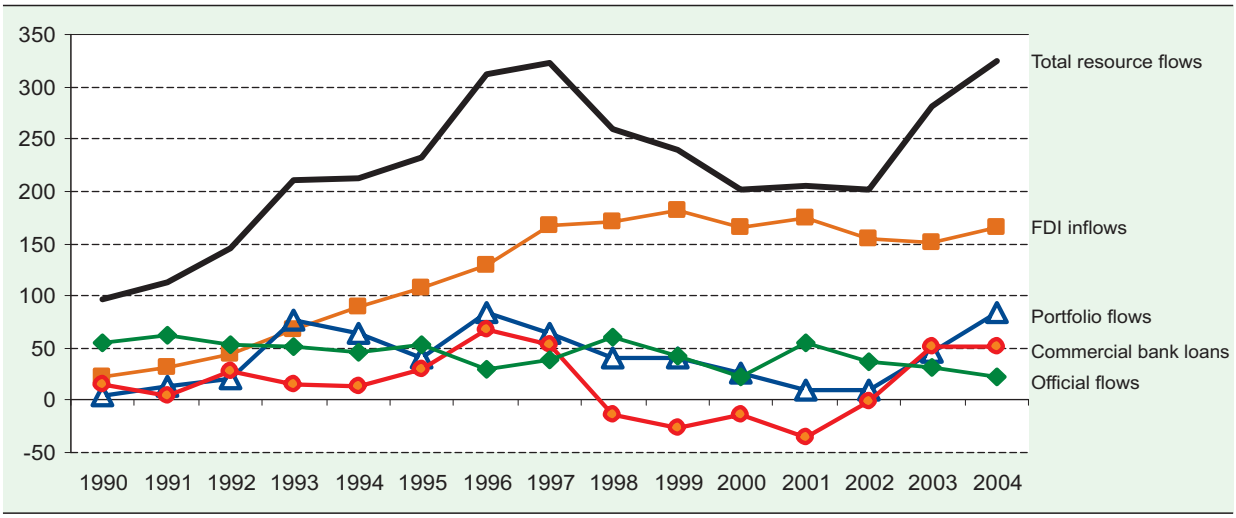
FDI flows to developing countries remain concentrated: the top five recipients, China, Hong Kong (China), Brazil, Mexico and Singapore, in that order, accounted for over 60% of total flows.

FDI inflows to the least developed countries (LDCs)[4] also rose, by 3% in 2004, to reach $11 billion, the highest level ever for these countries. Thirty-five of the 50 LDCs received higher inflows. FDI growth in this group in 2004 was largely due to an increase in flows to such countries as the Democratic Republic of the Congo, Myanmar and Equatorial Guinea; they experienced growth rates of 470%, 91% and 16% respectively (annex table B.1). (Flows to the major oil-producing countries in this group had risen considerably in 2003; for example, flows to Angola and Sudan doubled.) However, FDI flows to LDCs still remain low; in spite of the rise registered in 2004, their share in world and developing-country FDI inflows was no more than 2% and 5% respectively. Nonetheless, the shares of FDI inflows in gross fixed capital formation are more significant for the LDCs as a group than for other developing countries: 20% vs. 10% in 2002-2004 (annex table B.3).

In the new regional category of *South-East Europe* and the *CIS*, FDI flows amounted to $35 billion in 2004 compared with $24 billion in 2003 (chapter II). In the Russian Federation alone FDI grew from $8 billion to $12 billion.

Of all capital flows to developing countries, FDI continued to be the largest component and is increasing (figure I.2): it accounted for 51% of all resource flows to developing countries and has been several times larger than official flows in recent years.

Figure I.2. Total resource flows[a] to developing countries[b], by type of flow, 1990–2003
(Billions of dollars)



Source: UNCTAD, based on World Bank 2005a.

[a] Defined as net liability transactions of original maturity of greater than one year.

[b] The World Bank classification is used here. It differs from UNCTAD's classification in that it includes CEE countries under developing countries.

Unsurprisingly, there was no marked change in the sectoral distribution of FDI in 2003-2004. FDI in the services sector continued to grow, particularly in financial services (annex tables A.I.4-A.I.7). Services accounted for 63% of the total value of cross-border M&As in 2004 compared to 54% in 2003 (annex table B.5) and one-third of M&As in services were in financial services. In the primary sector, FDI, driven by rising demand for various commodities, particularly oil, started to grow significantly in some regions in 2004, especially in mining and oil-related industries in Africa and Latin America (chapter II).

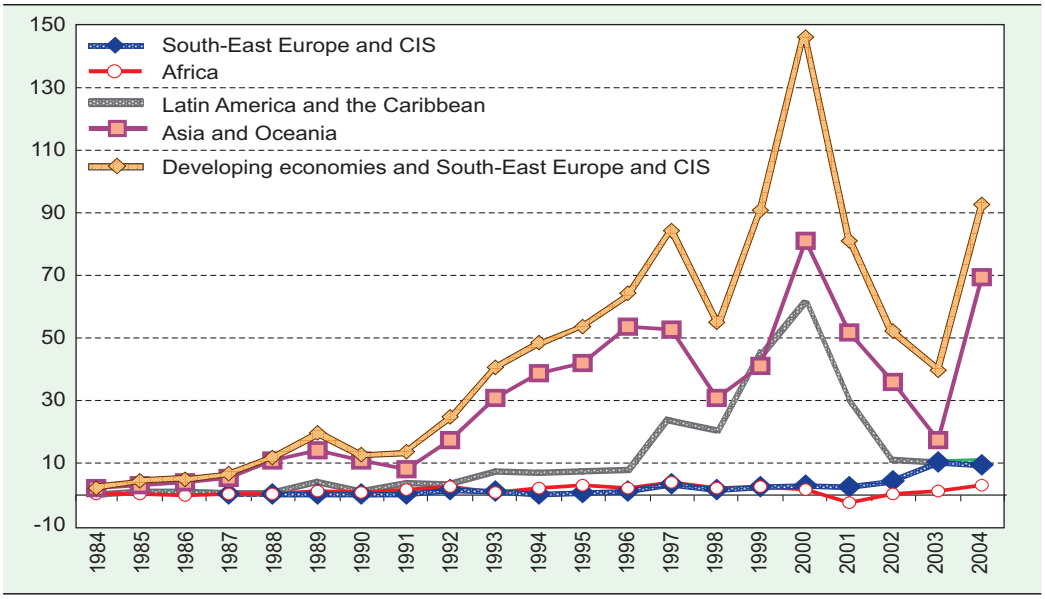
In terms of corporate functions there was a large increase in FDI as seen in the number of newly established regional headquarters: in 2004 more than 350, of which nearly 60% were established in developing countries. A noteworthy development is the continued growth of FDI in research and development (R&D), a phenomenon that is extending increasingly to developing countries (chapter IV). For instance, the number of foreign greenfield investment projects in R&D rose from 516 in 2003 to 642 in 2004 (annex table A.I.3).[5] The increase was higher in the case of host developing economies, which received 429 new R&D projects in 2004 compared with 316 in 2003. The increasing internationalization of TNCs' R&D activities and the implications of this, particularly for developing countries, are the special focus of Part Two of this *WIR*.

FDI *outflows* increased in 2004 by 18% to $730 billion, of which $637 billion were from developed countries. These countries remain significant net capital exporters through FDI: outflows exceeded inflows of developed countries by nearly $260 billion. While FDI outflows from the EU declined by 25% to $280 billion (a seven-year low), those from most other developed countries increased in 2004. FDI outflows from the United States increased by 90%, to $229 billion, its highest amount ever, and from Canada and Switzerland by 121% and 67% respectively (to $47 billion and $25 billion).

While developed countries remain the major source of FDI, outflows from developing countries have also risen, from a negligible amount in the early 1980s to $83 billion in 2004 (figure I.3).[6] The outward FDI stock from developing countries reached more than $1 trillion in 2004, with a share in world stock of 11% (annex table B.2). A number of notable M&As were undertaken recently by firms from developing countries (especially Asian firms), including in developed countries (chapter II). Developing countries are beginning to recognize the importance of such investment for their firms' competitiveness and their economies' performance. A few of them even invest relatively

Figure I.3. FDI outflows from developing economies, and South-East Europe and CIS, by group of economies, 1984-2004

(Billions of dollars)



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

more abroad than some developed countries (*WIR04*). For example, the ratio of FDI outflows to gross fixed capital formation was 25% for Singapore in 2002-2004 compared to 8% for the United States (annex table B.3). This rise of FDI from developing economies' TNCs has taken place largely in the context of government policies that have paid little attention to outward investment, have been restrictive or have not been actively supportive.[7]

b. Modes of FDI entry

Firms may enter host economies through greenfield investments or M&As.[8] The choice of mode is influenced by industry-specific factors. For example, greenfield investment is more likely to be used as a mode of entry in industries in which technological skills and production technology are key. The choice may also be influenced by institutional, cultural and transaction cost factors (*WIR00*), in particular, the attitude towards takeovers, conditions in capital markets, liberalization policies, privatization, regional integration, currency risks and the role played by intermediaries (e.g. investment bankers) actively seeking acquisition opportunities and taking initiatives in making deals.

In 2004, *cross-border M&As* rose by 28%, to $381 billion (annex tables B.4-B.5), amidst an overall expansion of total (cross-border plus domestic) M&As by nearly 50%, to over $2 trillion. The number of cross-border deals reached some 5,100 – 12% higher than the previous year. An increase in the number of mega cross-border deals (with transaction values exceeding $1 billion) contributed to the growth in the value of cross-border M&As (table I.1). The largest deal in 2004 was the acquisition of Abbey National (United Kingdom) by Santander Central Hispano (Spain) for $15.8 billion (annex table A.I.1), almost the same value as that of the largest deal in 2003 but only one-thirteenth of the largest deal ever (the Vodafone-Mannesmann deal in 2000).

Cross-border M&As rose more markedly at the domestic and regional levels than at the global level. For instance, between companies of the EU-15 such deals increased in value by 57% to $99 billion, accounting for 57% of the value of all cross-border deals in that region in 2004 (as compared with 52% in 2003).

In addition to low interest rates in major economies and rising corporate profits, the recovery of asset prices since 2003 (as reflected in the rise in stock exchange indices) contributed to the rise in M&As. Indeed, partly as a result of increased stock prices, the number of cross-border deals using stock swaps rose from 123 to 161 in 2004 (close to the number of such deals in 1999), accounting for 16% of the total value of cross-border M&As.[9]

The growth in the value and number of cross-border M&As in 2004 was largely due to transactions taking place among developed-country firms: their value rose by 29%. In developing countries – where such transactions are normally less common, as fewer companies attract foreign investors and restrictions continue to be imposed on M&As – cross-border M&As also rose in 2004 by 36% in value, to reach $55 billion, two-thirds of the peak reached in 2001 (annex table B.4). There was a significant rise in cross-border M&A purchases in China and India, with a doubling of value in both countries, to record highs of $6.8 billion and $1.8 billion respectively. For the first time, China became the largest target country for cross-border M&As in developing countries.

Greenfield FDI, for its part, expanded from an estimated 9,300 projects in 2003 to 9,800 projects in 2004.[10] As in 2003, developing and

Table I.1. Cross-border M&As with values of over $1 billion, 1987-2004

Year	Number of deals	Percentage of total	Value ($ billion)	Percentage of total
1987	14	1.6	30.0	40.3
1988	22	1.5	49.6	42.9
1989	26	1.2	59.5	42.4
1990	33	1.3	60.9	40.4
1991	7	0.2	20.4	25.2
1992	10	0.4	21.3	26.8
1993	14	0.5	23.5	28.3
1994	24	0.7	50.9	40.1
1995	36	0.8	80.4	43.1
1996	43	0.9	94.0	41.4
1997	64	1.3	129.2	42.4
1998	86	1.5	329.7	62.0
1999	114	1.6	522.0	68.1
2000	175	2.2	866.2	75.7
2001	113	1.9	378.1	63.7
2002	81	1.8	213.9	57.8
2003	56	1.2	141.1	47.5
2004	75	1.5	199.8	52.5

Source: UNCTAD, cross-border M&A database.

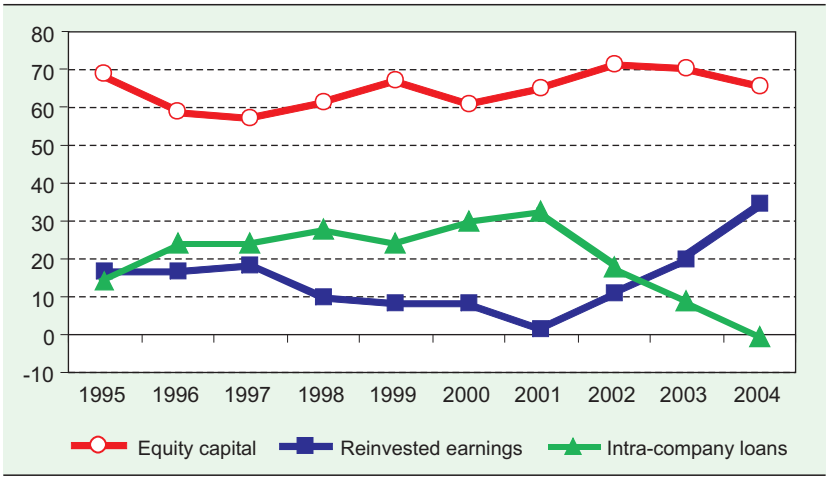
transition (South-East Europe and the CIS) economies attracted a larger number of greenfield investments than developed countries. This illustrates the tendency for developing countries to receive more FDI through greenfield projects than through M&As; greenfield investment is the key driver behind the recent recovery of FDI. However, in developing countries such investment is somewhat concentrated geographically: based on some 4,800 projects for which information was collected in 2004, for instance, only 11 economies[11] received more than 100 greenfield investments each in 2004 (annex table A.I.2). This concentration is in line with that of FDI as a whole in developing countries (chapter II). As in the case of M&As, China and India attracted significant numbers of such FDI projects, together accounting for nearly half of the total number in developing countries. Recent liberalization measures in India and strong economic growth in China, combined with increased liberalization after its accession to WTO (chapter II), contributed to this trend. Three-fifths of all greenfield projects in the world were in the services sector (annex table A.I.3).

c. Components of FDI flows

FDI is financed by TNCs through equity capital, intra-company loans and/or reinvested earnings.[12] The availability of data on each component of FDI flows varies by country: between 66 and 110 of the 212 economies for which FDI flows are reported provided data on all of these three components for the period 1995-2004.[13] Equity capital is the largest component of FDI financing. Worldwide, its share in total inflows fluctuated between 58% and 71% during the period 1995-2004; the higher shares were registered during the recent decline in world FDI flows (figure I.4). During the same period, intra-company loans, on average, accounted for 23%, and reinvested earnings for 12%, of world FDI inflows. The latter two components are much less stable. The share of reinvested earnings in FDI financing reached a low of 2% of worldwide FDI inflows in 2001, but it has been rising substantially since then. The share of intra-company loans, on the other hand, has fallen continuously and significantly (figure I.4).

The lion's share of FDI flows to developed countries comprises *equity capital* (around 67% of total FDI flows over the period 1995-2004) (figure I.4). Its importance varies by country and over time. For instance, the average share of equity capital in annual FDI flows was 85% in the United States, 78% in Germany and ranged between 50% and 70% in Finland, Norway, Switzerland and the United Kingdom. In contrast, in Ireland and the Netherlands the shares were only 23% and 35%, respectively, during that period. Equity capital was also the most important component of FDI flows to developing countries in 1995-2003, but to a lesser extent than for developed countries: its share in total FDI flows fluctuated between 49% and 67%. In 2004 it fell to only 29%.[14] Here again there are substantial differences between countries. In the case of

Figure I.4. Share of different financing components in world FDI inflows, 1995-2004
(Per cent)



Source: UNCTAD, based on national sources and IMF *Balance of Payments Statistics*, CD-ROM, June 2005.

Note: Based on data only for countries for which all three components of FDI inflows were available. This number ranges from 66 to 110 economies and it accounts for an average of 87% of total FDI inflows.

some host economies such as Brazil, inward FDI relied heavily on equity capital, while in some others like Hong Kong (China), the share of equity was only 28% during the period 1998-2004, with reinvested earnings and intra-company loans assuming greater importance.

In a number of countries the share of equity capital in FDI financing has also varied substantially over time. This reflects more the volatility of the two other components of FDI – reinvested earnings and, especially, intra-company loans – than that of equity capital. In the United States, for instance, the contribution of equity capital to FDI inflows varied from a low of 58% in 1997 to a high of 153%[15] in 2003 (72% in 2004), in Germany, from 27% in 1998 to 168%[16] in 2003 (70% in 2004) and in Argentina, from 72% in 1996 to 282%[17] in 2002 (53% in 2004).

As noted above, the share of *intra-company loans* in worldwide FDI inflows has fallen sharply since 2001 (figure I.4). This is mainly due to developments in a few large developed economies, such as the repatriation by TNCs of large amounts of credit from their affiliates in Germany ($10.1 billion in 2003 and $57.4 billion in 2004) and the United States ($31.7 billion in 2003 and $17.8 billion in 2004) (chapter II), resulting in negative flows of intra-company loans to the two countries in those years. Australia, Japan, the Netherlands and Portugal also experienced negative inflows of intra-company loans due to large-scale repatriations of such loans, but to a smaller extent than Germany and the United States. Similar trends have occurred in some developing economies. In Hong Kong (China), for instance, foreign TNCs withdrew credits of nearly $10 billion in 2002 and $3 billion in 2003, but resumed lending to their Hong Kong affiliates in 2004.

The share of intra-company loans differs between host countries. During the period 1995-2004 they contributed 40-50% of inward FDI flows in Germany[18] and France but less than 10% in Argentina, Australia and Switzerland. This variation can be explained partly by differences in the structural features of the host and home economies. Cross-border, intra-company loans often depend on the financial management of TNCs, which is in turn influenced by taxes and interest-rate differentials as well as by the characteristics of home- and host-country capital markets. For instance if the interest on a loan is received in a low-tax home country but the interest payment is deductible (as cost) in a high-tax host country, TNCs can save on their global taxes by using intra-firm lending.[19]

Empirical studies on FDI in the United States (Desai, Foley and Hines 2004, Altshuler and Grubert 2003) and Germany (Ramb and Weichenrieder 2004) have highlighted the role of tax differentials in intra-company lending across borders: low taxes in the United States compared to those in the home countries of foreign TNCs investing in the United States were found to reduce the incentive to finance FDI in the United States through intra-company loans. On the other hand, foreign TNCs were found to react to the high German tax rate by preferring intra-company loans to equity financing for their investments in Germany (chapter II).

As far as *reinvested earnings* are concerned (i.e. foreign affiliates' earnings not distributed as dividends to the parent company) their share in FDI flows has grown recently in all groups of economies. In developed countries as a group, it rose to 15% of FDI inflows in 2003 – more than double the average of the previous ten years. In 2004, the corresponding share was 33%, mainly due to negative flows of intra-company loans. As with other components of FDI inflows, the importance of reinvested earnings differs from country to country (table I.2). While most developed countries received positive FDI inflows in the form of reinvested earnings in 2003, France and Germany recorded negative reinvested earnings.[20] In the case of France, this seems to be a temporary phenomenon. In Germany, however, negative reinvested earnings of foreign affiliates have been registered for many years. This does not necessarily mean that affiliates of foreign TNCs located in Germany have been enduring sustained losses; data show that over a period of 30 years, aggregated dividends have been higher than the aggregated profits of all reporting foreign affiliates.[21] In principle, the distribution of large dividend payments by foreign affiliates in Germany reduces their retained profits, which can help reduce the taxes they pay in Germany (chapter II).

In developing countries the picture is slightly different, with reinvested earnings being more prominent: these earnings accounted for about 30% of FDI flows, on average, during the period 1995-2004, reaching 36% in 2003. Such earnings are therefore becoming crucial to sustained flows of FDI to developing countries, which is why a number of countries have

Table I.2. FDI inflows to the top 20 economies, ranked by size of different financing components, 2003

	Equity capital		Reinvested earnings		Intra-company loans	
Rank	Economy	Billions of dollars	Economy	Billions of dollars	Economy	Billions of dollars
1	United States	87.0	Ireland	19.4	France	27.7
2	Luxembourg	80.9	Hong Kong, China	16.0	Spain	14.2
3	Germany	45.7	United Kingdom	12.2	Italy	8.8
4	China	37.4	China	7.2	Luxembourg	6.4
5	Belgium	26.2	Russian Federation	7.1	Belgium	5.9
6	France	17.0	Canada	6.7	Mexico	5.8
7	Netherlands	14.6	Australia	5.7	Switzerland	5.3
8	Spain	13.0	Netherlands	5.2	Sweden	3.2
9	Brazil	9.3	Italy	4.8	Angola	2.8
10	Switzerland	8.3	Luxembourg	3.7	Russian Federation	2.8
11	Portugal	7.7	Switzerland	2.9	United Kingdom	2.8
12	Japan	7.6	Malaysia	2.8	China	2.5
13	Ireland	6.0	Mexico	2.3	New Zealand	2.3
14	United Kingdom	5.4	Finland	2.3	Ireland	1.5
15	Poland	4.6	Czech Republic	2.2	Norway	1.4
16	Austria	4.4	Hungary	2.1	Austria	1.3
17	Thailand	4.1	Chile	1.9	Ecuador	1.3
18	Azerbaijan	3.3	Nigeria	1.9	Venezuela	1.2
19	Argentina	3.0	Spain	1.9	Chad	1.0
20	Israel	2.9	India	1.8	Kazakhstan	0.9

Source: UNCTAD (www.unctad.org/fdistatistics) and UNCTAD's own estimates.

introduced fiscal incentives to encourage reinvestment of earnings by foreign affiliates.

d. Factors contributing to the recovery

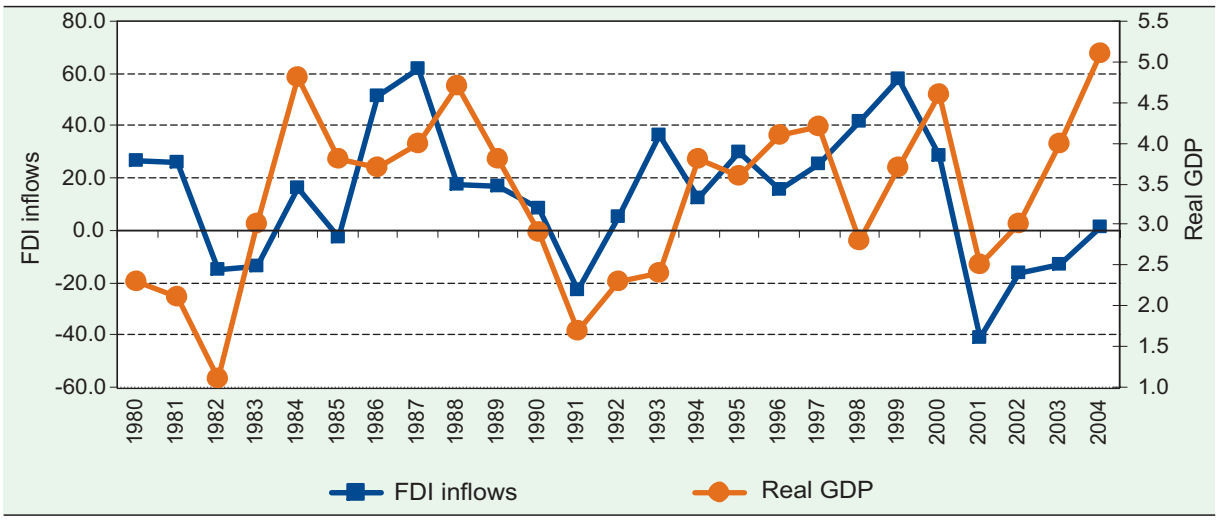
The recovery of FDI flows in 2004 is the result of favourable developments with respect to the macro, micro and institutional factors determining these flows.

Macroeconomic factors. After the sharp slowdown in 2001, global economic growth recovered gradually in 2002 and 2003. In 2004, world economic growth reached 5.1%, the strongest growth rate since the mid-1980s (figure I.5). As in the past, improved economic growth helped many countries attract more FDI (*WIR03*).

Most of the countries and regions with high economic growth rates recorded a sharp increase in FDI inflows in 2004. A number of developing countries in Asia, Africa and Latin America experienced a generally strong economic growth and, partly as a result, received significantly higher FDI inflows. This was also the case in the United Kingdom, the United States and the new EU member countries, which registered growth rates in 2004 of 3.1% (2.2% in 2003), 4.4% (3.0% in 2003) and 4.9% (3.7% in 2003) respectively (chapter II).[22] In contrast, several EU countries that grew at slower rates than the developed countries mentioned above, saw declining or stagnating FDI inflows.

The sharp increase in FDI inflows into the United States and some other countries (e.g. China) may also have been driven by the weakening dollar, which made investment in the United States – and in other countries with exchange rates pegged to the dollar – less costly for foreign investors. This is similar to the wave of FDI inflows into the United States in the 1980s in reaction to the dollar's weakness (Froot and Stein 1991). The declining dollar also improved the price competitiveness of companies located in these countries, therefore attracting efficiency-seeking FDI. The dollar's depreciation boosted their exports, which further stimulated FDI flows.[23] Rising exports are often accompanied by increasing FDI for improving distribution and marketing facilities for exports and for meeting the specific needs of exporters (Blomström, Lipsey and Kulchycky 1998, Pfaffermayer 1996, Egger 2001).

Figure I.5. Growth rates of world FDI inflows and GDP, 1980-2004
(Per cent)



Source: UNCTAD, based on UNCTAD FDI/TNC database (www.unctad.org/fdistatistics) for FDI and International Monetary Fund, *World Economic Outlook Database*, April 2005 for GDP.

Country risks, overall, declined worldwide in 2004[24] and business and consumer confidence increased.[25] The gradual decline of risk may have contributed to the recovery of FDI flows, although the empirical evidence for this is mixed (Moosa 2003, chapter 5).[26]

Microeconomic factors. Strong economic growth as well as large-scale restructuring and consolidation of business brought many companies back firmly to profit-making in 2004. Corporate profitability in the large economies improved even more.[27] Increased profits and favourable financing conditions have helped expand investments abroad. In addition, as many as 48 out of 49 major stock exchanges recorded rising share prices in 2004, which eased the financing of investments.[28] Increasing stock market values produce positive wealth effects and facilitate takeovers, especially through stock swapping. Higher stock market valuations also boost the value of cross-border M&As.

The recovery of FDI flows in many regions of the world was also influenced by fast rising commodity prices, at a rate of 11% for four years in a row.[29] Consequently, by 2004 such prices reached a record high. The higher prices and supply shortages induced TNCs to invest in new exploration and production facilities, especially in Africa and Latin America. Rising incomes of producers of oil, gas and other raw materials contributed to increasing FDI by TNCs in those industries.

Institutional factors. The process of privatization has come to an end in many developing and transition economies, and hence did not contribute much to FDI in 2004. But two other relatively new developments did. Private individual and institutional equity investors (as distinct from TNCs) gained significant importance in FDI. The value of cross-border M&As by private equity companies[30] rose from an estimated $69 billion in 2003 to $107 billion in 2004, accounting for 28% of all cross-border M&As, up from 23% in 2003.[31] Another development was the liberalization of FDI in real estate, traditionally closed to foreign investment in many countries (chapter II). In Germany[32] and Poland, for instance, liberalization and privatizations played a major role in attracting FDI into real estate. FDI in real estate grew rapidly worldwide in 2004, helped also by the rise in real estate prices: for example, the value of cross-border M&As in real estate tripled to $30 billion.[33]

e. The importance of TNC activities in the world economy

The universe of TNCs is large, diverse and expanding. By the early 1990s, there were an estimated 37,000 TNCs in the world, with at least 170,000 foreign affiliates. Of these, 33,500 were parent corporations based in developed countries. By 2004 the number of TNCs had risen to some 70,000 with at least 690,000 foreign affiliates,

almost half of which are now located in developing countries (annex table A.I.8).

The role of TNCs in the world economy has thus continued to grow, as reflected in the expansion of FDI stock and in the operations of foreign affiliates (table I.3). Sales, value added (gross product), assets, employment and exports of foreign affiliates have all resumed an upward trend since 2002.

The degree of transnationality of host countries stagnated during 2000-2002 in both developed and developing countries according to the transnationality indices for host economies (figure I.6). This reflects the decline of FDI flows in these regions during that period. There are also significant differences in the degree of transnationality of different countries. The most transnationalized economies in 2002 were Belgium and Luxembourg, among developed countries, and Hong Kong (China), among developing economies (figure I.7) – positions held by those economies since this index was developed in 1996 (*WIR99*). While India has been catching up in inward FDI, it still ranks near the bottom in 2002. The transnationality of host countries depends on the

Table I.3. Selected indicators of FDI and international production, 1982-2004
(Billions of dollars and per cent)

	Value at current prices (Billions of dollars)				Annual growth rate (Per cent)						
Item	1982	1990	2003	2004	1986-1990	1991-1995	1996-2000	2001	2002	2003	2004
FDI inflows	59	208	633	648	22.8	21.2	39.7	-40.9	-13.3	-11.7	2.5
FDI outflows	27	239	617	730	25.4	16.4	36.3	-40.0	-12.3	-5.4	18.4
FDI inward stock	628	1 769	7 987	8 902	16.9	9.5	17.3	7.1	8.2	19.1	11.5
FDI outward stock	601	1 785	8 731	9 732	18.0	9.1	17.4	6.8	11.0	19.8	11.5
Cross-border M&As [a]	..	151	297	381	25.9 [b]	24.0	51.5	-48.1	-37.8	-19.6	28.2
Sales of foreign affiliates	2 765	5 727	16 963 [c]	18 677 [c]	15.9	10.6	8.7	-3.0	14.6	18.8 [c]	10.1 [c]
Gross product of foreign affiliates	647	1 476	3 573 [d]	3 911 [d]	17.4	5.3	7.7	-7.1	5.7 [d]	28.4 [d]	9.5
Total assets of foreign affiliates	2 113	5 937	32 186 [e]	36 008 [e]	18.1	12.2	19.4	-5.7	41.1 [e]	3.0 [e]	11.9 [e]
Exports of foreign affiliates	730	1 498	3 073 [f]	3 690 [f]	22.1	7.1	4.8	-3.3 [f]	4.9 [f]	16.1 [f]	20.1 [f]
Employment of foreign affiliates (thousands)	19 579	24 471	53 196 [g]	57 394 [g]	5.4	2.3	9.4	-3.1	10.8 [g]	11.1 [g]	7.9 [g]
GDP (in current prices) [h]	11 758	22 610	36 327	40 671	10.1	5.2	1.3	-0.8	3.9	12.1	12.0
Gross fixed capital formation	2 398	4 905	7 853	8 869	12.6	5.6	1.6	-3.0	0.5	12.9	12.9
Royalties and licence fee receipts	9	30	93	98	21.2	14.3	8.0	-2.9	7.5	12.4	5.0
Exports of goods and non-factor services [h]	2 247	4 261	9 216	11 069	12.7	8.7	3.6	-3.3	4.9	16.1	20.1

Source: UNCTAD, based on its FDI/TNC database (www.unctad.org/fdi statistics), and UNCTAD estimates.

[a] Data are available only from 1987 onward.

[b] 1987-1990 only.

[c] Based on the following regression result of sales against FDI inward stock (in millions of dollars) for the period 1980-2002: Sales = 2 003.858+1.87288*FDI inward stock.

[d] Based on the following regression result of gross product against FDI inward stock (in millions of dollars) for the period 1982-2002: Gross product = 622.0177+0.369482*FDI inward stock.

[e] Based on the following regression result of assets against FDI inward stock (in millions of dollars) for the period 1980-2002: Assets = -1 179.838+4.177434*FDI inward stock.

[f] For 1995-1998, based on the regression result of exports of foreign affiliates against FDI inward stock (in millions of dollars) for the period 1982-1994: Exports = 357.6124+0.558331*FDI inward stock. For 1999-2004, the share of exports of foreign affiliates in world exports in 1998 (33.3 per cent) was applied to obtain the values.

[g] Based on the following regression result of employment (in thousands) against FDI inward stock (in millions of dollars) for the period 1980-2002: Employment = 16 552.15+4.587846*FDI inward stock.

[h] Based on data from the International Monetary Fund, *World Economic Outlook*, April 2005.

Note: Not included in this table are the values of worldwide sales by foreign affiliates associated with their parent firms through non-equity relationships and the sales of the parent firms themselves. Worldwide sales, gross product, total assets, exports and employment of foreign affiliates are estimated by extrapolating the worldwide data of foreign affiliates of TNCs from Austria, Finland, France, Germany, Italy, Japan, Portugal, Sweden, Switzerland and the United States for employment; those from Austria, Finland, France, Germany, Italy, Japan, Portugal and the United States for sales; those from Japan and the United States for exports; those from the United States for gross product; and those from Austria, Germany and the United States for assets, on the basis of the shares of those countries in worldwide outward FDI stock.

extent to which TNCs are expanding their foreign activities in various locations. The next section looks at the universe of the largest TNCs, which play an important role in that process.

2. The largest TNCs

TNCs are mainly based in developed countries, and are increasingly being established in developing countries as well. This section looks at developments among the largest TNCs: the 100 largest non-financial TNCs worldwide and the 50 largest ones from developing economies ranked by foreign assets. It also includes an analysis of the ten largest TNCs from South-East Europe and the CIS (also ranked by foreign assets), and, for the first time in the *WIR*, an analysis of the transnationalization of the 50 largest financial TNCs worldwide ranked by total assets.

a. The world's top 100 TNCs

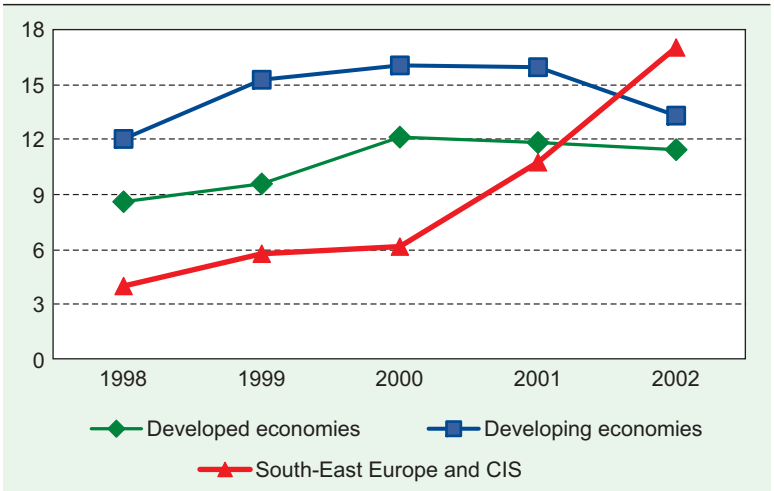
The 100 largest TNCs play a major role in international production; they account for 12%, 18% and 14%, respectively, of the estimated foreign assets, sales and employment of all TNCs in the world. Following a slowdown in their expansion in 2000, they resumed growth in 2002. In 2003, their assets and sales, both foreign and total, grew significantly (table I.4). Overall, the rankings in the top 100 list in 2003 (the latest year for which data on the top TNCs were available) were fairly similar to those in 2002 (annex table A.I.9). The top 10 companies maintained almost the same order as in 2002, General Electric and Vodafone heading the list each with foreign assets of about $250 billion. Despite the overall stability at the top of the list, there were 15 newcomers, including some manufacturing firms such as BAE Systems, Robert Bosch and United Technologies, as well as some petroleum and mining companies, like Petronas, Statoil and Rio Tinto.

Over the past decade or so, a number of new companies from the services sector have joined top rankings on the list, yet some companies in traditional industries have remained in the highest rankings. In the petroleum industry, for instance, Shell and ExxonMobil, which were numbers one and two, respectively, in 1992, are still among the top 10 TNCs. Motor vehicle companies like Ford, General Motors and Toyota are also still among the top 10. Globally, 10 of the top 20 companies in 2003 were already in the top 20 in 1992.

The three industries dominating the list are motor vehicles, petroleum and electrical/electronic equipment with 11, 10 and 9 entries each. Together, more than half of the 30 leading companies listed among the top 100 were in these industries. A large group of new TNCs has emerged in recent years in service industries that are relatively new to FDI – notably, telecommunications, electricity, water and postal services – many of which were former State-owned monopolies. In 2003, TNCs in these industries accounted for almost 20% of the top 100 firms. The two companies that climbed the most in the rankings in 2003, Suez (11th) and Deutsche Telekom (14th), operate in service industries.

The largest TNCs remain geographically concentrated in a few home countries. The United States dominated the list with 25 entries. Five

Figure I.6. Transnationality Index of host countries,[a] by group of economies, 1998-2002

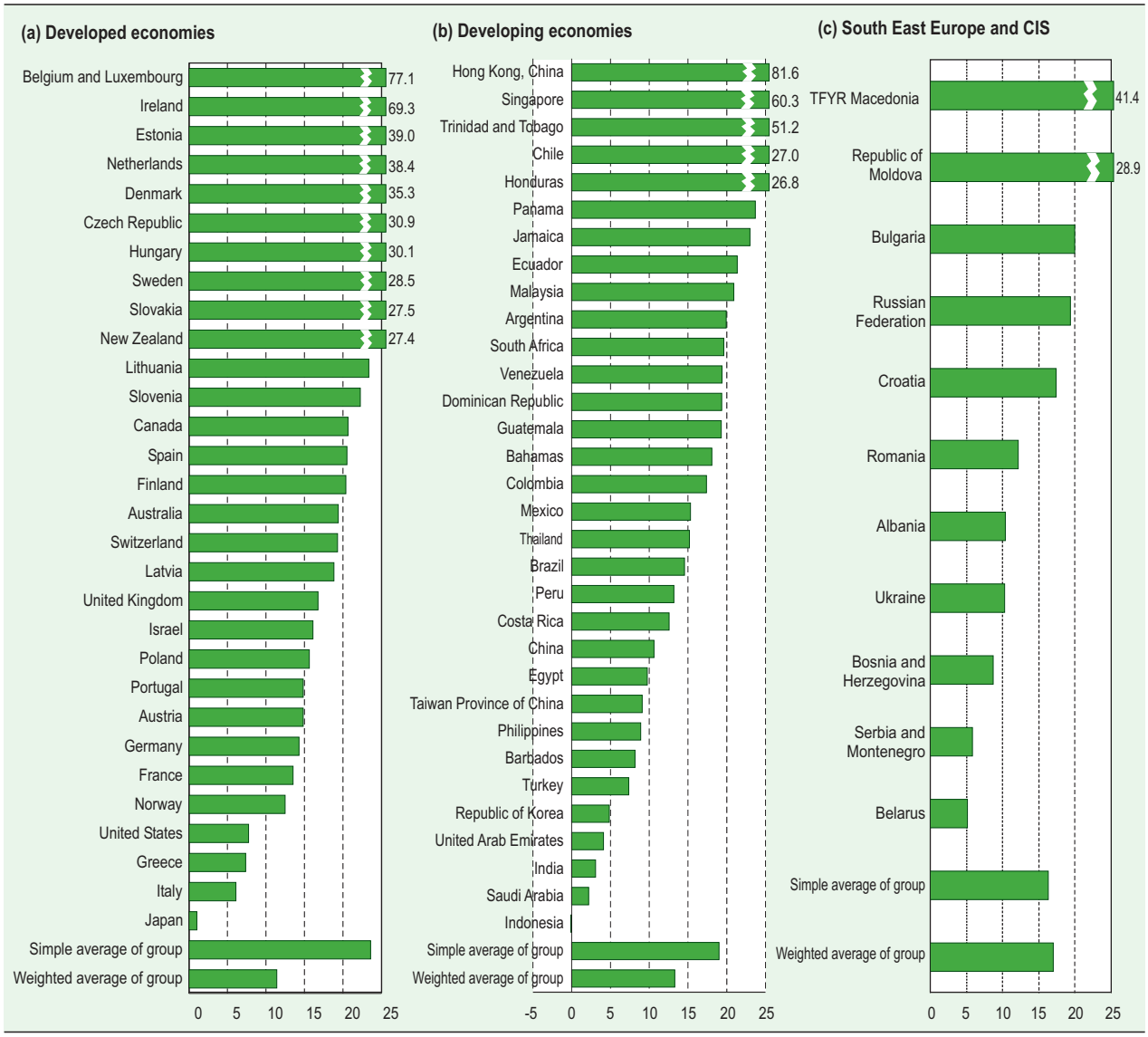


Source: UNCTAD.

[a] Average of four shares: three-year average of FDI inflows as a percentage of gross fixed capital formation; FDI inward stock as a percentage of GDP; value added of foreign affiliates as a percentage of GDP; and employment of foreign affiliates as a percentage of total employment. Data cover 73 economies: 22 developed countries, 32 developing countries and 19 countries which are classified under Central and Eastern Europe.

Note: For each group of economies, the weighted average is used. For details, see the note in figure I.7. For the country composition of each group of economies, see also figure I.7.

Figure I.7. Transnationality Index of host economies, 2002
(Per cent)



Source: UNCTAD estimates.

[a] Average of four shares: FDI inflows as a percentage of gross fixed capital formation for the past three years, 2000-2002; FDI inward stock as a percentage of GDP in 2002; value added of foreign affiliates as a percentage of GDP in 2002; and employment of foreign affiliates as a percentage of total employment in 2002.

[b] Only the economies for which data for all of these four shares are available were selected. Data on value added are available only for Belarus, Czech Republic, Finland (2001), France (2001), Hungary (2000), Ireland (2000), Italy (1997), Japan (1999), the Netherlands (1996), Norway (1998), Poland, Portugal, Sweden (2000), the United Kingdom (1997), the United States, China, India (1995), Malaysia (1995), Singapore (2000), Taiwan Province of China (1994) and the Republic of Moldova. For Albania, the value added of foreign owned firms was estimated on the basis of the per capita inward FDI stocks and the corresponding ratio refers to 1999. For the other economies, data were estimated by applying the ratio of value added of United States affiliates to United States outward FDI stock to total inward FDI stock of the country. Data on employment are available only for Austria (2001), the Czech Republic, Denmark (1996), Finland (2001), France (2001), Germany, Hungary (2000), Ireland, Italy (1999), Japan (2001), the Netherlands. For Albania, employment of foreign-owned affiliates was estimated on the basis of their per capita inward FDI stock, and the corresponding ratio refers to 1999. For the remaining countries, data were estimated by applying the ratio of employment of Finnish, German, Japanese, Swedish, Swiss and United States affiliates to Finnish, German, Japanese, Swedish, Swiss and United States outward FDI stock to total inward FDI stock of the economy. Data for France, the Netherlands, Norway, Sweden and the United Kingdom refer to majority-owned foreign affiliates only.

Note: The simple average refers to the simple mean of the indices of the individual countries within each group, while the weighted average takes into account the weight that each country has in each the four shares (as explained in footnote a above).

Table I.4 Snapshot of the world's 100 largest TNCs: assets, sales and employment, 2002, 2003
(Billions of dollars, thousand of employees, per cent)

Variable	2002	2003	% change
Assets			
Foreign	3 317	3 993	20.4
Total	6 891	8023	16.4
Foreign as % of total	48.1	49.8	1.7[a]
Sales			
Foreign	2 446	3 003	22.8
Total	4 749	5 551	16.9
Foreign as % of total	51.5	54.1	2.6[a]
Employment			
Foreign	7 036	7 242	2.9
Total	14 332	14 626	2.1
Foreign as % of total	49.1	49.5	0.4[a]

Source: UNCTAD/Erasmus University database.
[a] In percentage points.

countries (France, Germany, Japan, the United Kingdom and the United States) accounted for 71 out of the 100, while the EU alone accounted for 50. Four companies are from developing economies, Hutchison-Whampoa of Hong Kong (China) being the largest among them (16th).

b. The top 50 TNCs from developing economies

Since UNCTAD began publishing the list of the top 50 TNCs from developing economies in 1995, these companies have expanded their activities abroad. In 2003 their foreign assets climbed to $249 billion from $195 billion in 2002 (table I.5). As in 2002, the five largest TNCs accounted for almost half of the total foreign assets of the top 50. With foreign assets of $59 billion, Hutchison Whampoa (Hong Kong, China) continues to hold the leading position, with 25% of the total foreign assets of the top 50. Singtel (Singapore), Petronas (Malaysia), Samsung Electronics (Republic of Korea) and Cemex (Mexico) remained, in that order, in the next four positions. Although the top TNCs remained the same, 14 newcomers also entered the top 50 list in 2003 mainly from Asia (annex table A.I.10).

Asia has reinforced its dominance in the top 50 with 39 enterprises on the list. The other 11 enterprises came from South Africa (4), Mexico (4) and Brazil (3). Hong Kong (China) and Singapore remained the most important home economies, with ten and nine entries in the list respectively. Taiwan Province of China, with eight companies in the top 50, became the home economy with the third largest contingent of TNCs on the list largely owing to its electronics companies. The growing significance of this economy was mainly at the expense of South Africa, which had four companies listed in the top 50 in 2003 compared to seven in 2002.

The top 50 TNCs operate in a wide range of industries, the most important being electrical/electronic equipment and computers (mainly companies from Asia), followed by food and beverages. Other relatively significant industries for the top 50 include petroleum (6 TNCs), telecommunications (3), transportation (3), utilities (3) and hotels (3).

Four companies in the top 50 list (Hutchison Whampoa, Singtel, Petronas and Samsung) are also among the world's top 100 TNCs discussed above. It is likely that in the future more TNCs from developing economies will enter the list of the top 100, since outward FDI from these countries is expanding. Meanwhile, though, there remains a large gap in size between TNCs from the developed and developing groups. For instance, the total foreign assets of all the top 50 TNCs from developing economies in 2003 was barely equal to those of General Electric, the world's largest TNC.

In 2003, the assets, sales and employment, both foreign and total, of the largest TNCs from developing economies registered a large increase over previous years. However, the share of the foreign component of the three indicators declined. Moreover, when comparing the three ratios for the TNCs from developing economies with those from developed countries it is clear that the degree of internationalization of the former is lower (table I.5), as discussed in the following section.

c. Transnationality of the top TNCs

The degree of transnationality (or the importance of foreign as compared with the total activity of TNCs) stagnated during 2001-2003, for both the world's top 100 TNCs and the top 50 TNCs from developing countries, according to UNCTAD's Transnationality Indices (TNIs)[34] (figure I.8). An analysis of the TNI of the 100 largest TNCs suggests that the TNI, measured

Table I.5. Snapshot of the top 50 TNCs from developing countries: assets, sales and employment, 2002, 2003
(Billions of dollars, thousands of employees, per cent)

Variable	2002	2003	% change
Assets			
Foreign	195.2	248.6	27.4
Total	464.3	710.9	53.1
Foreign as % of total	42.0	35.0	- 7.0[a]
Sales			
Foreign	140.0	202.2	45.9
Total	308.4	512.5	66.1
Foreign as % of total	45.4	39.9	- 5.5[a]
Employment			
Foreign	713.6	1 077.2	50.9
Total	1 503.3	3 096.6	106.0
Foreign as % of total	47.5	34.8	- 12.7[a]

Source: UNCTAD/Erasmus University database.
[a] In percentage points.

as the simple average value of the TNIs of all the TNCs on the top 100 list, decreased again in 2003, from 57 to 55.8 (table I.6). However, if the value of the TNI is based on global figures for the assets, sales and employment of the top 100 (a weighted average), its value rose slightly in 2003, by 1.5 percentage points, suggesting that the degree of transnationality of the top quartile of the largest TNCs has recovered faster than that of the bottom quartile. This reflects the fact that TNCs are focusing more on their domestic markets at a time of worldwide economic slowdown of their activities, and that the largest TNCs are able to recover faster than the average-sized TNCs.

Of the top 100, firms from Japan and the United States are, on average, less transnationalized than their European counterparts (table I.6). Firms from small European economies have the highest average TNI, partly reflecting the need to go abroad to compensate for smaller home markets. Except in 2003, the TNI of the top 50 TNCs from developing countries has increased substantially over the past decade, and has been catching up with that of the world's largest TNCs (figure I.8).

The sales-to-assets ratio is an indicator of capital efficiency. The ratio of sales-to-employment shows the value of sales per employee, and provides an indication of labour productivity, which may in turn indicate

Table I.6. Average TNI values for the world's largest TNCs, 2002, 2003
(Per cent)

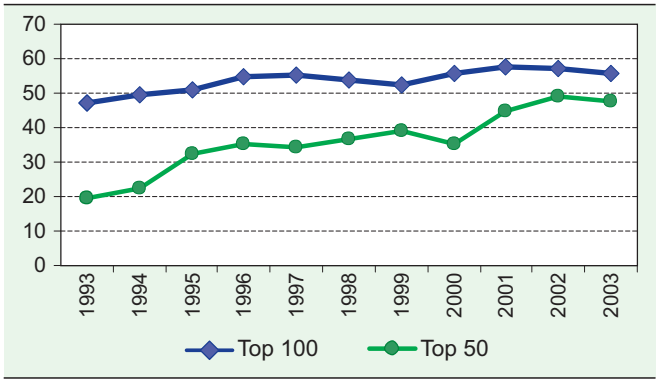
Variable	2002	2003
Top 100 TNCs	57.0	55.8
United States	43.8	45.8
United Kingdom	70.4	69.2
Japan	43.6	42.8
France	69.0	59.5
Germany	46.9	49.0
Small European countries	88.5	72.2
Top 50 TNCs	49.2	47.8

Source: UNCTAD/Erasmus University database.
Note: A simple average value is used. It is the sum of the TNI values of all the companies, divided by the total number of companies.

differences in the types of activities and technologies involved. A comparison of the sales-to-assets ratio for the top 100 TNCs worldwide and for the top 50 from developing economies shows a marginal difference. On the other hand, the indicator of labour productivity shows a much higher value for the world's 100 largest TNCs compared with the 50 largest TNCs from developing countries (table I.7). It should be noted that these ratios are highly dependent on the industry composition of the top 100 and top 50, and that the indicators differ across sectors of activity much more than between firms within the same sector.

The geographic spread of a company's operations and interests is captured by the Internationalization Index, the ratio of the number of foreign affiliates to the total number of affiliates: it shows that, on average, 66% of the affiliates of the top 100 TNCs are located abroad (annex table A.I.9). Like the TNI, the Internationalization Index is highest for top TNCs from small economies (such as Finland, Spain and Switzerland) and for the pharmaceutical industry. On average, the top TNCs have affiliates in 39 foreign economies. Ranking TNCs by the number of host countries shows that firms from European countries rank high, with affiliates in an average of 71 host economies.[35] The host country most favoured by these 100 largest TNCs is the Netherlands, where 91 of the 100 have at least one affiliate, followed by the United Kingdom and Canada. Among developing countries, Brazil hosts the largest number of affiliates of the top 100 TNCs (75), followed by China, with 60.

Figure I.8. Average TNI[a] of the 100 largest TNCs in the world and of the 50 largest TNCs from developing countries, 1993-2003



Source: UNCTAD/Erasmus University database.
[a] A simple average (for definition, see table I.6).

Table I.7 Measures of efficiency and productivity of the world's top 100 and developing countries' top 50 TNCs, 2002, 2003

	Top 100		Top 50	
Measure	2002	2003	2002	2003
Sales/assets	68.9	69.3	66.4	72.0
Sales/employment[a]	0.33	0.38	0.21	0.16

Source: UNCTAD/Erasmus University database.
[a] In millions of dollars per employee.

The Internationalization Index also shows that, on average, 49% of the affiliates of the top 50 TNCs are located abroad (annex table A.I.10). This index is highest for TNCs from Hong Kong (China), the Republic of Korea and Singapore, and for those in the electrical/electronics industry. On average, the top 50 TNCs have affiliates in 13 host economies, which is much less than those of the top 100 TNCs, though the East Asian firms at the top of the 50 list come close (with an average of 36 host economies) to their counterparts from developed countries.

d. The top 10 TNCs from South-East Europe and the CIS

During 2002-2003 the 10 largest non-financial TNCs from South-East Europe and the CIS continued to expand both at home and abroad in terms of assets, sales and employment (table I.8). Firms in natural resources and transportation dominate the list. The largest TNC, Lukoil, ranks within the top 10 of the largest TNCs from developing countries (annex table A.I.11).

Russian TNCs dominate the list, but on average they are less transnationalized than the top 50 TNCs from developing economies. The simple average TNI for the top 10 (36.6) is also much lower than that for the top 50. Although the sales-to-assets ratio is high, the ratio of sales to employment is much lower than for TNCs from developing economies.

e. The world's top 50 financial TNCs

During the past decade or so, deregulation of financial services in Europe and North America, technological change and competitive pressures have contributed to the creation of financial conglomerates that provide banking services, mortgages, all lines of insurance, asset management, and treasury and securities services. According to *Fortune*, the largest financial services companies by revenues did not rank among the top 50 of the world's biggest corporations in 1989. In 2003, the largest financial services company from Germany (Allianz) ranked 11th, and 13 financial groups from the Triad (EU, Japan and the United States) were listed among the top 50 corporations in the world in terms of revenues.[36]

The rise in the value of the assets of financial TNCs in the 1990s is mainly attributed to growth through M&As. The growth of transnational financial conglomerates is not confined to developed economies: foreign participation in the financial sectors of emerging markets also increased rapidly during the 1990s particularly in Latin America, the new EU member countries and South-East Europe. Mexico alone accounted for about 50% of the cumulative FDI flows in financial services in Latin America and the Caribbean region from 1990 to 2003. The new EU members and countries in South-East Europe became major recipients of FDI flows in the financial industry when privatizations and preparations for EU membership took place in the second half of the 1990s. The proportion of cross-border M&As in the financial sectors of Asia has been small compared to other regions (BIS 2004).

Large groups dominate world financial services, not only in terms of total assets but also in terms of the number of countries in which they operate.[37] This year, for the first time, *WIR*

Table I.8. Snapshot of the top 10 TNCs from SEE and CIS: assets, sales and employment, 2002, 2003
(Billions of dollars, thousands of employees, per cent)

Variable	2002	2003	% change
Assets			
Foreign	8.4	12.0	43.6
Total	42.7	48.9	14.6
Foreign as % of total	19.7	24.6	4.9[a]
Sales			
Foreign	14.5	24.9	72.0
Total	23.7	44.1	86.3
Foreign as % of total	61.2	56.5	-4.7[a]
Employment			
Foreign	19.1	39.9	108.4
Total	382.3	469.0	22.7
Foreign as % of total	5.0	8.5	3.5[a]

Source: UNCTAD/Erasmus University database.
[a] In percentage points.

introduces a list of the top 50 largest financial TNCs. These are ranked by total assets since data on foreign assets, foreign sales or foreign employment are not available.

TNCs from five countries (France, Germany, Japan, the United Kingdom and the United States) dominate the list, accounting for 70% of all companies in the top 50 and 74% of their total assets. However, there are companies from seven different countries in the top 10, accounting for 34% of total assets. In addition, the top 10 companies account for only 26% of total employment (annex table A.I.12).

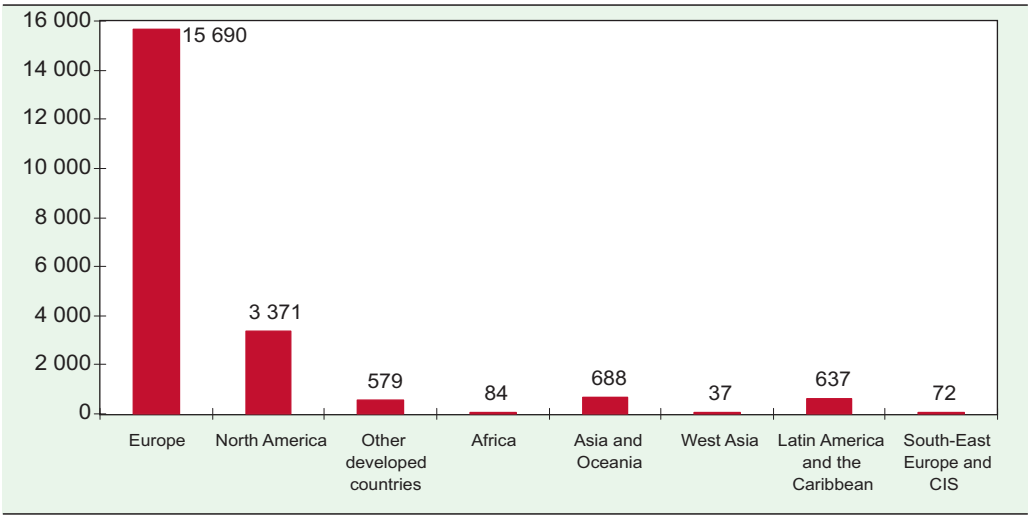
The degree of transnationality of financial TNCs can only be measured by the physical spread and location of their operations. The Internationalization Index shows that, on average, 46% of the affiliates of the top 50 financial TNCs are located abroad. The index is highest for financial groups from Switzerland that face domestic growth constraints due to the small size of the domestic market, amd have built up strong competitive advantages over a long period of time. The top 50 financial TNCs have, on average, affiliates in 25 countries. The largest share of affiliates is in Europe (figure I.9). There is a strong correlation between the size of a company and its transnationalization: the top 10 companies on the list have, on average, 58% of their affiliates located abroad in 44 countries, while the average for the whole group of affiliates is 43% in 25 host countries.

3. FDI performance and potential

The UNCTAD Inward FDI Performance[38] and Potential[39] Indices, as well as the Outward FDI Performance Index,[40] showed some noticeable changes for individual countries in 2004, reflecting uneven developments of FDI inflows and improvements in general economic performance (annex tables A.I.13-A.I.14).

The Inward FDI Performance Index for developing countries as well as the transition economies of South-East Europe and the CIS

Figure I.9. Distribution of foreign affiliates of the 50 largest financial TNCs, 2003



Source: UNCTAD, based on *Who Owns Whom* database (London: Dun & Bradstreet).

improved in 2004,[41] notably in South, East and South-East Asia, South-East Europe and the CIS (table I.9). However, it worsened in developed countries compared to 2003, although as a group they were well ahead of developing countries (table I.9). The United States, where FDI inflows rose by 69% in 2004, had a lower Performance Index and ranked at 114th out of 140 countries in the world, due to its lower FDI flows in 2002-2003; these are taken into account in the 2004 index (see annex table A.I.13 for rankings of all 140 countries). Denmark, the Netherlands, Portugal and Sweden fell by more than 30 positions in the country rankings (figure I.10). With large negative FDI inflows in 2004, Denmark fell by nearly 100 positions and was ranked second from the bottom. The top position in 2004 was held by Azerbaijan due to large oil-related FDI flows relative to the small size of its economy. In 2004, Tajikistan rose the most in the country rankings to 19th in the world (table I.10), reflecting a significant increase of FDI inflows in mining in 2002-2004 (annex table B.1).

In contrast to the changes in rankings by the Inward FDI Performance Index (see annex table A.I.13 for rankings of all 140 countries), there were almost no changes in the Inward FDI Potential Index rankings of the top ranked countries between 2002 and 2003[42] (table I.11). This reflects the stability of the structural variables comprising the Index. In other words, this index shows how the structural variables move in relation to each other. Comparing the rankings by the Potential Index with those of the Performance Index gives an indication of how each country performs against its potential. Countries in the world can be divided into the following four categories: front-runners (countries with high FDI potential and performance); above potential (countries with low FDI potential but strong FDI performance); below potential (countries with high FDI potential but low FDI performance); and under-performers (countries with both low FDI potential and performance (table I.12). The data for this categorization are limited to 2003 (due to unavailability of the 2004 data for the Potential Index), the last year of the global FDI downturn period. As in past years, there are no significant changes in the first and last groups, with many developed and newly industrializing economies in the former and many LDCs or poor developing countries in the latter. The second and third groups also include mostly the same countries as in the previous year. The question remains for the above-potential countries as to how they can continue to sustain their FDI performance at levels comparable with those of the past while addressing structural problems (i.e. FDI potential). The concern for the below-potential countries, on the other hand, is how they could raise their FDI performance to match their potential.

Performance in FDI outflows relative to the size of economies as measured by the Outward FDI Performance Index (annex table

Table I.9. Inward FDI Performance Index, by region, 1990, 2003, 2004[a]

Region	1990	2003	2004
World	1.000	1.000	1.000
Developed countries	1.022	0.947	0.891
Western Europe	1.310	1.837	1.625
European Union	1.310	1.866	1.647
Other Western Europe	1.307	1.261	1.175
North America	1.129	0.474	0.402
Other developed countries	0.290	0.202	0.372
Developing countries	0.977	1.187	1.353
Africa	0.731	1.253	1.226
North Africa	0.847	0.925	1.031
Other Africa	0.650	1.508	1.360
Latin America and the Caribbean	0.898	1.394	1.523
South America	0.741	1.399	1.648
Other Latin America and the Caribbean	1.302	1.386	1.359
Asia and Oceania	1.075	1.092	1.306
Asia	1.063	1.092	1.306
West Asia	0.141	0.415	0.478
South, East and South-East Asia	1.312	1.230	1.482
South Asia	0.115	0.320	0.418
East and South-East Asia	1.735	1.444	1.729
East Asia	1.193	1.523	1.821
South-East Asia	3.104	1.180	1.423
Oceania	7.358	0.936	0.795
South-East Europe and CIS	0.955 [b]	1.254	1.787
South-East Europe	0.835 [b]	2.273	3.064
CIS	0.981 [b]	1.044	1.533

Source: UNCTAD.

[a] Three-year moving average, using data for the three years ending with the year in question.

[b] As most of the countries in this region did not exist in their present form before 1992, the period for the index is 1992-1994.

A.I.14) shows some changes in country positions in 2004 as compared with those in 2003. There are three newcomers to the list of the top 20 outward investment economies: Australia, Austria and Estonia (table I.13). However, Denmark, Finland and Ireland are no longer in the list, unlike other small economies that rank relatively high. Denmark and Finland also fell in ranking on the Inward FDI Performance Index in 2004.

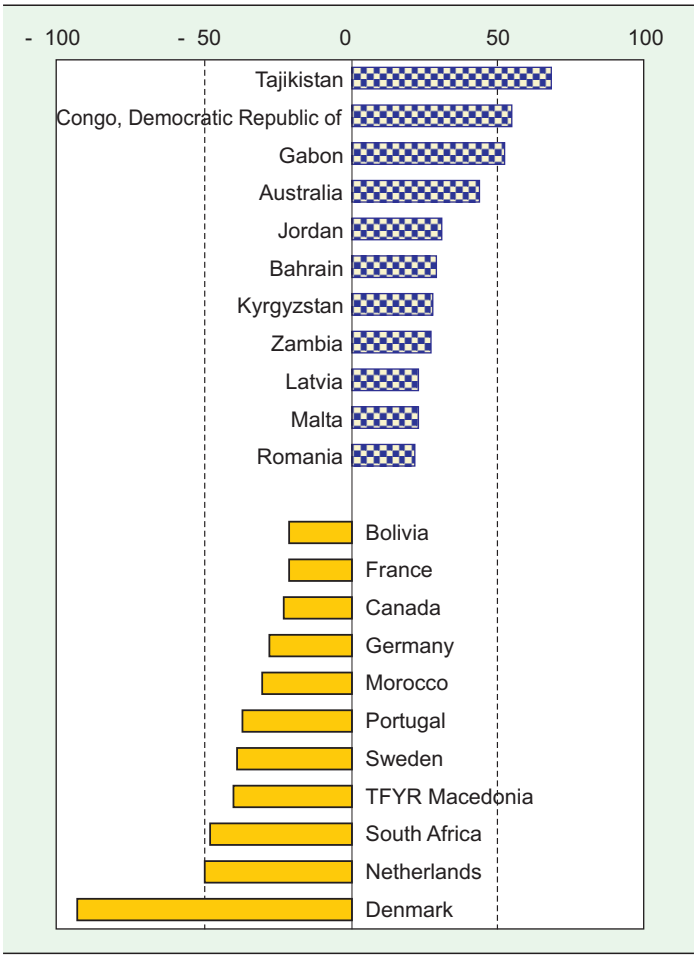
B. Policy developments

1. National policy changes

With a view to upgrading or enhancing their ability to attract and benefit from FDI, countries are continuing to adopt measures intended to improve their investment climates. In 2004, both the number of national policy measures affecting FDI and TNCs that were introduced and the number of economies involved in the process increased. A total of 271 new measures were adopted by 102 economies (table I.14).

The vast majority (87%) of regulatory changes tended to make conditions more favourable for foreign companies to enter and operate. Most of these measures implied further liberalization of investment regimes; 95 involved new promotional efforts (including various types of incentives) and 37 greater investor protection. In terms of regional distribution, Asia and Oceania accounted for 30% of the new measures, followed by the transition economies (22%), Africa (21%), developed countries (14%) and Latin America and the Caribbean (13%).

Figure I.10. Largest gains and losses in inward FDI performance, 2003-2004[a]
(Changes in country ranking)



Source: UNCTAD, based on annex table A.I.13.

[a] Three-year moving average, using data for the three years ending with the year in question.

While the trend towards more welcoming policies for FDI continued, 36 were less favourable in 2004 – an unusually high share. This is the highest number reported since UNCTAD started monitoring changes in national laws in 1991. In Latin American and the Caribbean countries, as many as 24% of all changes were unfavourable, and the share was also relatively high in Africa (19%). In terms of their nature, 11 involved less promotional efforts (e.g. making incentives less generous), 9 involved new restrictions to FDI entry and establishment, while 5 affected the operations of foreign investors. The relatively high incidence of such measures may reflect the growing disappointment of many developing countries in the ability of liberalization, generous incentives and promotion to attract the level of FDI inflows that is commensurate with their potential.

An area in which many changes were undertaken in 2004 was corporate taxation. Reflecting the growing competition for FDI (as well as the need to stimulate investment generally), significant reductions in corporate income tax rates were noted in many countries.[43] According to UNCTAD's findings, about 20 economies reduced their corporate income tax rates during 2004 (table I.15) – nine were developed economies, five transition economies and six developing economies. From a regional perspective, developed countries as a group showed the most significant reduction in their average

Table I.10. Rankings by the Inward FDI Performance Index, 2004 [a]

1	Azerbaijan	36	Tanzania, United Republic of	71	Ukraine	106	Thailand
2	Belgium and Luxembourg	37	Mali	72	Macedonia, TFYR	107	Paraguay
3	Brunei Darussalam	38	Zambia	73	El Salvador	108	Egypt
4	Angola	39	Syrian Arab Republic	74	New Zealand	109	Korea, Republic of
5	Ireland	40	Australia	75	Poland	110	Oman
6	Gambia	41	Botswana	76	Iceland	111	Turkey
7	Hong Kong, China	42	Albania	77	Kyrgyzstan	112	India
8	Singapore	43	Bolivia	78	United Kingdom	113	Zimbabwe
9	Mongolia	44	Nigeria	79	Mexico	114	United States
10	Congo	45	China	80	France	115	Burkina Faso
11	Kazakhstan	46	Hungary	81	Portugal	116	Libyan Arab Jamahiriya
12	Bulgaria	47	Latvia	82	Argentina	117	Myanmar
13	Georgia	48	Jordan	83	Israel	118	Germany
14	Cyprus	49	Spain	84	Malta	119	Malawi
15	Trinidad and Tobago	50	Viet Nam	85	Guinea	120	Guatemala
16	Estonia	51	Costa Rica	86	Venezuela	121	Saudi Arabia
17	Jamaica	52	Bahamas	87	Côte d'Ivoire	122	Bangladesh
18	Sudan	53	Honduras	88	Russian Federation	123	Madagascar
19	Tajikistan	54	Uganda	89	Austria	124	Rwanda
20	Congo, Democratic Republic of	55	Finland	90	Lebanon	125	Taiwan Province of China
21	Chile	56	Malaysia	91	Ghana	126	South Africa
22	Armenia	57	Gabon	92	Papua New Guinea	127	Kenya
23	Mozambique	58	Dominican Republic	93	Sweden	128	Niger
24	Ethiopia	59	Lithuania	94	Canada	129	Greece
25	Slovakia	60	Slovenia	95	Algeria	130	Iran, Islamic Republic of
26	Moldova, Republic of	61	Switzerland	96	Sri Lanka	131	Sierra Leone
27	Bahrain	62	Brazil	97	Benin	132	Yemen
28	Czech Republic	63	Qatar	98	Italy	133	Haiti
29	Panama	64	Peru	99	Belarus	134	Japan
30	Nicaragua	65	Morocco	100	Philippines	135	Nepal
31	Guyana	66	Togo	101	Senegal	136	Indonesia
32	Namibia	67	Tunisia	102	Pakistan	137	Cameroon
33	Croatia	68	Netherlands	103	Norway	138	Kuwait
34	Ecuador	69	Colombia	104	United Arab Emirates	139	Denmark
35	Romania	70	Uruguay	105	Uzbekistan	140	Suriname

Source: UNCTAD, based on annex table A.I.13.

[a] Three-year moving average, using data for the three years ending with the year in question.

corporate tax rate from 29.7% to 26.5% (KPMG 2005). Among individual economies, Romania made the largest tax cut, from 25% to 16%, followed by Uruguay and Bulgaria. Only three countries reported increased rates (Germany, India and Viet Nam).

Corporate taxes may affect a country's international attractiveness in the eyes of foreign investors (OECD 2002a).[44] Studies show that location of FDI is becoming more sensitive to taxation, and that corporate income tax rates can influence a TNC's decision to undertake FDI, especially if competing jurisdictions have similar "enabling conditions". For instance, EU investors were found to increase their FDI positions in other EU member States by approximately 4% if the latter reduced their effective corporate income tax rates by one percentage point relative to the European mean (Gorter and Parikh 2003).

While policy changes overall are in the direction of more liberalization and deregulation, there are some differences between regions. FDI policy changes at the regional level are described in the analysis of regional trends in chapter II.

2. International investment agreements

The past year saw a further proliferation of international investment agreements (IIAs)[45] at the bilateral, regional and interregional levels. Several developments are worth noting in this context. First, the universe of bilateral investment treaties (BITs) and bilateral double taxation treaties (DTTs) continued to expand, albeit at a

Table I.11. Top 25 economies by the Inward FDI Potential Index, 1990, 2002, 2003 [a]

Economy	1990	2002	2003
United States	1	1	1
Norway	5	2	2
United Kingdom	3	3	3
Canada	2	5	4
Singapore	15	4	5
Sweden	6	7	6
Qatar	19	6	7
Germany	4	10	8
Belgium and Luxembourg	10	8	9
Ireland	27	9	10
Netherlands	8	11	11
France	7	15	12
Finland	9	12	13
Iceland	14	14	14
Hong Kong, China	20	13	15
Japan	13	16	16
Switzerland	11	18	17
Denmark	16	17	18
Australia	12	21	19
Korea, Republic of	21	19	20
Taiwan Province of China	22	20	21
United Arab Emirates	26	22	22
Israel	31	23	23
Austria	18	24	24
Spain	24	25	25

Source: UNCTAD, based on annex table A.I.13.

[a] Three-year moving average, using data for the three years ending with the year in question.

slower pace than in previous years. Second, international investment rules are becoming increasingly sophisticated and complex in content, and are also being formulated as part of agreements that encompass a broader range of issues (including trade in goods and services as well as the movement of other factors of production). Third, among the new BITs, some are re-negotiated treaties that replace earlier BITs between the same partners, either because the original treaty has reached its expiry date or because of changed circumstances. Fourth, South-South cooperation in the area of international investment policy is intensifying. And fifth, there is a marked rise in investor-State disputes. As a result of these developments, countries and firms have to operate within an increasingly complicated framework of investment rules that is both multilayered and multifaceted, with overlapping obligations and commitments as well as gaps in its coverage.

a. Bilateral investment treaties

The number of BITs worldwide has continued to expand over the past year, but at a slower pace than before. During 2004, 73 new BITs were concluded, 10 of which replaced earlier BITs, bringing the total number to 2,392 (figure I.11). However, this represents a slowdown in the conclusion of BITs since 2001. The largest number of the new BITs signed during 2004 was between developing countries, with 28 BITs or 38% of the total, followed closely by BITs between developed and developing countries with 27 of all BITs signed.

As of the end of 2004, the share of BITs signed between developed and developing countries in total BITs worldwide was 40%. BITs concluded among developing economies accounted for 25%, while those between developing and transition economies (South-East Europe and CIS) rose to 10% of the total (figure I.12). BITs typically are not concluded between developed economies because, with a few exceptions, investment relations between these countries are traditionally governed by other international instruments.[46] Developed countries dominate the list of economies with the highest number of BITs. Only two countries within the top ten are developing economies (figure I.13).

Within the South-South BITs universe, China, Egypt, the Republic of Korea and Malaysia have each signed more than 40 treaties with other developing countries. Each of these four countries has signed more agreements with other developing countries than with developed countries. The recent increase in developing-country BITs reflects a greater emphasis on South-South cooperation on investment, as well as the rise of outward FDI from developing countries (UNCTAD forthcoming a).

Not all BITs signed are in force (i.e. ratified and/or enacted). In fact, only about 70% of the 2,392 BITs signed by the end of 2004 were in force. For 46% of the BITs that had not entered into force, the time period since signature exceeded five years (i.e. longer than the average period of two to three years that it takes to ratify a BIT and for it to enter into force). This proportion is higher for BITs concluded by developing economies: 51% of them exceed the five-year span. The same ratio for BITs concluded by LDCs is 33% (UNCTAD forthcoming b). This

Table I.12. Matrix of inward FDI performance and potential, 2003[a]

	High FDI performance	Low FDI performance
	Front-runners	Below potential
High FDI potential	Bahamas, Bahrain, Belgium and Luxembourg, Botswana, Brazil, Brunei Darussalam, Bulgaria, Chile, China, Costa Rica, Croatia, Cyprus, the Czech Republic, Denmark, Dominican Republic, Estonia, Finland, France, Hong Kong (China), Hungary, Ireland, Israel, Kazakhstan, Latvia, Lithuania, Mexico, the Netherlands, Panama, Portugal, Qatar, Singapore, Slovakia, Slovenia, Spain, Sweden, Switzerland, Trinidad and Tobago, Tunisia and Viet Nam.	Argentina, Australia, Austria, Belarus, Canada, Germany, Greece, Iceland, Islamic Rep.of Iran, Italy, Japan, Jordan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Malaysia, Malta, New Zealand, Norway, the Oman, the Philippines, Poland, the Republic of Korea, the Russian Federation, Saudi Arabia, Taiwan Province of China, Thailand, Ukraine, United Arab Emirates, the United Kingdom and the United States.
	Above potential	Under-performers
Low FDI potential	Albania, Angola, Armenia, Azerbaijan, Bolivia, Colombia, Congo, Ecuador, Ethiopia, Gambia, Georgia, Guyana, Honduras, Jamaica, Mali, Mongolia, Morocco, Mozambique, Namibia, Nicaragua, Nigeria, Peru, Republic of Moldova, Romania, Sudan, Syrian Arab Republic, TFYR Macedonia, Togo, Uganda, the United Republic of Tanzania and Zambia.	Algeria, Bangladesh, Benin, Burkina Faso, Cameroon, the Democratic Republic of the Congo, Côte d'Ivoire, Egypt, El Salvador, Gabon, Ghana, Guatemala, Guinea, Haiti, India, Indonesia, Kenya, Kyrgyzstan, Madagascar, Malawi, Myanmar, Nepal, Niger, Pakistan, Papua New Guinea, Paraguay, Rwanda, Senegal, Sierra Leone, South Africa, Sri Lanka, Suriname, Tajikistan, Turkey, Uruguay, Uzbekistan, Venezuela, Yemen and Zimbabwe.

Source: UNCTAD.

[a] Three-year moving average, using data for the three years ending with the year in question.

Table I.13. Outward FDI Performance Index for the 20 leading investor economies, 1990, 2003, 2004[a]

Rank	Economy	1990	2003	2004
1	Belgium and Luxembourg	2.740	22.331	20.070
2	Panama	7.800	9.479	9.791
3	Hong Kong, China	3.451	3.526	7.002
4	Azerbaijan	..	3.313	6.535
5	Iceland	0.067	1.937	5.604
6	Bahrain	0.588	2.244	3.774
7	Singapore	2.961	5.792	3.526
8	Sweden	4.649	2.499	2.870
9	Switzerland	3.525	2.485	2.786
10	Spain	0.439	2.390	2.649
11	Netherlands	3.965	4.623	2.627
12	Cyprus	0.037	1.915	2.282
13	Canada	0.926	1.835	2.014
14	United Kingdom	3.034	1.822	1.799
15	Portugal	0.165	1.800	1.697
16	France	1.890	2.097	1.574
17	Austria	0.609	1.205	1.431
18	Australia	0.970	1.347	1.380
19	Botswana	0.069	1.824	1.332
20	Estonia	..	1.172	1.123

Source: UNCTAD.

[a] Three-year moving average, using data for the three years ending with the year in question.

Notes: Economies are ranked in descending order of their performance index in 2002-2004.

reflects, among other things, the fact that the formal requirement for the ratification and enactment of BITs varies from country to country according to their constitutions and legislative procedures. In some countries, for example, the ratification of a treaty may require the enactment of an implementing legislation, which in turn may require major adaptations of relevant legislation. In other countries, ratification and entry into force of international treaties takes place only after a certain number of treaties ready to be ratified have been accumulated. Non-ratification may also be due to lack of coordination and communication within the government, changes in government and/or changes in government policy, political upheaval, civil unrest or war, or a deliberate policy choice of the government.

It is important to note in this context that the signature of a treaty itself has legal implications for its parties. According to Article 18 of the Vienna Convention on the Law of Treaties, "A State is obliged to refrain from acts which would defeat the object and purpose of a treaty when: (a) it has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not

Table I.14. National regulatory changes, 1991-2004

Item	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76	60	63	69	71	70	82	102
Number of regulatory changes	82	79	102	110	112	114	151	145	140	150	208	248	244	271
of which:														
More favourable to FDI [a]	80	79	101	108	106	98	135	136	131	147	194	236	220	235
Less favourable to FDI [b]	2	-	1	2	6	16	16	9	9	3	14	12	24	36

Source: UNCTAD database on national laws and regulations.

[a] Includes liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.

[b] Includes changes aimed at increasing control, as well as reducing incentives.

to become a party to the treaty; or (b) it has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed".

Two issues arise. The first concerns the applicability of the substantive provisions of a treaty even though not ratified. The second issue concerns the availability of recourse for an investor or a government to international arbitration. While the case law on this matter is limited,[47] it appears that it could be difficult for an investor or a government to invoke consent to arbitration under a treaty that has not yet entered into force.

Table I.15. Changes in corporate income tax rates in selected economies, 2004
(Per cent)

Economy	1 January 2004	1 January 2005
Decrease		
Albania	25.00	23.00
Austria	34.00	25.00
Barbados	33.00	30.00
Bulgaria	19.50	15.00
Czech Republic	28.00	26.00
Denmark	30.00	28.00
Finland	29.00	26.00
France	34.33	33.83
Greece	35.00	32.00
Israel	36.00	34.00
Japan	42.05	40.69
Korea, Republic of	29.70	27.50
Latvia	19.00	15.00
Mexico	33.00	30.00
Netherlands	34.50	31.50
Romania	25.00	16.00
Singapore	22.00	20.00
Switzerland	24.10	21.30
Turkey	33.00	30.00
Uruguay	35.00	30.00
Increase		
Germany	38.29	38.31
India	35.875	36.5925
Viet Nam	26.00	28.00

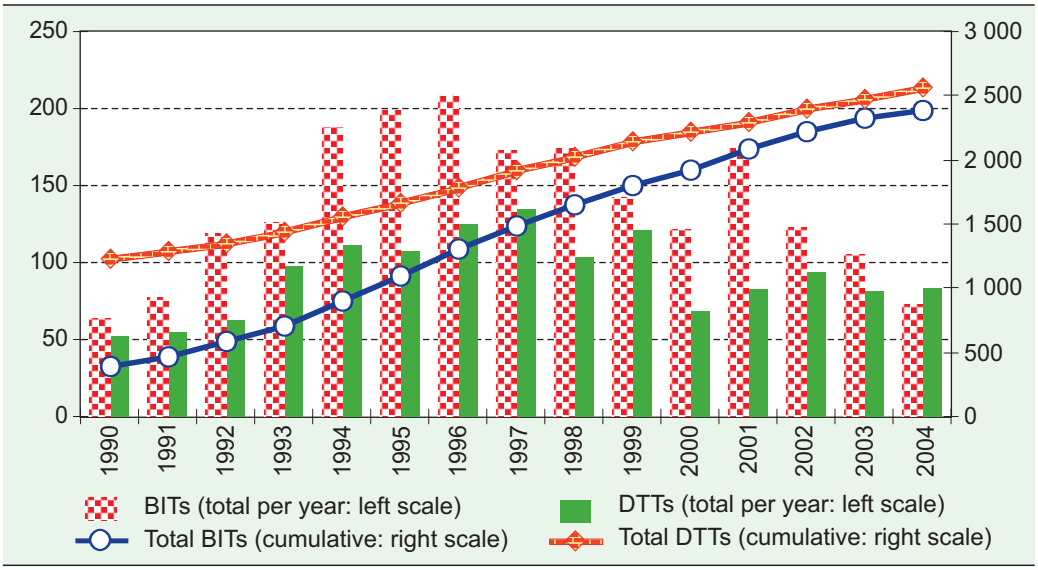
Source: UNCTAD, based on national sources and KPMG, 2005.

It is also worth noting that countries are increasingly renegotiating their existing BITs. While BITs generally provide for tacit renewal after their expiration, in some cases countries undertake re-negotiation of these agreements, either to obtain stronger commitments or because of the need to make existing BITs comply with the parties' commitments made under other investment agreements.[48] In such cases, the new BIT supersedes the earlier one. The trend towards renegotiation accelerated in the late 1990s and continued at an increasing pace thereafter, reaching 34 renegotiated BITs by the year 2000, and over 85 renegotiations by 2004.

Some of the BITs concluded most recently may have been influenced in some respect by the experience in the application and implementation of the investment chapter of the North American Free Trade Agreement (NAFTA) and of a few other IIAs. The United States-Uruguay BIT (2004) and – to a lesser degree – the BIT between Japan and the Republic of Korea (2002) reflect this phenomenon. In particular, some recent BITs (and BIT models) deviate from the traditional open-ended asset-based definition of investment, with a view to striking a balance between maintaining a comprehensive investment definition, on the one hand, and excluding from coverage those assets that are not intended by the parties to fall under an agreement's protective wings, on the other.[49]

Furthermore, some recent BITs include significant revisions to the wording of various substantive treaty obligations. For instance, drawing on the implementation legacy of the

Figure I.11. Number of BITs and DTTs concluded, cumulative and annual, 1990-2004



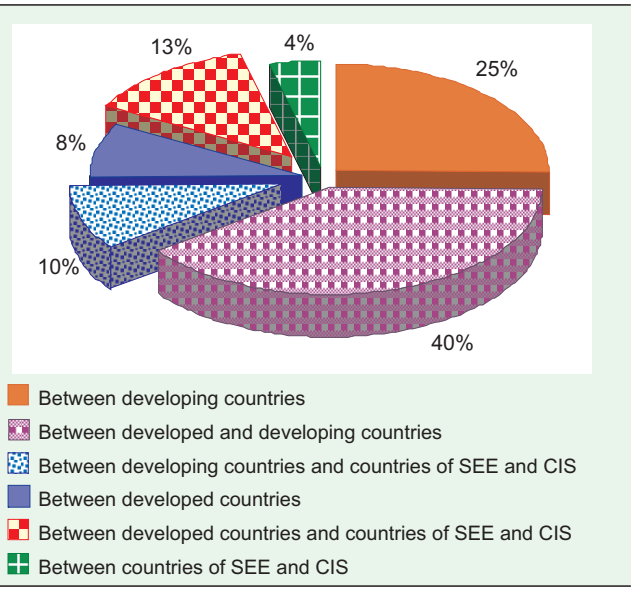
Source: UNCTAD, BIT/DTT database (www.unctad.org/iia).

investment chapter of NAFTA, the new model BITs of Canada and the United States elaborate the language and clarify the meaning of provisions dealing with absolute standards of protection. This is notably the case with the meaning of the minimum standard of treatment concept in accordance with international law and the concept of indirect expropriation.[50]

Some new BITs also address a broader set of issues, including not only specific economic aspects such as investment in financial services, but also other issues where greater policy space for host-country regulation may be sought. In this regard, language is sometimes included to clarify that the investment protection and liberalization provisions cannot be pursued at the expense of the protection of key public policy objectives such as health, safety, the environment and the promotion of internationally recognized labour rights.

Finally, some recent BITs have made significant innovations regarding investor-State dispute settlement procedures, in an effort to secure greater transparency in arbitral proceedings, including open hearings, publication of related legal documents and the possibility for representatives of civil society to submit "*amicus curiae*" (i.e. "friends of the court") briefs to arbitral tribunals. In addition, other very detailed provisions on investor-state dispute settlement are included in order to provide for more legally oriented, predictable and orderly conduct at the different stages of the ISDS process. Thus, for example, the Canadian BIT model includes specific standard waiver forms to facilitate the filing of waivers as required by Article 26 of the Agreement for purposes of filing an ISDS claim. The United States-Uruguay BIT, on the other

Figure I.12. Total BITs concluded, by country group,[a] end 2004

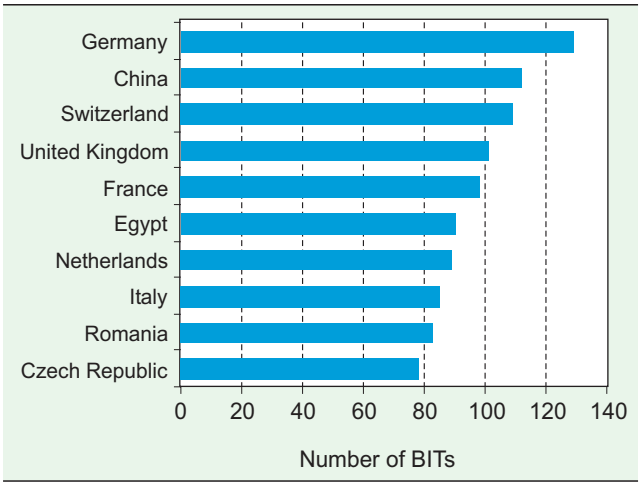


Source: UNCTAD, BIT/DTT database (www.unctad.org/iia).

[a] Due to the accession of ten countries to the EU on 1 May 2004, the BITs previously signed by those countries have been added to the BITs involving developed countries.

Note: SEE: South-East Europe.

Figure I.13. Top 10 signatories of BITs, end 2004



Source: UNCTAD, BIT/DTT database (www.unctad.org/iia).

hand, not only provides for a special procedure available at the early stages of the ISDS process aimed at discarding frivolous claims or to seek interim injunctive relief, but also envisages the possibility to set up a mechanism for appellate review, in order to foster a more consistent and rigorous application of international law in arbitral awards. A number of these procedural issues have also been taken up in the debate about changes to ICSID's rules and regulations.[51]

b. Double taxation treaties

In 2004, 84 new DTTs were concluded between 79 countries. This represents a continued growth of DTTs, albeit at a slightly slower pace compared to 2003. The total number of DTTs rose to 2,559 by the end of 2004 (figure I.11). Austria set the pace by concluding ten new DTTs, Azerbaijan concluded six, while South Africa and Lithuania each concluded five. Unlike in the case of BITs, the top ten economies in terms of number of DTTs signed are all developed economies (figure I.14).

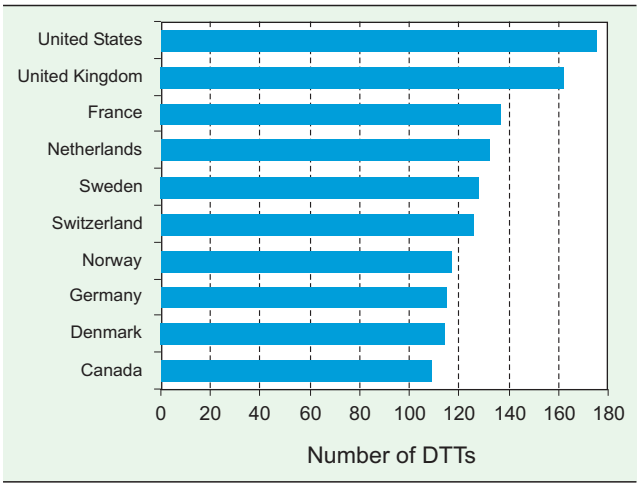
As of the end of 2004 about 39% of all DTTs were concluded between developed and developing countries. DTTs among developed countries accounted for 29%, another 19% involved countries in South-East Europe and the CIS and the remaining 13% were concluded among developing economies (figure I.15).

As far as developing-country DTTs are concerned, a trend can be observed that is similar, but less pronounced, than that of BITs regarding increasing South-South investment cooperation. Although the first South-South DTT was concluded as early as 1948 (by Argentina and Peru), such DTTs proliferated only during the second half of the 1990s. During the 1990s, 156 new DTTs were signed between 69 developing countries, bringing the total number of South-South treaties to 256 by the end of 1999. Growth persisted until 2004, with the number of South-South DTTs reaching 345 between 90 countries.

c. Other international investment agreements

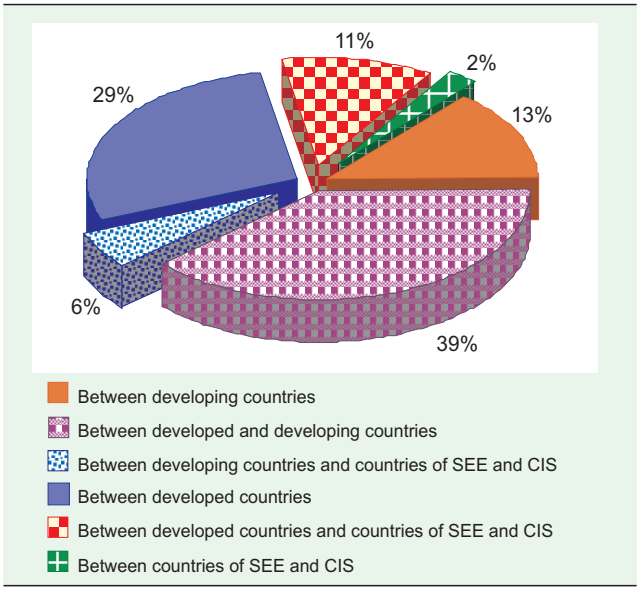
Besides BITs and DTTs, international investment rules are increasingly being adopted as part of bilateral, regional and interregional agreements that address trade and investment transactions. These agreements contain, in addition to a range of trade liberalization and promotion provisions, commitments to liberalize, protect and/or promote investment flows between the parties. They respond to the increasing global competition facing national economies for resources and markets. The number of such agreements has been growing steadily, and by April 2005 exceeded 212 (209 at the end of 2004). The large majority of these agreements (about 87%) were concluded since 1990 (figure I.16). In 2004 and early 2005 at least 32 new agreements were concluded and about 66 others were under negotiation or consultation (annex tables A.I.15 and A.I.16). Until the late 1980s, investment facilitation through these agreements remained confined mainly to intraregional

Figure I.14. Top 10 signatories of DTTs, end 2004



Source: UNCTAD, BIT/DTT database (www.unctad.org/iia).

Figure I.15. Total DTTs concluded, by country group,[a] end 2004



Source: UNCTAD, BIT/DTT database (www.unctad.org/iia).

[a] Due to the accession of ten countries to the EU on 1 May 2004, the DTTs previously signed by those countries have been added to the DTTs involving developed countries.

Note: SEE: South-East Europe.

processes, with some exceptions (e.g. early agreements between the European Community and developing countries). Since 1990, countries and groups located in different regions have begun to conclude trade and investment agreements with one another, with the result that interregional agreements now account for more than half of the total, and for about 49% of the 182 concluded since 1990.

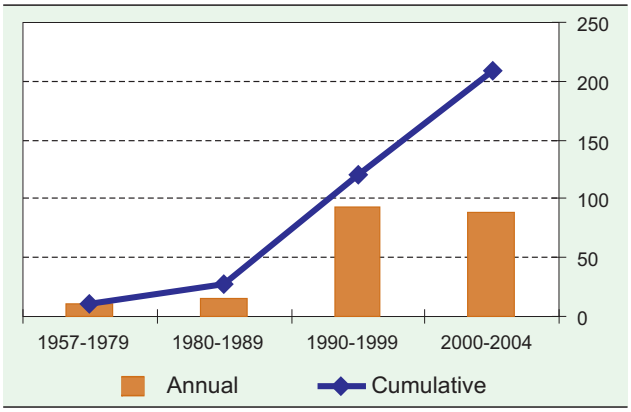
The growth of IIAs (other than BITs and DTTs) is partly the result of two important qualitative changes that took place during the 1990s. First, these agreements, which previously had been used mainly by countries at similar levels of development, started to be concluded between developed and developing countries: by April 2005, 81 had been signed (77 since 1990) and 39 were under negotiation (annex table A.I.16). Second, there has also been a dramatic increase in such agreements between developing countries since the 1990s. By April 2005 at least 70 of them had been signed (59 since 1990) and another 24 were under negotiation, suggesting that developing countries are increasingly pursuing development strategies based on cooperation among themselves.

Compared to BITs, these other IIAs show far more variation in their scope, approach and content. Moreover, they increasingly encompass a broader range of economic transactions, including, notably, trade in goods and services, investment and capital flows, as well as movement of labour. The more issues that are addressed, the more complex the agreement, and the greater the likelihood of overlaps and inconsistencies between provisions. At the same time, their greater variation presents an opportunity for experimenting with different approaches to promoting international investment flows that better reflect the special circumstances of countries at different levels of economic development and in different regions. A number of patterns have emerged concerning investment provisions in recent IIAs, though with many significant variations.

With respect to investment liberalization, IIAs other than BITs and DTTs have typically followed two main approaches. One is to provide for actual liberalization subject to a list of country exceptions (negative list approach). This approach is typical of most agreements signed between countries of the Western Hemisphere following the NAFTA model. The second approach is to provide for the progressive abolition of restrictions to the entry, establishment and operation of investment. This pattern has been followed notably in the agreements between the European Community and third countries, as well as by the members of the Association of South-East Asian Nations (ASEAN) in the Framework Agreement on the

Figure I.16. The growth of international investment agreements other than BITs and DTTs, 1957-2004

(Number)



Source: UNCTAD (www.unctad.org/iia).

ASEAN Investment Area and several agreements signed by ASEAN members with third countries. Under the latter approach, the level of liberalization sought varies considerably. While some agreements commit to achieving full liberalization of investment by a particular date (e.g. the ASEAN Investment Area), others aim at completing the process of investment liberalization in several stages (e.g. the Europe Association Agreements signed by the European Community with Central European countries). Still others establish a framework for future negotiations to liberalize investment (e.g. the Euro-Mediterranean Agreements signed between the European Community with countries in Northern Africa and the Middle East; the African Economic Community; the ASEAN Agreement with China).

The more recent agreements that provide for investment protection in addition to liberalization, concluded by countries such as Chile, Japan, Singapore, Morocco and the United States, are more comprehensive, detailed, and, for the most part, more rigorous than prior NAFTA-style agreements. While these agreements address many of the same topics, they also deal with additional issues, or modify the NAFTA approach to these issues on the basis of accumulated experience. They typically deal extensively with trade in services, while separate chapters or provisions are devoted to topics such as competition policy, government procurement, intellectual property rights, labour, environment, trade and investment in particular industries, temporary entry for business persons, and transparency.

On the other hand, other recent agreements have remained narrow in their coverage of investment issues, limiting themselves to establishing a framework for cooperation on investment promotion. Recent examples include the free trade agreements signed between the members of the European Free Trade Association (EFTA) and Central European countries, bilateral agreements between Canada and countries in various regions, as well as a number of framework agreements on trade and investment relations between the United States and countries in Africa and the Middle East. The cooperation provided for under the latter type of agreements is typically aimed at creating favourable conditions for encouraging investment, notably through the exchange of information. It is also common for such agreements to set up consultative committees, or a similar institutional arrangement involving the parties, to follow up on the implementation of negotiated commitments and to discuss and study possible obstacles to market access for trade and investment.

d. International investment disputes

A new and significant development is the rise of investor-State disputes. These involve the whole range of investment activities and all kinds of investments, including privatization contracts and State concessions.[52]

Numerous IIAs allow investors to choose between the arbitral proceedings of the World Bank Group's International Centre for Settlement of Investment Disputes (ICSID) (including ICSID's Additional Facility) and ad hoc arbitration procedures, using arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL) for example. Other institutional facilities available for use are the International Chamber of Commerce (ICC) Court of Arbitration in Paris, the Stockholm Chamber of Commerce Arbitration, the London Court of International Arbitration and various regional arbitration centres, particularly in Singapore and Cairo. However, only ICSID provides a list of cases. And even under ICSID, decisions of the tribunals have not all been made public. While this situation may gradually be changing, it is not possible to know the actual number of cases to date, nor is it possible to learn about the legal issues or factual circumstances they encompassed.

The cumulative number of treaty-based cases brought before ICSID and other arbitration fora has been rising dramatically over the past five years, reaching 171 known claims by December 2004 and at least 183 by June 2005.[53] At least 57 governments – 36 of them of developing countries, 12 of developed countries and 9 of South-East Europe and the CIS – are involved in investment treaty arbitration. Argentina leads them all with 40 claims, 37 of which relate at least in part to that country's financial crisis. Mexico has the second highest number of known claims (15), most of them falling under NAFTA and a handful under various BITs. The United States has also faced a sizeable number (10), all of them pursuant to NAFTA. Poland (7 claims), Egypt (6) and the Russian

Federation (6) also figure prominently, along with nine countries that have each faced four claims: Canada, Chile, the Czech Republic, the Democratic Republic of Congo, Ecuador, India, Kazakhstan, Ukraine and Venezuela.

This rise in investment disputes poses a particular challenge for developing countries. The financial implications of the investor-State dispute-settlement process can be substantial, both from the point of view of the costs of the arbitration proceedings and the awards rendered. Information about the level of damages being sought by investors tends to be patchy and unreliable. Even ascertaining the amounts sought by foreign investors can be difficult, as most of the cases are still at a preliminary stage and, under the ICSID system, claimants are not obliged to quantify their claims until after the jurisdictional stage has been completed. Claims proceeding under other rules of arbitration are also difficult to quantify. It is, nonetheless, clear that some claims involve large sums.[54] Furthermore, even defending against claims that may not ultimately be successful costs money. A cursory review of cost decisions in recent awards suggests that the average legal costs incurred by governments are between $1 million and $2 million including lawyers' fees, the costs for the tribunal of about $400,000 or more, and the costs for the claimant, which are about the same as for the defendant.[55]

The surge in investment disputes arising from IIAs and the costs incurred from these disputes signify that governments that decide to enter into IIAs need to be judicious in negotiating such agreements. They also need to follow the developments of disputes in order to be sensitive to actions that could trigger litigation. Furthermore, it is important to review experiences in implementing international commitments in IIAs and to draw lessons from them.

C. Prospects: further FDI growth expected

Economic growth, continuing liberalization of investment policies and trade regimes, and increased competition among firms are likely to drive the global expansion of TNC activity. Following slow growth or recession during 2002-2003, the world economy has entered a period of recovery. Projections indicate that world real GDP, which grew by 5.1% in 2004, will increase more moderately, by 4.3% in 2005 and 4.4% in 2006 (IMF 2005). The rate of growth is likely to slow down in developed countries from 3.4% to 2.6% in 2005 and 3.0% in 2006, while still registering a high level in developing countries of above 6% during 2005-2006. Estimates by the United Nations and the World Bank corroborate these projections (UNDESA-UNCTAD 2005, World Bank 2005a). With the substantial increase registered in the rate of world economic growth since 2003, and moderate downward adjustments in projected growth, FDI flows should continue to rise, at least over the next couple of years.

Meanwhile, the slowdown of growth in some developed countries and structural weaknesses, along with financial and corporate vulnerabilities in some regions, continue to hinder a strong recovery in FDI. Continuing external imbalances in some countries and sharp exchange rate fluctuations, as well as high and volatile commodity prices, pose additional risks that may also limit global FDI flows.

Looking at prospects by sector, FDI is expected to pick up in natural resources, reflecting high demand for such resources partly stemming from China's growing economy and the opening up of new and potentially profitable opportunities, for instance in the oil and gas industries. Announcements abound, for example, two Japanese general trading companies, Ito Chu and Mitsui, plan to invest jointly a total of $3 billion in iron ore in Australia with BHP Billiton (Australia), while Rio Doce (Brazil) and Rio Tinto (Australia) plan to expand their production capacities in Brazil.[56] The anticipated increase in the offshoring of services also augurs well for FDI in that sector. One exception is telecommunications: in the United States alone, a reduction of more than $2 billion in investment in that industry is expected in 2006, in order to rationalize investment after the merger boom.[57] For developing countries overall, FDI inflows in telecommunications are now well below their historical highs in the 1990s (World Bank 2005b). Prospects for FDI in manufacturing are positive overall, especially as regards investment in special economic zones, encouraged by a variety of incentives offered by most developing countries.

The need for private financing of infrastructure in developing countries remains stronger than ever, with new modalities of investment (e.g. public-private partnerships that are gaining in popularity). A recent study by the World Bank, the Japan Bank for International

Cooperation (JBIC) and the Asian Development Bank, for example, estimated that the infrastructure financing needs of developing countries in Asia will exceed $1 trillion over the next five years.[58] It is likely that countries will seek to attract FDI to meet at least part of these needs.

Trends in cross-border M&As also point to increased investment activity. M&As, which account for the largest proportion of FDI flows to developed countries, rose in 2004 and are expected to do so again in 2005. Almost 40% of the United States tax and finance executives and senior professionals participating in a survey undertaken by KPMG in 2004 predicted that the number of worldwide M&A transactions would exceed 30,000 in 2005.[59] Nearly 90% of respondents indicated that their company expects to complete at least one merger or acquisition in 2005, compared with roughly 70% who said so in 2004. In developing countries, greenfield FDI is expected to increase as a proportion of all FDI, as investment channelled via privatization is declining, and because several countries (e.g. India) are actively seeking this form of investment via regulatory reforms and incentives.

Outward investment by TNCs based in a number of developing countries is likely to grow further. Like their counterparts in developed countries, these TNCs are in search of resources, markets and technology, driven by the same factors that determine FDI in countries with a long history of outward investment (UNCTAD 2005a). In some countries, government policies seek to encourage this trend.

On the policy front, liberalization is continuing, and has intensified in key developing economies such as China and India. China, whose transition period in the context of the WTO is coming to an end, has introduced legislation opening up several new industries to FDI (chapter II). India has also been opening up important industries, such as telecommunications, construction and real estate, to FDI (chapter II). At the same time privatization continues to wind down in many countries, especially in Latin America and the transition economies of South-East Europe and the CIS; moreover, recent privatization deals have also been smaller in size. While this reduces FDI potential via this channel, it may lead to expansion and sequential investment.

At the international level, the continued trend towards greater liberalization, in particular, the pursuit of negotiations on a number of bilateral, regional and international agreements (chapters I.B and II), may facilitate increased flows in years to come. On the trade front, eligibility under the African Growth and Opportunity Act (AGOA) has been extended to 37 countries in Africa, while the Central America Free Trade Agreement (CAFTA) is awaiting ratification and the free trade agreement (FTA) between the Southern Common Market (MERCOSUR) and the Andean Pact was signed in 2004.

A number of specific policy developments in 2005 are also likely to have an impact on the size and direction of FDI flows. First, a one-off tax amnesty on foreign earnings awarded by the United States has already led to announcements of the repatriation of sizeable funds by several United States TNCs (chapter II). Had these earnings been reinvested, they would have been counted as part of FDI outflows for 2005. This repatriation of earnings by firms from the United States, the largest outward investor in 2004, is likely to lead to a substantial decline in United States FDI outflows. While the exact magnitude of the repatriation is difficult to predict, it will be a force holding back global FDI flows.

Second, the value of the dollar will have an effect on all cross-border financial flows by TNCs, be they in the form of equity, earnings or loans. It is not certain at the time of writing how the dollar exchange rate will develop. For foreign-based TNCs, a dollar depreciation means that United States assets become cheaper. For foreign affiliates of United States-based TNCs, this means that it is a good time to repay intra-firm dollar-denominated debt or repatriate foreign earnings. The appreciation of the United States dollar that started in 2005, if continued, will mean the opposite. In any event, the net impact will depend on the relative magnitudes of the currency fluctuations.

Third, a likely outcome of the tsunami disaster is increased investment, both domestic and foreign, in infrastructure in the affected countries over the next few years. During the reconstruction phase, foreign and domestic investors are expected to be called upon to participate in tenders for the rebuilding of large infrastructure projects such as seaports and power

utilities. In both Indonesia and Sri Lanka, for example, public-private partnerships, including some with foreign investors, are expected to play an important role in the rebuilding of infrastructure and in the revival of the tourism industry.[60] Complemented by foreign aid and grants from multilateral and regional development banks, these partnerships will boost foreign investor involvement in post-tsunami reconstruction.

A number of surveys confirm promising prospects for FDI flows in 2005, and even beyond, although respondents do not seem to be as optimistic as they were last year. This is the case, for instance, with the *McKinsey Global Survey of Business Executives Confidence Index* (McKinsey 2005). This report revealed optimism among the more than 9,300 business executives from 130 countries surveyed; however their views were less positive than a year ago. The *CEO Briefing 2005* compiled by the Economist Intelligence Unit found that competition for global offshoring is intensifying, with 57% of executives viewing offshoring as a critical force reshaping the global marketplace in 2005, up from 51% in 2004 (EIU 2005a). As regards Japanese TNCs, the annual survey undertaken by JBIC found that about half of the manufacturing firms surveyed in 2004 would strengthen and expand foreign operations in the following three years and that 5% would reduce them (compared to 42% and 7%, respectively, in the 2003 survey) (JBIC 2005).

A survey undertaken by UNCTAD (box I.3) also points to increased world FDI flows in the near future.[61] Expectations, however, vary by region, being more positive for developing regions such as Asia and Oceania than for other regions (chapter II examines regional prospects separately). In the longer term, FDI is poised to continue its upward trend, although it may be some time before FDI flows reach levels comparable to those of the late 1990s.

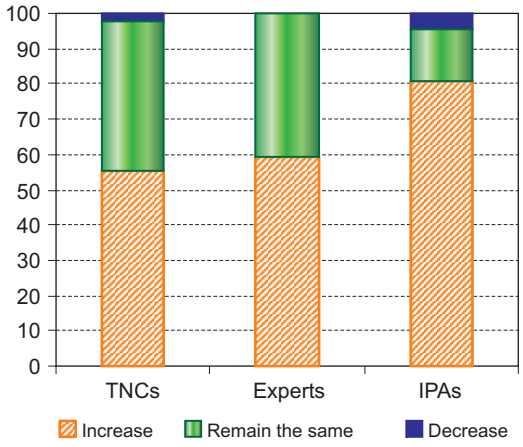
Box I.3. FDI prospects: results of UNCTAD's survey

The overall findings of the 2005 UNCTAD survey[a] on FDI prospects is that prospects for FDI in 2005-2006 are promising, although forecasts are not as optimistic as in the 2004 survey (*WIR04*, p. 32). More than half of the responding TNCs and experts as well as four-fifths of the IPAs expected short-term (2005-2006) growth in FDI flows, while almost all the remaining respondents expected FDI levels to be stable (box figure I.3.1). Only a small fraction expected that FDI would decrease in the immediate future.

Prospects for FDI vary significantly by industry:[b]

- In the primary sector, FDI in mining and petroleum is expected to increase: over two-thirds of the IPA respondents, and a slightly lower percentage of the experts, expected improved FDI prospects. This is not surprising, since demand for natural resources is forecast to remain strong (chapter II). Expectations regarding FDI in agriculture were less upbeat, with less than half of the IPAs and only a quarter of the experts forecasting improved prospects. This might be due to ongoing trade disputes in agriculture, lack of further liberalization in this area, and the fact that the sector as a whole has traditionally attracted less FDI.
- In manufacturing, expectations are high for increased flows in electrical and electronic products, machinery and equipment, and metals and metal products. A majority of respondents (IPAs as well as experts) expected a growth of FDI in these industries. On the other hand, there is less optimism regarding prospects for FDI

Box figure I.3.1. Prospects for global FDI flows: responses of TNCs, experts and IPAs, 2005-2006
(Per cent)



Source: UNCTAD (www.unctad.org/fdiprospects).

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Box I.3. FDI prospects: results of UNCTAD's survey

flows in textiles and clothing, rubber and plastic products, non-metallic minerals or media and publishing.

- The FDI outlook for the services sector continues to be more positive than that for the manufacturing and primary sectors. A majority of the respondents – experts as well as IPAs – expected improved prospects in most service industries. The industries expected to be at the forefront of FDI growth in services include computing/ICT, public utilities (such as the generation and distribution of electricity, water and gas), transportation and tourism-related services.

In terms of the investment locations selected as the most attractive, four of the top five countries ranked by the percentage of responses from experts and TNCs combined, are in the developing world. China is considered the most attractive location by 85% of TNCs and experts (box figure I.3.2). India's high ranking, albeit with 30% fewer responses than China's, is even more remarkable, given that FDI flows to the country have been modest until recently. The United States, Germany, the United Kingdom and Canada (in the ranking by TNC responses) only made it to the lower half of the top ten rankings.

Box figure I.3.2. Most attractive global business locations: responses of experts and TNCs[a]

Responses from experts
1. China (85%)
2. United States (55%)
3. India (42%)
4. Brazil (24%)
5. Russian Federation (21%)
6. United Kingdom (21%)
7. Germany (12%)
8. Poland (9%)
9. Singapore (9%)
10. Ukraine (9%)

Responses from TNCs
1. China (87%)
2. India (51%)
3. United States (51%)
4. Russian Federation (33%)
5. Brazil (20%)
6. Mexico (16%)
7. Germany (13%)
8. United Kingdom (13%)
9. Thailand (11%)
10. Canada (7%)

Source: UNCTAD (www.unctad.org/fdiprospects).

[a] Countries are ranked according to the number of responses that rated each as the most attractive location.

Views on the risks for global FDI differ among the three groups of respondents to the 2005 survey (box figure I.3.3). Judging from the rates of response, TNCs and FDI experts consider protectionism and slow growth in developed countries to be the major threats. Indeed, every TNC respondent felt that potential trade friction could undermine FDI growth in 2005-2006. The fact that TNCs and experts regarded protectionism as a major risk for global FDI growth is also evident from other parts of the survey. For example, the lowest number of respondents expected an "increase" in FDI in industries recently affected by trade disputes, such as textiles and agriculture.

In contrast, IPAs were more concerned about the financial instability of major economies and the volatility of raw material prices than about any other factors listed. This difference could well be due to the fact that a larger proportion of IPA respondents are from developing countries. It also explains why "political instability and civil war" is the third greatest concern of IPAs according to the percentage of respondents, while the other two groups of respondents rank it last.

Countries employed a variety of measures to attract FDI in 2004 (box figure I.3.4). The overwhelming majority of them plan to adopt further FDI policy measures in 2005-2006. Over 95% of responding IPAs expect to employ new and different policy measures to compete for FDI, including additional incentives, further liberalization and other promotion measures. This suggests that global and regional competition for FDI is increasing and will continue to do so in the future. Furthermore, given the limited resources at their disposal, most countries intend to use much more targeted approaches to investment promotion.

The positive outlook for global FDI in the short term is driven largely by the potential of specific regions, primarily developing regions along with South-East Europe and the CIS. UNCTAD surveys at the regional level find that FDI growth is being led by developing economies rather than by developed countries. FDI prospects in each of the individual regions are discussed in chapter II.

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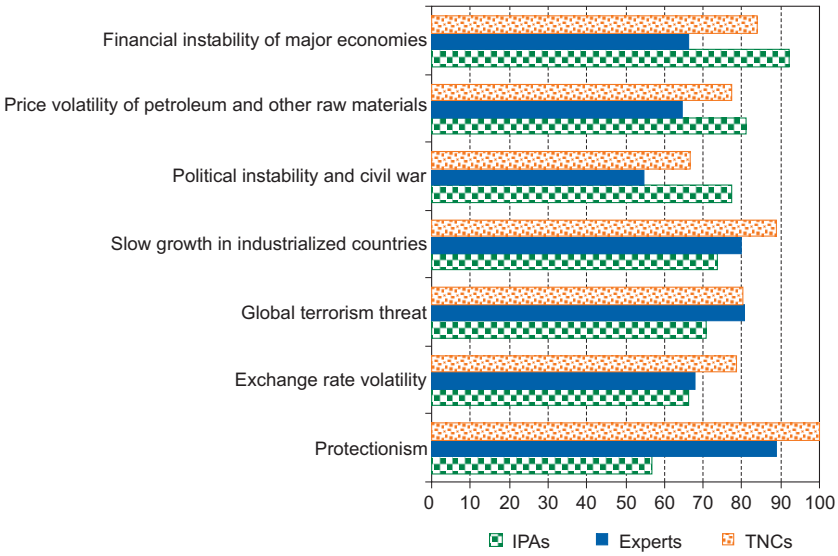
Box I.3. FDI prospects: results of UNCTAD's survey (concluded)

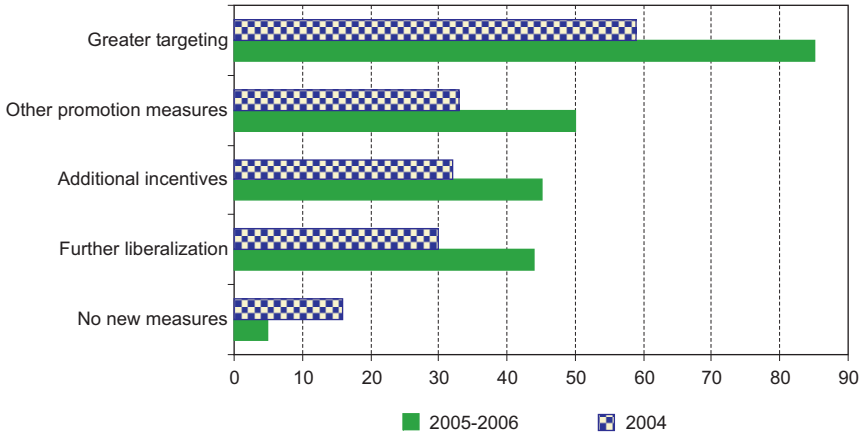
Box figure I.3.3. Major risks to global FDI flows,[a] 2005-2006
(TNC, expert and IPA respondents)



Source: UNCTAD (www.unctad.org/fdiprospects).

[a] Percentage of respondents that considered each factor as important or very important.

Box figure I.3.4. Investment policy measures to attract FDI: responses by IPAs



Source: UNCTAD (www.unctad.org/fdiprospects).

Source: UNCTAD (www.unctad.org/fdiprospects).

[a] UNCTAD's survey on FDI prospects analyses expected future patterns of FDI flows at the global, regional, national and industry levels based on the perspectives of global investors, host countries and international FDI experts. The 2005 *Survey of FDI Prospects for 2005-2008* involved IPAs of 109 countries, 81 of the largest TNCs (ranked by the size of their foreign assets) from developed, developing and transition economies as well as 74 international investment experts. Their replies are based on their perceptions.

[b] Only IPAs and FDI experts were questioned about the prospects for FDI by industry, since TNCs are generally not well placed to provide forecasts for industries other than their own.

Notes

1 In 2000 for instance, the gap between developed and developing country FDI flows was $881 billion.

2 Luxembourg was the largest recipient of FDI inflows in the world in both 2002 and 2003 due to massive FDI in special purpose entities (holding companies) that was transhipped to other countries (for details on this kind of FDI, see *WIR03*, p. 69).

3 The fact that Central Asia is now excluded from the region (box I.2) had a small effect (-$10 billion).

4 Countries are designated by the United Nations as "least developed" on the basis of national income per capita, human assets and economic vulnerability. This category included 50 countries as of May 2005. For more details see UNCTAD 2004a.

5 The figures refer to the number of primary activities of the projects.

6 The data must be interpreted with caution. They are over-stated for some economies, as they include round-tripping (which may, for example, be around 25% in the case of Hong Kong, China); investment by foreign affiliates of (typically) developed-country TNCs established in developing economies (investment that is particularly large in economies such as Cyprus, Hong Kong (China), Mauritius, Singapore and a number of tax havens); and capital flight. On the other hand, other factors may lead to under-reporting of outflows. Moreover, firms from some developing economies are not allowed to transfer funds from their home countries, but rather need to raise them locally or in international markets; in that case, the extent of their international production activities is not reflected in FDI statistics.

7 Some countries, however, are relaxing their policies on outward investment and are encouraging their firms to go abroad as international players. The 9th session of the Commission on Investment, Technology and Related Financial Issues of UNCTAD, 7-11 March 2005, noted important aspects of the links between outward FDI and the competitiveness of firms in developing countries as well as the role host- and home-country governments can play. See UNCTAD, "Emerging FDI from developing countries", note prepared by the UNCTAD secretariat for the Commission on Investment, Technology and Related Financial Issues, TD/B/COM.2/64, 4 February 2005.

8 Greenfield investment refers to investment in new facilities and the establishment of new entities through entry as well as expansion, while M&As refer to acquisitions of, or mergers with, existing local firms. For both, data used in *WIR* are original data collected by private firms (OCO Consulting for greenfield investments and Thomson Financial for cross-border M&As). Data on greenfield FDI from OCO Consulting's LOCOmonitor database (www.locomonitor.com) include new and expanding FDI projects worldwide, both announced and realized. The data are available from 2002 onwards. For an explanation of the data on cross-border M&As used in *WIR*, see annex B, "Definitions and sources".

9 Data from UNCTAD's cross-border M&A database.

10 Information from OCO Consulting, LOCOmonitor website (www.locomonitor.com).

11 Brazil, China, Hong Kong (China), India, Malaysia, Mexico, the Republic of Korea, Singapore, Thailand, the United Arab Emirates and Viet Nam. Bulgaria also received more than 100.

12 For definitions of each of these components of FDI, see "Definitions and sources" in Annex B of *WIR05*.

13 For developed countries, almost all of the FDI inflows over the period 1995-2004 can be broken down into the three components of FDI financing, whereas only 54% of total FDI inflows into developing countries can be classified under these three categories.

14 Based on data for 31 countries that account for about 38% of the total FDI flows to developing countries.

15 More than 100% due to negative figures for the other components.

16 More than 100% due to negative figures for the other components.

17 More than 100% due to negative figures for the other components.

18 The sum of the shares of equity capital and intra-company loans is more than 100% because of negative reinvested earnings.

19 Thus, if a parent company in the United States gives a loan to a foreign affiliate located in Germany the interest income of the parent firm (received from the affiliate located in Germany) is taxed in the United States at a low tax rate, whereas the interest payment of the German affiliate can be deducted from its revenue, lowering its taxed profits in Germany.

20 Reinvested earnings represent additions to a direct investor's stake in its foreign affiliates. In the balance of payments they are recorded, therefore, as FDI inflows into the host county of the foreign affiliates (with a positive sign). If foreign affiliates' activities result in losses, the direct investor's equity claims on the foreign affiliates decrease. The losses are recorded under reinvested earnings in the balance of payments, but with a negative sign as it indicates a reduction or disinvestment of accumulated FDI.

21 Data from Deutsche Bundesbank, *Balance of Payments Statistics*.

22 IMF 2005. The data on growth rates of the new EU members are obtained from Eurostat (www.eurostat.cec.eu.int).

23 The volume of world trade in goods and services in 2004 grew by nearly 20%, much faster than in 2002 and 2003 (5% and 16%, respectively) (table I.3; IMF 2005), and well above the long-term trend.

24 According to PRS Group/International Country Risk Guide, the average of the composite risk ratings (based on three factors – political, financial and economic risks) of some 150 countries improved from 69 in 2003 to 71 in 2004, and is expected to be 73 in 2005 and 78 in 2009.

25 Many indicators in 2004 show more favourable business and consumer sentiments than in 2003: in the United States, for example, the Personal Consumption Expenditure Price Index of the Department of Commerce and the Consumer Sentiment Index of the University of Michigan were up by 6% and 8.6% respectively; for the EU, the Economic Sentiment Indicator was up by 9.1%, the Industrial Confidence Indicator by 64% and the Consumer Confidence Indicator by 25%, all of the European Commission;

and in Japan, the Business Conditions Diffusion Index was up by 97% and the Consumer Confidence Index by 17%.

[26] The country risk is also one of the 12 variables used by UNCTAD for constructing the FDI Potential Index.

[27] For example, net profits of Japanese firms reached a record high in the year ending March 2005 (31% larger than in fiscal year 2003 for all firms listed in the stock markets – *Nihon Keizai Shimbun*, 1 June 2005) while those of the 500 largest firms in terms of sales of the United States and Europe improved by 12% and 71% respectively in 2004 (*source*: UNCTAD, based on data from Thomson One Banker).

[28] Data from the World Federation of Exchanges (www.fibv.com).

[29] Based on the Reuters-CRB-Index of 17 raw materials.

[30] Investment, commodity and exchange firms and dealers.

[31] Cross-border investments of private equity funds that lead to an ownership of 10% or more are in most cases recorded as FDI even if private equity funds do not always have the motivation for a lasting interest or a long-term relationship with the acquired enterprise. The figures in the text refer to these investments.

[32] In Germany, for instance, public communities and public entities also sold houses and apartments because of budgetary problems.

[33] Data from UNCTAD cross-border M&A database.

[34] The Transnationality Index is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[35] UNCTAD's calculations, based on data from Dun & Bradstreet, *Who Owns Whom* database.

[36] *Fortune*, 26 July 2004, pp. F1-F10.

[37] According to the Wall Street Journal Market Data Group, the top 30 companies represented 60% of total assets of the top 100 largest public financial companies in 2003, and the top 50 almost 77%.

[38] The UNCTAD Inward FDI Performance Index is a measure of the extent to which a host country receives inward FDI relative to its economic size. It is calculated as the ratio of a country's share in global FDI inflows to its share in global GDP.

[39] The UNCTAD Inward FDI Potential Index is based on 12 economic and structural variables measured by their respective scores on a range of 0-1 (raw data available on www.unctad.org/wir). It is the unweighted average of scores on the following: GDP per capita, the rate of growth of GDP, the share of exports in GDP, telecoms infrastructure (the average of telephone lines per 1,000 inhabitants, and mobile phones per 1,000 inhabitants), commercial energy use per capita, the share of R&D expenditures in gross national income, the share of tertiary students in the population, country risk, exports of natural resources as a percentage of the world total, imports of parts and components of electronics and automobiles as a percentage of the world total, exports in services as a percentage of the world total, and inward FDI stock as a percentage of the world total. For the methodology for building the index, see *WIR02*, pp. 34-36.

[40] The UNCTAD Outward FDI Performance index is calculated in the same way as the Inward FDI Performance Index: the ratio of a country's share in global FDI outflows to its share in world GDP.

[41] A three-year moving average is used. Thus the data used for calculating the 2004 index are for those of 2002, 2003 and 2004.

[42] Because of late availability of the data used for the Potential Index, the most recent available year is always one year behind that for the Performance Index.

[43] It should be noted that a reduction of the tax rate does not necessarily signify a lowering of the overall tax burden. For example, a widening of the tax base or less generous rules on depreciation may counteract a lower rate.

[44] Corporate tax incentives may be provided in a number of ways, including tax holidays, statutory corporate income tax reductions, enriched capital cost allowances, investment tax credits, reductions of withholding tax on dividends and the extension of imputation relief to non-resident shareholders (OECD 2000).

[45] IIAs include bilateral treaties for the promotion and protection of investment (or bilateral investment treaties), treaties for the avoidance of double taxation (or double taxation treaties), other bilateral and regional trade and investment agreements as well as various multilateral agreements that contain a commitment to liberalize, protect and/or promote investment.

[46] The number of BITs involving developed countries also increased due to the accession of ten countries to the EU on 1 May 2004, whereupon the earlier BITs signed by these countries began to be counted as developed-country BITs. For the same reason, the total number of BITs signed between transition economies and between these and developed and developing countries shows a corresponding reduction.

[47] See the case of Ceskoslovenska Obchodni Banka, A.S. v. the Slovak Republic, Decision on jurisdiction, 24 May 1999, available at (www.worldbank.org/ICSID/cases).

[48] BITs signed by Central European countries prior to their accession to the EU in 2004 have been affected by these countries' EU membership. In these circumstances, the United States and the European Commission signed a Memorandum of Understanding (MoU) in September 2003 concerning the applicability and the preservation of BITs concluded between the United States and the new EU members or countries candidates for accession (see *WIR04*, box II.20). A similar exercise is currently taking place with Canada. In addition, Finland renegotiated its BITs with China, Egypt and Ukraine.

[49] For example, in the new Canada model BIT (2004), the open asset-based definition of investment was replaced by a comprehensive, but finite, definition of investment. The recently negotiated BIT between the United States and Uruguay, on the other hand, opted to define the term "investment" in economic terms. Such a definition covers, in principle, every asset that an investor owns and controls, but with the qualification that such assets must have the "characteristics of an investment" such as "the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk". This approach is complemented by the explicit exclusion of several kinds of assets from

the category of covered investment under the agreement (e.g. certain debt instruments).

50 For instance, the new treaty models make clear that an adverse effect on the economic value of an investment does not *per se* establish that an indirect expropriation has occurred. It is further stated that, except in rare circumstances, non-discriminatory regulatory actions by a Party aimed at protecting legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.

51 See the ICSID website, www.worldbank.org/icsid.

52 For an analysis in the rise of treaty-based investment disputes, see UNCTAD forthcoming c.

53 UNCTAD database on investor-State dispute-settlement cases.

54 For instance, the Czech Republic's payout of some $270 million plus substantial interest in the Lauder case; the recent award in CSOB v Slovakia (29 December 2004) of $824 million plus an additional $10 million as partial contribution to CSOB's costs; or Occidental's 2002 award against Ecuador of $71 million plus interest.

55 Preliminary results of a CEPMLP/Dundee research project on economic analysis of transnational dispute management.

56 *Nihon Keizai Shimbun*, 21 March 2005.

57 *Nihon Keizai Shimbun*, 17 February 2005.

58 "East Asia needs $1 trillion for infrastructure over next five years" (www.worldbank.org).

59 "Economic confidence will drive M&A activity through 2005, according to KPMG survey", www.biz.yahoo.com.

60 See interview with Sri Lanka's tourism minister in "Plans to bring back the tourists", *FDI Magazine*, 7 February 2005 (www.fdimagazine.com).

61 As far as developing and transition economies (according to the IMF's classification) are concerned, the International Monetary Fund's *World Economic Outlook* (April 2005) estimates FDI flows will increase to $217.4 billion in 2005 and to $222.3 billion in 2006 (www.imf.org). The Institute of International Finance (March 2005) forecast an increase in FDI in 29 emerging markets in 2005, to $148.2 billion from $138.3 billion in 2004 (www.iif.com). The World Bank's *Global Development Finance 2005* (April 2005) projected an annual growth rate of 9% for FDI flows to developing countries (or low-income and middle-income countries according to the World Bank's classification) (nominal value) over the next two years (www.siteresources.worldbank.org).