UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

World Investment Report 2006

FDI from Developing and Transition Economies: Implications for Development

CHAPTER I

GLOBAL TRENDS: RISING FDI INFLOWS

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A. Overall trends and developments in FDI

Global foreign direct investment (FDI) flows grew substantially in 2005 over those in 2004. As in the late 1990s, that growth was spurred by cross-border mergers and acquisitions (M&As). Recent increases in FDI have been concentrated in certain sectors and regions/countries, and the level of concentration of FDI worldwide has also risen again. Furthermore, investments by collective investment funds (e.g. private equity and hedge funds) – a relatively new source of FDI – have been growing. As investments by these funds often have a shorter time horizon than those by more conventional transnational corporations (TNCs), current FDI growth may not be sustainable. In addition, the way in which the rise in global FDI flows is measured, does not necessarily translate fully into capital formation in host economies, as data on FDI flows include items unrelated to investment in production capacity. This section discusses recent trends in FDI, its composition and characteristics, as well as some issues related to FDI statistics.

1. Trends, patterns and characteristics

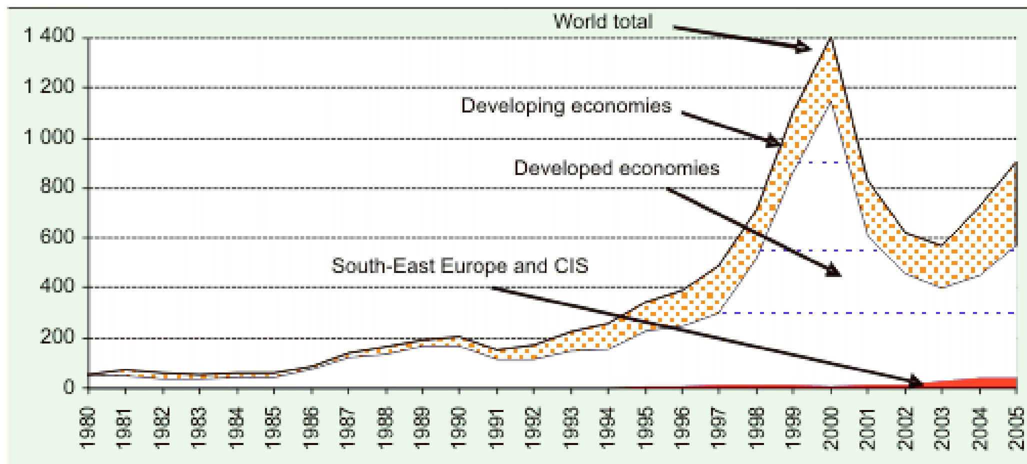
a. Global FDI

Global FDI inflows rose by 29% to $916 billion in 2005, compared to a 27% increase in 2004 (figure I.1), largely reflecting a significant increase in cross-border M&As, both in value and in number of deals. FDI inflows increased in both developed and developing countries. The concentration of FDI flows between certain countries remains high, even accentuating somewhat since 2000 for developing countries and since 2003 for developed countries (figure I.2). However, its level is considerably lower than in the 1980s when not many countries received FDI inflows on any significant scale, or in the late 1990s when FDI distribution was particularly distorted by large-scale M&As. Even though concentrated, FDI inflows nevertheless grew in 126 out of 200 economies in 2005, compared to 111 economies in 2004. Growth in 2005 was broad-based geographically as in the previous year, but higher in developed than in developing countries. Thus, despite record inflows into developing countries, the share of developing countries in world FDI inflows fell slightly (to 36%), thereby increasing the gap in FDI inflows between developed and developing countries to over $200 billion in 2005.[1] The United Kingdom was the largest recipient of FDI in 2005, ahead of the United States, China and France (annex table B.1).

The *value* of cross-border M&As – a key mode of global FDI since the late 1980s – started to pick up in 2004 following three years of decline, while their *number* has been growing since 2002 (annex tables B.4-B.7). On the other hand, greenfield FDI projects fell after increasing for two consecutive years (annex table A.I.1).[2] Diverging trends between cross-border M&As and greenfield FDI are not surprising, because, to some extent, companies tend to consider these two modes of market entry as alternative options.

Figure I.1. FDI inflows, global and by group of economies, 1980–2005

(Billions of dollars)



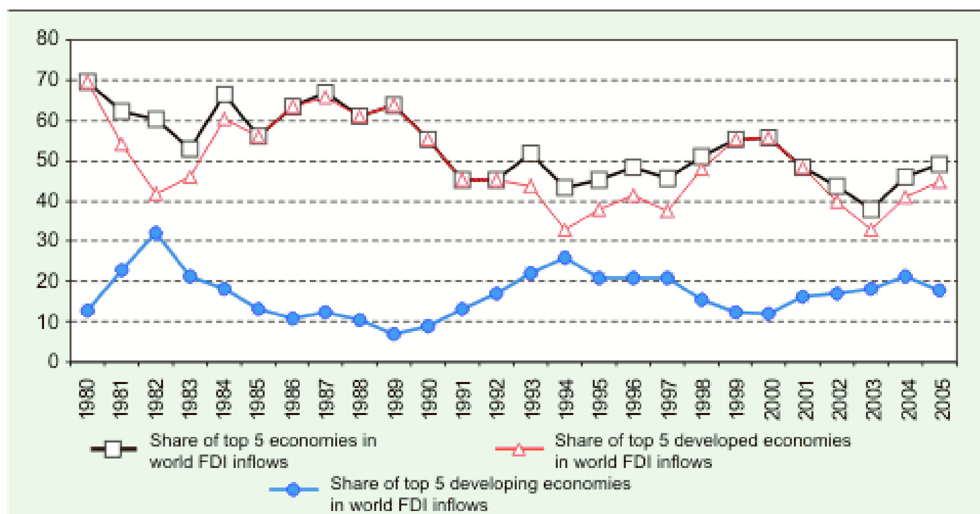
Source: UNCTAD, based on its FDI/TNC database (www.unctad.org/fdi statistics).

Inward FDI in *developed countries* had already started to increase in 2004, after three years of significant decline between 2000 and 2003. That decline was mainly due to sluggish growth in the developed countries, in particular in the euro area and Japan. While developed countries other than those of the European Union (EU) contributed to the growth of inflows in 2004, the increase in 2005 was particularly marked in the EU (97%), most notably in Germany, the Netherlands and the United Kingdom, each of which experienced an increase of more than $40 billion (more than $100 billion in the case of the United Kingdom). The five largest host economies in 2005 – the United Kingdom, the United States, France, the Netherlands and Canada in that order – accounted for 75% of total FDI inflows to developed countries.

Inward FDI in *developing countries* rose by another 22% to $334 billion, following a 57% growth in 2004. Compared to other capital flows, FDI inflows remain the largest component of net resource flows to developing countries (figure I.3) and their share rose in 2005. While all developing regions experienced an increase in FDI flows, *Africa* saw a rise of 78%, with record inflows of $31 billion. Flows to *West Asia* reached $34 billion, an 85% increase over the previous year, and to

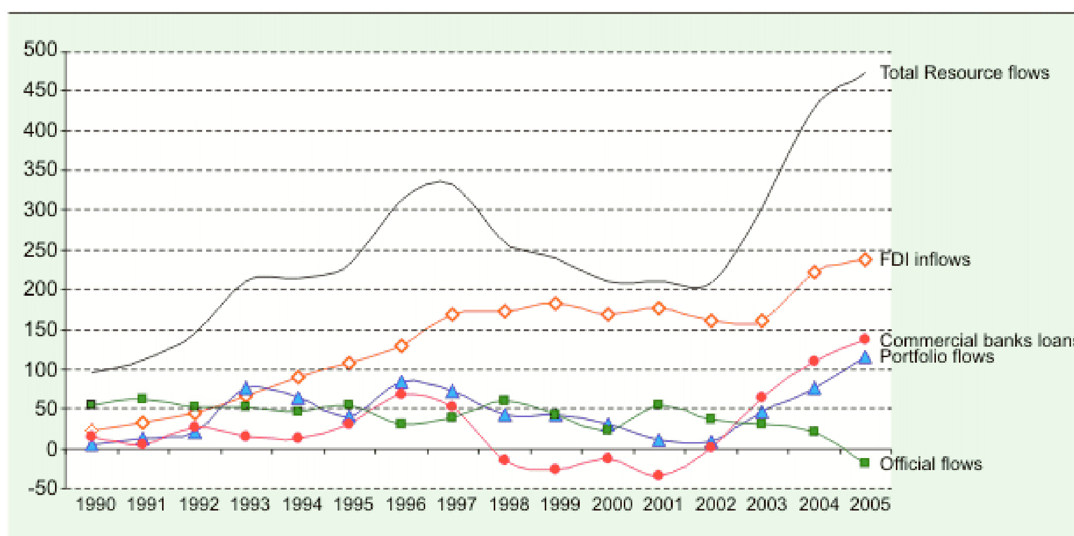
Figure I.2. Concentration of FDI inflows: the share of the top 5 FDI recipients in the world total, 1980-2005

(Per cent)



Source: UNCTAD.

Figure I.3. Total net resource flows[a] to developing countries[b], by type of flow, 1990-2005
(Billions of dollars)



Source: UNCTAD, based on World Bank 2006.

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

[b] The World Bank's classification of developing countries is used here. It differs from UNCTAD's classification in that it includes new EU member States from Central and Eastern Europe and excludes high-income countries such as the Republic of Korea and Singapore.

South, East and South-East Asia they increased by 20%. In *Latin America and the Caribbean,* on the other hand, there was only a 3% increase, a much lower rate than in 2004 when flows to the region rose by 118% after four consecutive years of decline. FDI inflows in the 50 *least developed countries* (LDCs) recorded a historic high of $9.7 billion, mainly due to a significant rise in flows to Cambodia, the Democratic Republic of the Congo, the Gambia, Guinea-Bissau and Mauritania, in each of which inflows more than doubled. Overall, FDI had been less concentrated and has not fluctuated widely since the mid-1980s compared to developed countries. Brazil, China, Hong Kong (China), Mexico and Singapore – that have been the five largest host developing economies almost every year since 1996 – accounted for some 48% of total flows to developing countries.

In South-East Europe and the Commonwealth of Independent States (CIS), FDI inflows remained almost at the same level as in 2004, at around $40 billion. While there was a considerable increase in inflows in Ukraine, in other major recipient countries (Bulgaria, Kazakhstan, Romania and the Russian Federation) they declined.

Global outflows in 2005 showed a somewhat different picture than did inflows, declining by 4% to $779 billion. It should be pointed out in this regard that the divergence in trends in FDI inflows and outflows reflects differences in the way countries compile FDI data. The size of earnings repatriated by a number of United States parent companies in 2005 partly explains, for instance, the divergence noted for that year: repatriated profits from foreign affiliates of United States firms are recorded in United States FDI data as negative outflows, while the host countries of these affiliates do not necessarily take into account reinvested earnings in their FDI data.[3]

Developing countries as emerging sources of FDI strengthened their global position further in 2005, investing $117 billion in 2005 – 4% more than in the previous year. The most notable growth of outflows was from West Asia: FDI outflows more than doubled, to $16 billion, backed by huge amounts of petrodollars and strong economic growth. Flows from South, East and South-East Asia declined by 11%, although China saw a sixfold increase in outward investments, amounting to $11 billion, while the other giant in this region, India, experienced a decline, after an almost twofold increase the year before. FDI outflows from Latin America and the Caribbean rose by 19%, to $33 billion, led by Colombia and Mexico (excluding offshore financial centres). Outflows from South-East Europe and the CIS rose modestly, with flows from the Russian Federation declining somewhat. Altogether, transition economies and developing countries invested a total of $133 billion abroad, the largest amount since 2000.[4]

The changes discussed above reflect recent FDI trends and changes in the geographic patterns of FDI flows. There are also significant long-term changes in the relative positions of countries and regions as hosts and home bases for FDI. Indeed, over the past few decades, the geography of FDI has undergone some major shifts, as noted below:

- Over the past few decades the share of the Triad (the EU, Japan and the United States) in total world inward FDI flows and stocks has fluctuated at around 60-70%. However, within the Triad, there has been a marked shift towards the EU. The share of the EU in FDI inflows into the Triad was 75% in 2003-2005, compared to 62% in 1978-1980 (table I.1). The EU – which now also includes eight economies formerly classified under Central and Eastern Europe – today accounts for almost half of global inward and outward flows and stocks. The rise of the EU in outward FDI flows and stocks is even more pronounced. Conversely, the importance of the United States in both inward and outward FDI flows and stocks has declined: since the beginning of the 1980s for outward FDI and the beginning of the 1990s for inward FDI (table I.1). Japan, which had emerged as an important source of FDI in the 1980s, has declined considerably in importance as an outward investor over the past 15 years, but gained somewhat as a recipient. However, it remains marginal as a host country.
- Developing countries have gained in importance as recipients of FDI in terms of both inward flows and stocks (table I.1). Their share in total world inflows rose from an average of 20% in 1978-1980 to an average of 35% in 2003-2005, though the performance of the different regional groups was uneven. The share of African countries gradually fell, from 10% of total inflows to developing countries in 1978-1980 to around 5% in 1998-2000, but in the past few years it has recovered. The share of Asia and Oceania, particularly South, East and South-East Asia, increased rapidly – driven partly by flows to China which appeared on the FDI scene only in the late 1970s – until the end of the 1990s and then slowed down somewhat in the early 2000s. Latin America and the Caribbean region has experienced a noticeable decline from its dominant position of the 1970s and early 1980s. And so far it has not recovered to its previous level, even though FDI flows to the region are again on the rise.
- Data on FDI outflows from developing countries point to the increasing dynamism of this group of countries as sources of FDI. Their share in global outward FDI stock has fluctuated between 8% and 15% over the past 25 years, while their share in outflows points to a clearly increasing trend. Negligible or small until the mid-1980s, such flows from developing countries amounted to $117 billion, or about 15% of world outflows in 2005 (annex table B.1). Their FDI outward stock increased from $72 billion in 1980 to $149 billion in 1990 and to more than $1 trillion in 2005. More importantly, a number of developing countries have emerged as significant sources of FDI in other developing countries (chapter III), and their investments are now considered a new and important source of capital and production know-how, especially for host countries in developing regions. The increasing importance of FDI from developing countries reflects stronger ownership advantages of developing-country firms, related somewhat to the growing importance of their home countries in the world economy, as demonstrated by various indicators. For example, developing countries accounted for over half of global output at purchasing-power parity value in 2005,[5] for more than 40% of world exports, and for two thirds of global foreign exchange reserves. According to the competitiveness rankings of the world's economies, in 1986 there was only one developing economy (Turkey) among the 20 most competitive economies, and by 2005 the number had increased to five: Taiwan Province of China, Singapore, the Republic of Korea, the United Arab Emirates and Qatar in that order (World Economic Forum 2005).
- In the case of South-East Europe and the CIS, where FDI to and from most economies started to increase from the early 1990s onwards in the wake of their transition to market economies, their share in both inward and outward flows and stocks, albeit very small, is on the rise. Within the region, the Russian Federation has always occupied a dominant position in FDI inflows as well as outflows.

The emergence of developing countries and the transition economies of South-East Europe and the CIS as significant outward investors – one of

Table I.1. Distribution of FDI by region and selected countries, 1980-2005
(Per cent)

Region	Inward stock				Outward stock			
	1980	1990	2000	2005	1980	1990	2000	2005
Developed economies	75.6	79.3	68.5	70.3	87.3	91.7	86.2	86.9
European Union	42.5	42.9	37.6	44.4	37.2	45.2	47.1	51.3
Japan	0.6	0.6	0.9	1.0	3.4	11.2	4.3	3.6
United States	14.8	22.1	21.7	16.0	37.7	24.0	20.3	19.2
Developing economies	24.4	20.7	30.3	27.2	12.7	8.3	13.5	11.9
Africa	6.9	3.3	2.6	2.6	1.3	1.1	0.7	0.5
Latin America and the Caribbean	7.1	6.6	9.3	9.3	8.5	3.4	3.3	3.2
Asia and Oceania	10.5	10.8	18.4	15.4	2.9	3.8	9.5	8.2
West Asia	1.4	2.2	1.1	1.5	0.3	0.4	0.2	0.3
South, East and South-East Asia	8.8	8.5	17.2	13.8	2.5	3.4	9.3	7.8
South-East Europe and CIS	..	0.01	1.2	2.5	..	0.01	0.3	1.2
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Region	Inflow				Outflow			
	1978-1980	1988-1990	1998-2000	2003-2005	1978-1980	1988-1990	1998-2000	2003-2005
Developed economies	79.7	82.5	77.3	59.4	97.0	93.1	90.4	85.8
European Union	39.1	40.3	46.0	40.7	44.8	50.6	64.4	54.6
Japan	0.4	0.04	0.8	0.8	4.9	19.7	2.6	4.9
United States	23.8	31.5	24.0	12.6	39.7	13.6	15.9	15.7
Developing economies	20.3	17.5	21.7	35.9	3.0	6.9	9.4	12.3
Africa	2.0	1.9	1.0	3.0	1.0	0.4	0.2	0.2
Latin America and the Caribbean	13.0	5.0	9.7	11.5	1.1	1.0	4.1	3.5
Asia and Oceania	5.3	10.5	11.0	21.4	0.9	5.6	5.1	8.6
West Asia	-1.6	0.3	0.3	3.0	0.3	0.5	0.1	1.0
South, East and South-East Asia	6.7	10.0	10.7	18.4	0.6	5.1	5.0	7.7
South-East Europe and CIS	0.02	0.02	0.9	4.7	..	0.01	0.2	1.8
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics) and annex tables B.1 and B.2.

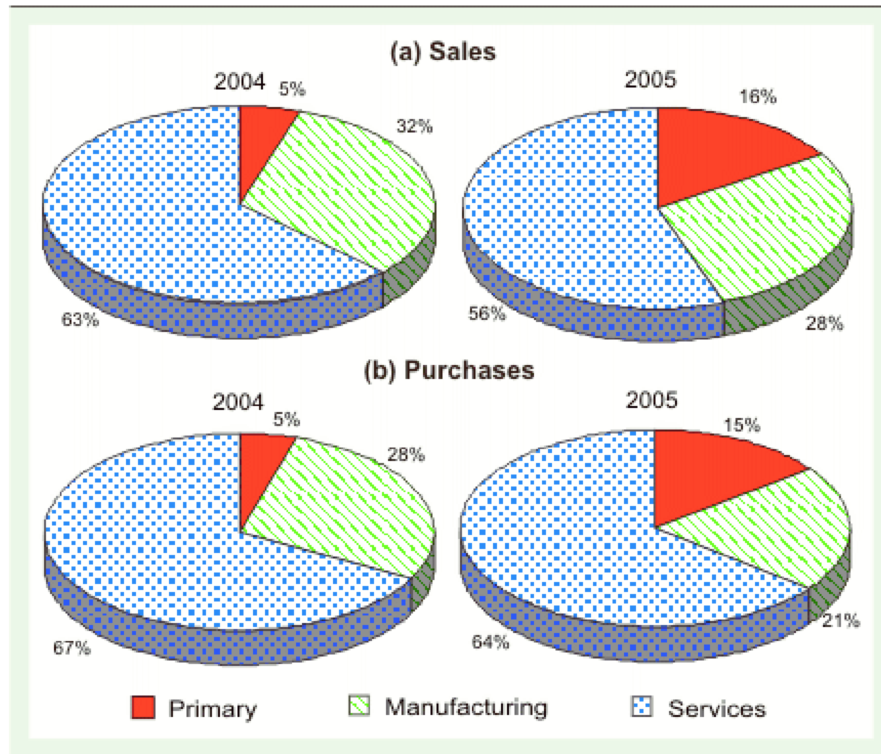
the above-mentioned significant changes in the pattern of FDI – and the development implications of this phenomenon are discussed in detail in Part Two of this Report.

b. Sectoral analysis: revival of FDI in natural resources

The sectoral breakdown of FDI data is available for only a limited number of countries, and at most up to 2004, which prevents a comprehensive sectoral analyses of FDI. According to available data, the overall sectoral distribution of FDI in 2004 remained almost the same as in previous years (annex tables A.I.2-A.I.5). However, data on various forms of FDI by sector – especially cross-border M&As– show that in 2005 the primary sector gained in importance, in terms of both target and acquiring industries (figure I.4), while both manufacturing and services declined. Nevertheless, services remain the dominant sector in cross-border M&A deals (*WIR04*). By contrast, FDI in manufacturing is on a downward trend, recording its lowest share ever of cross-border M&A sales and purchases in 2005 (excluding 2000, when the largest ever M&A deal of Vodafone-Mannesmann distorted the distribution, mainly in favour of services) (figure I.5). On the other hand, the growth of FDI in the primary sector, especially in mining activities, is very recent – if viewed over the past 25 years – and indeed dramatic. Cross-border M&A sales as well as purchases in this sector rose more than sixfold, and the sector's share in both sales and purchases reached close to the peak attained in 1987-1988 (figure I.5 for sales).[6] FDI in mining (including oil and other mining), which accounts for the bulk of the primary sector, has been largely responsible for the recent growth of global FDI.

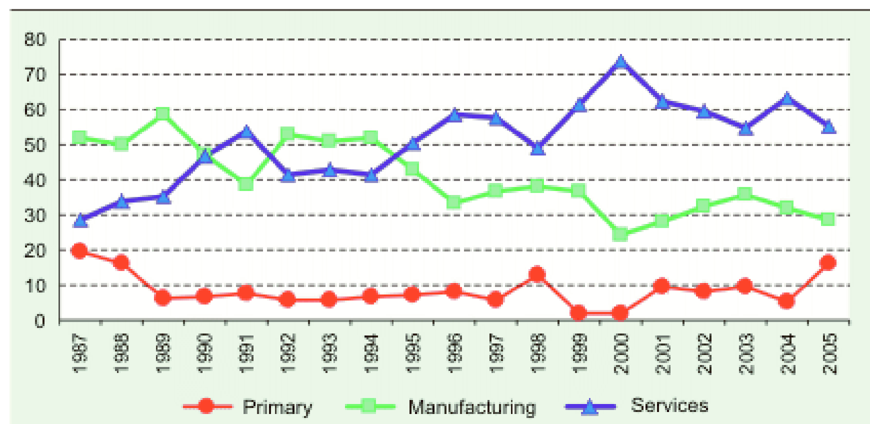
Current FDI growth seems to be led primarily by a few specific industries, rather than being broad-based sectorally. Specifically, in 2005, oil and gas, utilities (e.g. telecommunications, energies), banking and real estate were the leading industries in terms of inward FDI. For the first time since 1987 (M&A data are available only from that

Figure I.4. Cross-border M&As by sector, 2004-2005
(Per cent)



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

Figure I.5. Sectoral breakdown of cross-border M&A sales, 1987-2005
(Per cent)



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

year onwards), the petroleum (includes oil and natural gas) industry became the largest FDI recipient, accounting for 14% of all cross-border M&A sales, followed by finance and telecommunications – the latter two partly as a result of further liberalization in some countries (chapter II) (annex table B.6). These three activities accounted for more than one third of the total value of M&A deals. They were closely followed by real estate, which has also become an important recipient of FDI since 2004 following the liberalization of FDI entry by various countries (*WIR05*). Considerable FDI also went to service industries such as construction, transport and software businesses that were responsive to economic growth in 2005 as in the previous year. In manufacturing, FDI in the industries related to primary products rose: for example, cross-border M&As in oil refining doubled and those in rubber and plastic goods quadrupled, while in metals industries they rose sixfold (annex table B.6). Metals, telecommunications and real estate also attracted more greenfield FDI than in 2004.[7]

In terms of outward FDI, according to cross-border M&A purchase data, the petroleum industry was dwarfed by the special finance industry comprising investment and commodity firms, including private equity firms and hedge fund investors (discussed in section 3.c). This special finance industry alone accounted for more than 30% of total cross-border M&A purchases in terms of value in 2005 (annex table B.6). The petroleum industry was the second largest acquiring industry, followed by telecommunications.

Sectorally, FDI in the primary sector (natural resources, in particular, mining) has recovered slightly in the past few years, after a considerable decline in importance over the past two decades or more, while the services sector continues to capture an increasing share of FDI. A corollary of this is a further decline of the manufacturing sector in total FDI flows and stock. This is the same scenario for both inward and outward FDI, and in all groups of economies (annex tables A.I.2-A.I.5).

Table I.2. Selected indicators of FDI and international production, 1982-2005

Item	Value at current prices (Billions of dollars)				Annual growth rate (Per cent)						
	1982	1990	2004	2005	1986-1990	1991-1995	1996-2000	2002	2003	2004	2005
FDI inflows	59	202	711	916	21.7	21.8	40.0	-25.8	-9.7	27.4	28.9
FDI outflows	28	230	813	779	24.6	17.1	36.5	-29.4	4.0	44.9	-4.2
FDI inward stock	647	1 789	9 545	10 130	16.8	9.3	17.3	9.7	20.6	16.1	6.1
FDI outward stock	600	1 791	10 325	10 672	18.0	10.7	18.9	9.6	17.7	14.1	3.4
Income on inward direct investment	47	76	562	558	10.4	30.9	17.4	10.8	37.0	32.3	-0.7
Income on outward direct investment	47	120	607	644	18.7	18.1	12.7	6.3	37.0	26.6	6.1
Cross-border M&As [a]	..	151	381	716	25.9[b]	24.0	51.5	-37.7	-19.7	28.2	88.2
Sales of foreign affiliates	2 620	6 045	20 986[c]	22 171[c]	19.7	8.9	10.1	11.2	30.4	11.4[c]	5.6[c]
Gross product of foreign affiliates	646	1 481	4 283[d]	4 517[d]	17.4	6.9	8.8	1.9	20.3	22.8[d]	5.4[d]
Total assets of foreign affiliates	2 108	5 956	42 807[e]	45 564[e]	18.1	13.8	21.0	36.7	27.9	3.5[e]	6.4[e]
Exports of foreign affiliates	647	1 366	3 733[f]	4 214[f]	14.3	8.4	4.8	4.9[f]	16.5[f]	21.0[f]	12.9[f]
Employment of foreign affiliates (thousands)	19 537	24 551	59 458[g]	62 095[g]	5.4	3.2	11.0	10.0	-0.5	20.1[g]	4.4[g]
GDP (in current prices)	10 899	21 898	40 960	44 674[h]	11.1	5.9	1.3	3.9	12.1	12.1	9.1
Gross fixed capital formation	2 397	4 925	8 700	9 420	12.7	5.6	1.1	0.4	12.4	15.5	8.3
Royalties and licence fee receipts	9	30	111	91	21.2	14.3	7.8	7.9	14.1	17.0	-17.9
Exports of goods and non-factor services [h]	2 247	4 261	11 196	12 641	12.7	8.7	3.6	4.9	16.5	21.0	12.9

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

[a] Data are available only from 1987 onwards.

[b] 1987-1990 only.

[c] Data for 2004 and 2005 are based on the following regression result of sales against FDI inward stock (in $ million) for the period 1980-2003: Sales=1 646.227+2.02618*FDI inward stock.

[d] Data for 2004 and 2005 are based on the following regression result of gross product against FDI inward stock (in $ million) for the period 1982-2003: Gross product=474.0967+0.399066*FDI inward stock.

[e] Data for 2004 and 2005 are based on the following regression result of assets against FDI inward stock (in $ million) for the period 1980-2003: Assets= -2 174.209+4.712645*FDI inward stock.

[f] For 1995-1998, based on the regression result of exports of foreign affiliates against FDI inward stock (in $ million) for the period 1982-1994: Exports=357.6124+0.558331*FDI inward stock. For 1999-2005, 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 $ million) for the period 1980-2003: Employment=16 415.27+4.509468*FDI inward stock.

[h] Based on data from IMF, *World Economic Outlook*, April 2006.

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, Canada, the Czech Republic, Finland, France, Germany, Italy, Japan, Sweden, Switzerland and the United States (for employment); those from Austria, Canada, the Czech Republic, Finland, France, Germany, Italy, Japan, Luxembourg, Sweden and the United States (for sales); those from Japan and the United States (for exports); those from the Czech Republic, Portugal and the United States (for gross product); and those from Austria, Germany, Japan and the United States (for assets), on the basis of the shares of those countries in the worldwide outward FDI stock.

c. Trends in international production

International production, as measured by estimates of global FDI stock and of sales, assets, value-added, employment and exports by foreign affiliates, grew further in 2005 (table I.2). Given the important role of cross-border M&As and their rise in 2005, part of the expansion of international production and related assets and activities represents a shift of such assets and activities from domestic firms to TNCs rather than an addition to host countries' output, employment and value added. However, the shift may itself contribute to a growth in host countries' production capabilities over time due to possible sequential FDI aimed at expanding acquired production facilities (section 3 below).

The number of TNCs worldwide has risen to about 77,000, with at least 770,000 foreign affiliates (annex table A.I.6). More than 20,000 of the TNCs originate in developing countries. FDI has grown faster than domestic investment (gross fixed capital formation), and FDI stock continues to rise. Thus the share of international production in world output, as measured by the share of value added of foreign affiliates in world GDP, is rising and is estimated to have been 10% in 2005, compared to 7% in 1990. On the assumption that a dollar of FDI stock from any home country leads to the same amount of international production everywhere, and based on past estimates of the relationship between FDI stock and foreign sales, employment and value added, respectively, TNCs based in developing countries and in South-East Europe and the CIS are estimated to have accounted for about $2.6 trillion in sales, employed 7.4 million workers and generated more than $500 billion in value added outside their home countries in 2005. (For individual country data on international production, see annex tables B.8-B.19).

The degree of transnationality of host countries – both developed and developing, as well as the transition economies of South-East Europe and the CIS – measured by UNCTAD's Transnationality Index, fell somewhat in 2003 (figure I.6), reflecting a decline in FDI flows in that year. Significant differences continue to prevail in the degree of transnationality of different countries in all three groups, but the most and least transnationalized countries have remained the same in each host group as in the previous year. Some small developing countries experienced large changes in their ranking in 2003. The most significant changes were for Costa Rica, up from ranked 21 in 2002 to 13 in 2003, and the Dominican Republic, down from 13 in 2002 to 20 in 2003. The most transnationalized economy of all in 2003 was Hong Kong (China), followed by Ireland and Belgium.

The increase in global FDI flows in 2005 was driven by many factors: macroeconomic, microeconomic (corporate) and institutional. The most important factor at the macroeconomic level has been continued economic growth.[8] At the microeconomic level, a surge of financial flows to collective investment institutions (e.g. private equity funds, hedge funds) led to massive cross-border investments by these funds. At the institutional level, although a number of restrictive measures are being adopted to discourage takeovers, favourable conditions in financial and stock markets prompted the growth of cross-border M&As.

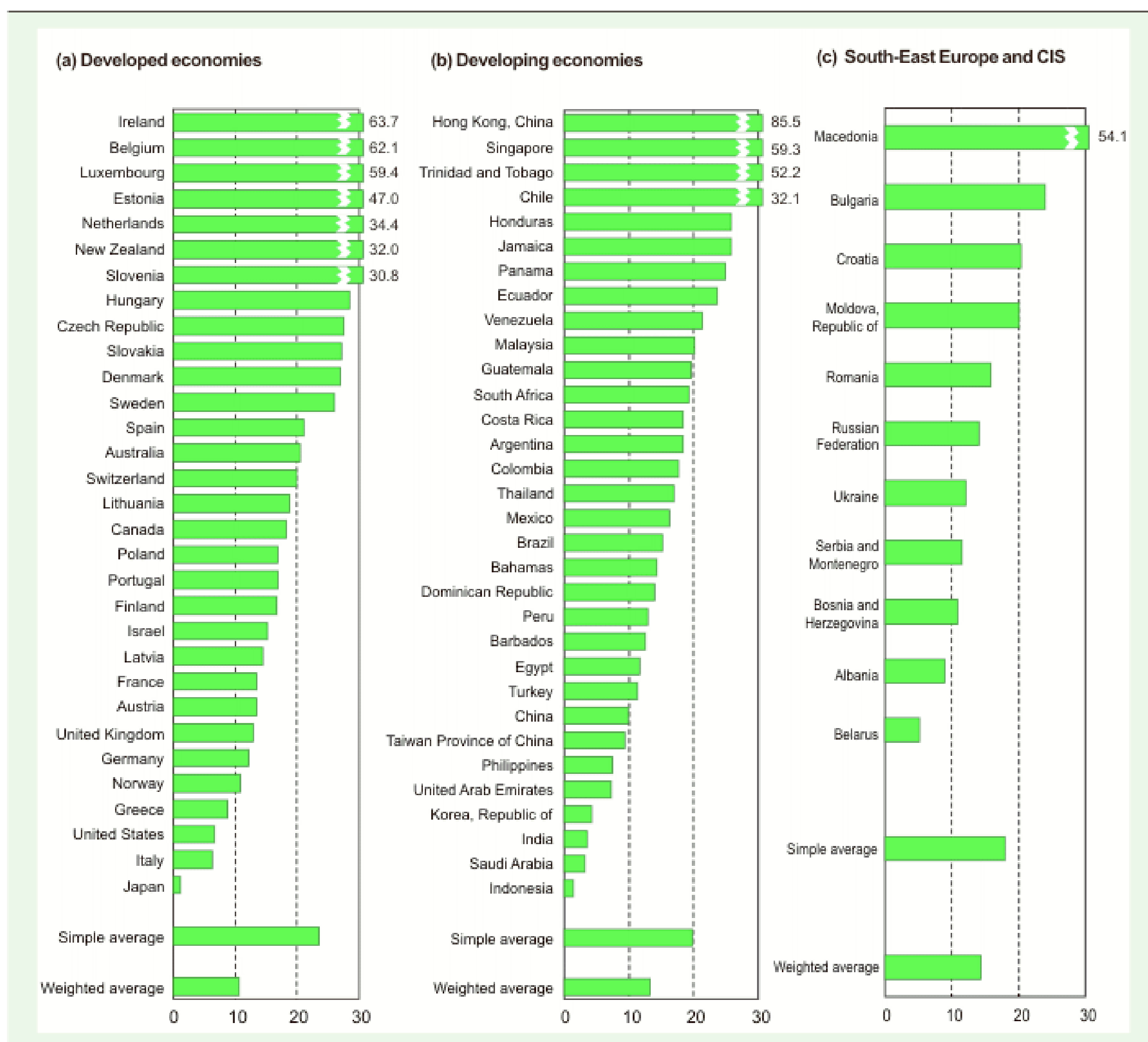
However, data on FDI flows and stocks should be interpreted with caution, taking into account a number of issues related to FDI statistics. A rise in global FDI flows, for instance, does not necessarily mean increased productive capacities in host economies, as explained in the next section.

2. Some issues concerning FDI statistics: what is behind the numbers?

Host countries today generally welcome FDI, on the condition that it will lead to higher value added and/or higher rates of output growth in their economies. FDI flows are expected to represent funds for expenditure on capital formation in host economies. But in reality not all of the flows shown in FDI data represent external financial resources for investment, because they may have originated in that country itself in the first place (round-tripping), or because they are intended mainly for FDI in some other country (trans-shipping), as discussed below. And, even if they are trans-shipments, they do not necessarily translate into expenditures to build production capacity in host economies.

Capital formation is the flow of expenditures that increase or maintain the real capital stock (sum of the value of capital goods used as factor inputs for production) in an economy. FDI that goes into new investment projects in an economy is part of

Figure I.6. Transnationality index[a] of host economies[b], 2003
(Per cent)



Source : UNCTAD estimates.

[a] Average of the four shares : FDI inflows as a percentage of gross fixed capital formation for the past three years 2001-2003; FDI inward stocks as a percentage of GDP in 2003; value added of foreign affiliates as a percentage of GDP in 2003; and employment of foreign affiliates as a percentage of total employment in 2003. For Belgium and Luxembourg, the corresponding ratio of FDI inflows to gross fixed capital formation refers only to 2002-2003.

[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 (2002), Czech Republic (2002), Finland (2001), France (2001), Hungary (2000), Ireland (2000), Italy (1997), Japan (2002), Netherlands (1996), Norway (1998), Portugal (2002), Sweden, United Kingdom (1997), United States, China (2002), India (1995), Malaysia (1995), Singapore (2002), Taiwan Province of China (1994) and 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, Czech Republic, Denmark (1996), Finland (2001), France (2001), Germany, Hungary (2000), Ireland (2001), Italy (1999), Japan (2002), Netherlands (1996), Norway (1996), Poland (2000), Portugal (2002), Republic of Moldova, Slovenia (2000), Sweden, Switzerland, United Kingdom (1997), United States, Hong Kong (China) (1997), Indonesia (1996) and Singapore (2002). For Albania, the employment impact of foreign-owned affiliates was estimated on the basis of their per capita inward FDI stocks 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 their outward FDI stock and to total inward FDI stock of the respective economy. Data for France, Netherlands, Norway, Sweden and United Kingdom refer to majority-owned foreign affiliates only.

Box I.1. FDI and round-tripping of investments

Different treatment for foreign investors, as opposed to domestic investors, and tax differentials between countries affect the size and direction of FDI flows, leading in some cases to what is known as "round-tripping", or "the channelling by direct investors of local funds to SPEs (special purpose entities) abroad and the subsequent return of the funds to the local economy in the form of direct investment" (IMF 2004, p. 70).[a]

While estimates of such FDI vary, a large share of FDI from and in major developing host economies such as China and Hong Kong (China) is round-tripped. In the case of inward FDI in China, some of which is round-tripped via Hong Kong (China), estimates vary from 25% (*WIR03*, p. 45) to about 50% (Xiao 2004). Chinese firms try to benefit from special treatment and incentives given to foreign investors by remitting funds to Hong Kong (China) and then having their Hong Kong affiliates reinvest the funds back in China. After its accession to the World Trade Organization (WTO), China has removed many of the incentives, but there are still differences in treatment between domestic and foreign investors; for example, the corporate tax is still levied at lower rates on foreign TNCs than on domestic firms (normally 5%-13% on the former, compared with 25% on the latter).

Additional notable examples include the Russian Federation and others that have relatively recently opened up to foreign investors that tend to offer special incentives to FDI. However, in all these other cases, only small amount of FDI is round-tripped, as their FDI inflows are relatively small compared to those of China.

Source: UNCTAD.

[a] The term "round-tripping" is not mentioned in the existing official documents related to compilation of FDI data such as the IMF's *Balance of Payments Manual, Fifth Edition* (1993), or the OECD's *Benchmark Definition of FDI* (1996). However, the *Revision of the Balance of Payments Manual, Fifth Edition*, currently being undertaken by the IMF in cooperation with other international organizations (including UNCTAD) will include a reference to it (IMF 2004, p.70).

Box I.2. FDI and trans-shipping of investments

A large amount of FDI is invested in special purpose entities (SPEs) not only in developing countries (in particular tax havens or some offshore financial centres) but also in developed countries. Even in some major developed host countries the share of holding companies – one type of SPEs – in total inward FDI is relatively high (box table I.2.1). In a number of developed countries, it is usually difficult to ascertain to what extent FDI from SPEs is trans-shipped to other countries, but in the case of financial centres, it is likely that most of their FDI will be redirected to other countries.

In Luxembourg – the largest FDI recipient in 2002-2003 if FDI in SPEs or trans-shipped FDI were to be included – official data suggest that an estimated 95% of FDI inflows during 2002-2005 were trans-shipped (box table I.2.2).

Box table I.2.1. Inward FDI stock in holding companies of selected countries, 2003

Country	Millions of dollars	Share in total (%)
France	196 860	38
Germany	87 363	23
Portugal	11 762	20
United States [a]	84 361	6

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

[a] Data refer to 2004.

Box table I.2.2. FDI inflows in Luxembourg, distributed between SPE/trans-shipped FDI and non-SPE/non-trans-shipped FDI, 2002-2005
(Millions of dollars)

Item	2002	2003	2004	2005
Total inflows including SPE/ trans-shipped FDI	117 218	83 814	77 215	43 755
Non-SPE/non-trans-shipped FDI	3 992	3 943	3 958	3 685
SPE/trans-shipped FDI	113 226	79 871	73 257	40 070

Source: UNCTAD, based on official communications with Statec, Luxembourg.

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Box I.2. FDI and trans-shipping of investments (concluded)

Furthermore, offshore financial centres located in the Caribbean alone accounted for 10% of inward FDI inflows to developing countries during 2000-2005 (annex table B.1).

Data for Hong Kong (China) show that 27% of its outward FDI stock in 2004 was accounted for by FDI that is directed to non-operating companies in offshore financial centres (mainly British Virgin Islands) (China, Hong Kong Census and Statistics Department, various years).[a] This type of FDI may have increased after the return of Hong Kong to China in 1997 as both local and foreign investors in Hong Kong (China) sought to diversify their financial holdings as a hedge against policy changes that might be detrimental to their interests (Ramstetter 2005).In addition, in some major host countries for which information is available, the share of tax havens in total inward FDI is substantial: for example, 14% of inward stock in Singapore (2003), 39% in Hong Kong, China (2004), and 15% in Brazil (2000).

Source: UNCTAD.

[a] Round-tripped FDI from China via Hong Kong (China) should also be taken into account, but official estimates of this type of FDI are not available. Thus it is not considered here.

this. However, FDI flows in the form of cross-border M&As in many cases simply end up transferring the ownership of production assets to the foreign investor and do not entail, at least in the short-term, any direct addition to capital stock in a host country (other than possible transfers of technology and know-how), as discussed in section 3 below. In addition, for different reasons, round-tripped investments (box I.1), trans-shipped investments (box I.2), as well as the bulk of investments in special purpose entities (SPEs) and in tax havens do not necessarily represent foreign investments in production capacity in host countries: they might eventually be used for productive investment in other, or even the originating, countries. The current FDI data, which include these kinds of investments, thus overestimate actual investment in production capacity.

These issues are being extensively discussed by expert groups on FDI at the international level, in particular the Direct Investment Technical Expert Group[9] and the OECD's Benchmark Advisory Group,[10] for the purpose of the revisions of the IMF's *Balance of Payments Manual* and the OECD's *Benchmark Definition of FDI*. Both groups set international guidelines for the compilation of statistics on balance of payments and international investment positions.[11] These issues and problems were also underlined at an UNCTAD expert meeting held in Geneva in December 2005 (box I.3).

FDI data should therefore be interpreted and used with all of these caveats in mind. More importantly, developing countries need to improve the quality of their FDI statistics – a major challenge for many of them. Moreover, FDI data alone are not enough to assess the importance and impact of FDI in host economies. They should be complemented with statistical information on the activities of TNCs and their foreign affiliates (e.g. sales, employment, trade, research and development (R&D)).

3. A new wave of cross-border M&As

This section takes a closer look at the new wave of cross-border M&As, including the growing importance of collective investment funds – particularly private equity funds and hedge funds – in FDI and their contribution to the recent recovery of FDI flows. It also highlights some of the questions this phenomenon raises concerning future FDI flows.

a. Recent trends

Both the value and number of cross-border M&As rose in 2005, to $716 billion (an 88% increase) and to 6,134 (a 20% increase) respectively – levels close to those of 1999, the first year of the latest cross-border M&A boom (annex tables B.4-B.7). While this high level of M&As reflected strategic choices of TNCs, it was also fuelled by the recovery of stock markets, which led to an increasing number of mega deals (each worth more than $1 billion in transaction value): in 2005, there were 141 such deals, representing a total value of $454 billion – more than twice the amount recorded in 2004 – and accounting for 63% of the total value of global cross-border M&As (table I.3; for individual deals see annex table A.I.7). These deals, the very large ones in particular, are typically concluded through the exchange of shares as a means of reducing the

Box I.3. UNCTAD expert meeting on FDI statistics: sound data essential for sound policies

Reliable data are essential for analysing the process of globalization in all its dimensions, including its impact on sustainable economic development, which provides the basis for formulating development-oriented policies. In host economies, adequate and timely policies play a crucial role in ensuring that FDI brings the desired kinds of investment and benefits. But without proper information, it is difficult to formulate sound FDI policies that are conducive to development.

Against this background, the Expert Meeting on Capacity Building in the Area of FDI: Data Compilation and Policy Formulation in Developing Countries, convened by UNCTAD in December 2005, provided a forum for discussing some key issues. The meeting emphasized that data collected should be reliable, comparable, useful, comprehensive and timely. By all of these criteria, wide-scale improvements in data gathering are required.[a]

Providing increased and improved information on FDI would facilitate the analysis of trends and the assessment of the impact of FDI on development. At the UNCTAD expert meeting, it was recognized that the present data collecting and reporting systems of many developing countries, in particular LDCs, may not be able to provide the data required for sound analysis and appropriate policy formulation. Ways of improving this situation need to be considered, including through international and regional cooperation. UNCTAD is currently involved in expert meetings/consultations in various regions to identify steps that can be taken in this direction. These include institutional capacity-building activities relating to FDI statistics, and support to regional cooperation among relevant institutions in developing countries and economies in transition to help promote a harmonized system for measuring, collecting and reporting statistics on FDI and the activities of TNCs.

Source: UNCTAD, based on "FDI statistics: data compilation and policy issues", note prepared by the UNCTAD secretariat (TD/B/COM.2/EM.18/2) for the Expert Meeting on Capacity Building in the Area of FDI: Data Compilation and Policy Formulation in Developing Countries, Geneva, 12-14 December 2005 and "Report of the Expert Meeting on Capacity Building in the Area of FDI: Data Compilation and Policy Formulation in Developing Countries"(TD/B/COM.2/EM.18/3).

[a] See annex on Definitions and Sources, section B, for a discussion of some limitations of currently available FDI data.

Table I.3. Cross-border M&As valued at over $1 billion, 1987-2005

Year	Number of deals	Share in total (%)	Value ($ billion)	Share in 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
2005	141	2.3	454.2	63.4

Source: UNCTAD, cross-border M&A database (www.unctad.org/fdistatistics).

need for cash as well as for deferring or minimizing tax payments over capital gains. Indeed, some of them are impossible to effect by cash payment because of their sheer size. This is reflected in the increasing number of deals through an exchange of shares when cross-border M&As rise in value (table I.4). However, more recently, as noted below, due to the growth of FDI by collective investment institutions (e.g. private equity funds and hedge funds), M&As involving cash payment have also been on the rise.

Although it is too soon to make exact comparisons, the present boom in cross-border M&As bears a number of similarities as well as differences with the previous one (table I.5). The value and number of M&As in 2005 were comparable to the averages in 1999-2001, as were the number of mega deals. The top three target countries in terms of shares of total sales by value – the United Kingdom, the United States and Germany – were the same as in the previous boom.

On the other hand, there were some changes in the sectoral and industrial distribution of M&As in the two periods: the share of the primary sector

Table I.4. Cross-border M&As through exchange of shares, 1987-2005
(Billions of dollars and per cent)

	World		Developed countries		Developing economies[a]	
Year	Stock swap	Share in total	Stock swap	Share in total	Stock swap	Share in total
1987	1.5	2.0	1.5	2.1	-	-
1988	1.6	1.4	1.6	1.4	0.0	0.4
1989	11.2	8.0	11.2	8.2	0.0	0.8
1990	12.6	8.4	12.2	8.5	0.5	6.6
1991	2.3	2.9	2.3	3.0	-	-
1992	3.0	3.8	3.0	4.1	0.0	0.2
1993	14.3	17.3	13.4	18.6	0.9	8.2
1994	5.3	4.2	4.9	4.3	0.4	2.8
1995	13.8	7.4	12.6	7.3	1.2	9.0
1996	29.8	13.1	20.9	10.6	9.0	30.0
1997	32.4	10.6	30.8	11.4	1.6	4.6
1998	140.9	26.5	139.9	27.5	1.0	4.6
1999	277.7	36.3	250.3	35.7	27.4	42.7
2000	507.8	44.4	496.1	45.6	11.7	24.0
2001	140.9	23.7	115.8	21.6	23.8	42.4
2002	39.9	10.8	37.4	10.9	2.5	8.8
2003	32.7	11.0	31.7	12.3	1.1	2.6
2004	62.2	16.3	50.4	14.8	11.8	28.9
2005	123.7	17.3	121.4	19.4	2.3	2.6

Source: UNCTAD, cross-border M&A database (www.unctad.org/fdistatistics).
[a] Includes South-East Europe and CIS.
Note: Covers only the deals whose transaction value is known.

was higher in the latest boom, at the expense of services; this is reflected in the fact that the top three target industries in 2005 were mining, quarrying and petroleum. They pushed the two leading industrial categories in the previous M&A peak – transport, storage and communications, and finance – to the second and third positions respectively, and displaced business services from the top three.

There are some noticeable differences in the factors underlying the present upsurge in cross-border M&As, compared to those that drove the previous one. The financial markets and the "dot-com" boom no longer play key roles. Moreover, there is reason to believe that the present boom is driven primarily by strategic choices of firms in light of opportunities provided by economic growth, and that opportunistic factors play a smaller role in the current M&As. Thus the deals involve fewer industries than in the previous boom. Most cross-border M&As are undertaken within the same industry, except where new types of investors are involved, such as private equity firms (discussed later), that usually invest in any industry.

b. Cross-border M&As versus greenfield FDI

Greenfield FDI refers to investment projects that entail the establishment of new production facilities such as offices, buildings, plants and factories, as well as the movement of intangible capital (mainly in services). This type of FDI involves capital movements that affect the accounting books of both the direct investor of the home country and the enterprise receiving the investment in the host country. The latter (or foreign affiliate) uses the capital flows to purchase fixed assets, materials, goods and services, and to hire workers for production in the host country. Greenfield FDI thus directly adds to production capacity in the host country and, other things remaining the same, contributes to capital formation and employment generation in the host country.

Cross-border M&As involve the partial or full takeover or the merging of capital, assets and liabilities of existing enterprises in a country by TNCs from other countries. M&As generally involve the purchase of existing assets and companies. The target company that is being sold and acquired is affected by a change in owners of the company. There is no immediate augmentation or reduction in the amount of capital invested in the target enterprise at the time of the acquisition, except in some cases involving operations in which the direct investor already has an interest (see below). However, M&As may subsequently lead to an expansion (or reduction) of operations.

If the acquisition is strictly an exchange of shares between residents and non-residents with no cash involved,[12] there are no actual flows of financial capital. In the balance of payments, the exchanges of shares, which are recorded as inflows and outflows in the financial accounts of the two countries involved, should balance, resulting in no net inflow or outflow of financial capital. Such stock-swapping M&As accounted for 17% of total cross-border M&As in 2005 (table I.4).[13]

It should be underlined, however, that even though FDI through M&As may not add directly to the total capital stock of a host country, it does add to *foreign-owned* capital stock (when domestic firms are acquired) and to international production. Thus, from the point of view of the outward investors, these are investments that add to their production capacities, and from a global point of view, they add to international production capacity

Table I.5. Main characteristics of cross-border M&As: then and now

Item		1999-2001 (Previous peak period)		2005
Value ($ million) (Annual average)		834 607		716 302
Number (Annual average)		6 974		6 134
Number of mega deals (Annual average acquisition worth over $1 billion in transaction value)		134		141
Regional breakdown based on totals (% of total) (based on sales)				
Developed countries		90		84
Developing countries		9		14
South-East Europe and CIS		-		2
Sectoral breakdown based on sales (% of total)				
Primary		4		16
Manufacturing		29		28
Services		67		55
Top 3 target countries (% of total)				
	United States	30	United Kingdom	24
	United Kingdom	15	United States	15
	Germany	13	Germany	9
Top 3 target industries (% of total)				
	Transport, storage and communications	26	Mining, quarrying and petroleum	16
	Finance	17	Transport, storage and communications	14
	Business activities	10	Finance	13
Factors				
	Financial market boom		Economic growth	
	Pressures to merge		Strategic choices (firm's growth, consolidation, protection from acquisition)	
	Strategic and financial		New investors (private equity firms)	
	The dot-com surge			

Source: UNCTAD. M&A data from cross-border M&A database (www.unctad.org/fdistatistics).

and cross-border production under the common governance of TNCs. More importantly, although most FDI through M&As does not represent a direct addition to the capital stock of countries, several factors must be taken into account in assessing its significance for capital formation and for development in host countries (*WIR00* and box I.4).

c. An emerging trend: the rise in FDI by collective investment funds

Investment firms, or collective investment institutions and schemes – that include, among others, private equity firms and various financial investment funds (e.g. mutual funds, hedge funds) – have recently become growing sources of FDI, mainly through cross-border acquisitions. This emerging trend is examined here, in particular with reference to private equity funds and hedge funds that are frequently used for FDI, and the transactions of which are recorded in FDI statistics.

As long as cross-border investments of private equity and hedge funds exceed the 10% equity threshold of the acquired firm, these investments are classified and should be recorded as FDI, even if a majority of such investments are short term and are closer in nature to portfolio investments. Investments by these funds may be the latest examples of portfolio investment turning into FDI (Dunning and Dilyard 1999). Recent investments, however, involve a relatively long period of management by the funds themselves (box I.5) and have the characteristics of FDI. Further research is needed to better assess the true FDI or portfolio nature of such investments.

Private equity funds are emerging as a new and growing source of investment, with a record amount of funds raised in 2005 – $261 billion –[14] about half of which were used for FDI.[15] The investments are made primarily in companies in need of venture capital and in companies in distress, as well as in firms divested by large enterprises that prefer to concentrate on core

Box I.4. Comparison of the impact of cross-border M&As and greenfield FDI on host countries

The main difference between the impact on the host-country of FDI through cross-border M&As and greenfield investment lies in the immediate or short-term effects on capital formation and employment. Greenfield FDI, or FDI in new projects, adds directly to the stock of productive capital (and to employment) in the host country, while a merger or acquisition represents a change in ownership that does not necessarily involve any immediate additions to investment or employment in the host country. Over time, however, the impact of FDI through the two modes is likely to be similar in these and other respects, while differing in some others, particularly in the competition area by eliminating acquired companies or crowding out domestic companies.

First and foremost, over the longer term, both cross-border M&As and greenfield entry are likely to provide similar investment inflows in similar situations (*WIR00*, p.171). Evidence from developing countries shows that new (sequential) investments after cross-border M&As can be sizeable. Moreover, sequential investments can be encouraged through policy measures or provisions in privatization deals.

Second, there are situations in which cross-border M&As are the only realistic option for FDI entry, for example when there is a need for rescuing ailing companies in a financial crisis or when large-scale privatization is under way. Even when the two entry modes may be considered alternatives, industry-specific factors, such as market concentration, high barriers to entry, slow growth or excess capacity, may limit the probability of greenfield entry. Moreover, when FDI is motivated by the search for assets embodied in other firms, or driven by competitive pressures that force firms to access assets or restructure rapidly, the greenfield option is often ruled out (*WIR00*, p.161). However, these latter factors are likely to apply mainly to relatively advanced host developing economies; in less developed ones, the paucity of firms that are candidates for M&As may make greenfield entry the only option.

Third, FDI is a package of assets, including not only capital for investment but potentially also technology, organizational and managerial practices and market access. Greenfield FDI can provide this, while the potential impact of cross-border M&As on these aspects of host-country development is less known. Nevertheless, cross-border M&As, for example, can bring in their wake transfers of technology, especially when acquired firms are restructured to increase the efficiency of their operations. When TNCs invest in building local skills and technological capabilities, they do so regardless of how their affiliates are established.

In sum, the impact of FDI on host countries is difficult to distinguish by mode of entry once the initial period has passed. The possible exceptions are their impacts on market structure and competition, for instance when cross-border M&As have adverse effects by monopolizing production (closing down of the acquired firms or crowding out of local firms), and on economic restructuring of industries and activities, where cross-border M&As may play a more positive role than greenfield FDI (*WIR00*, pp.193-197).

Source: UNCTAD, based on *WIR00*.

competencies. Private equity firms are still largely concentrated in the United States and the United Kingdom, and the majority of the investments by private equity funds are still made in their home markets. But in recent years, such funds have expanded their business and investments into other countries and regions of the world. In 2005, 10% of all private equity funds raised were spent outside Europe and North America, in addition to "global" funds – which are a mixture of funds raised in more than one country – that accounted for another 20% (Private Equity Intelligence 2006, p. 9). In Europe, the single currency and the increasing integration of financial markets contributed to a significant increase in the importance of the private equity market (ECB 2005, p. 24). In Asia, companies with growth potential but in financial difficulty following the financial crisis (or a prolonged recession as in the case of Japan) have attracted such funds. In recent years, private equity funds have been joined by another type of funds – hedge funds. These funds have also started to participate in buyout transactions and are in competition with traditional TNCs and private equity funds, with

Box I.5. Characteristics of private equity and hedge fund investments

Private equity funds are financial service firms or institutions that purchase equity shares in companies at home and abroad. Most of the money raised for investments comes from institutional investors, such as banks, pension funds and insurance companies. In addition, commercial corporations, private foundations and private individuals invest in these funds. The funds are engaged in asset management that focuses on actively investing in and supporting businesses with a potential for high growth. The target companies are typically not listed on the stock market, or if listed, they are normally de-listed after acquisition. The aim of the investors is to earn profits (mainly in the form of capital gains) by helping the acquired companies to grow over several years through the provision of financial resources, advice, networking and knowledge. The capital gain for the investors is derived from the value creation achieved in the company, and is realized when the investment is exited. Venture capital is a subset of private equity, and refers to investments in companies at early stages of their development. Investments at the buyout stage apply to more mature companies, and involve larger amounts and different types of finance.

Hedge funds do not own or run a specified asset management business, but generally have broad investment mandates. There are very few regulatory restrictions on the types of instruments in which they deal, and they make extensive use of short selling, leverage and derivatives. They are often referred to as speculative funds. In recent years, however, hedge funds have expanded their equity stakes in selected stock-listed companies.

Durations of investment by private equity and hedge funds differ. In the case of private equity funds, investors tend to take equity positions with a time horizon of 5 to 10 years (or an average of 5-6 years). Hedge funds normally stay very short.

Source: UNCTAD, based on ECB (2006a), EVCA (2005).

a record $1,200 billion raised in 2005. Box I.5 provides an overview of the main characteristics of private equity funds and hedge funds and their investments.

Private equity-financed FDI increased in 2005, but it is difficult to calculate exactly its share in total FDI inflows worldwide, as balance-of-payments data do not distinguish between different types of investors.[16] The only available data are those on cross-border M&As by private equity funds, hedge funds and other similar investors.[17] Such data suggest that such investments are rising: they reached a record $135 billion and accounted for as much as 19% of total cross-border M&As in 2005 (table I.6). These figures are even higher than those of the M&A peak period of the late 1990s and 2000. About 10% and 30% of the value and number, respectively, of these deals took place in developing countries, in particular developing Asia (figure I.7 for number of deals).

Private equity funds normally obtain a majority of shares or full control and management of the companies they buy, and stay longer than other funds. Thus they are much more important for FDI than are hedge funds. The analysis that follows focuses on private equity funds.

In 2005, the private equity market boomed worldwide, particularly in Asia, including Japan, and the EU. Historically low interest rates, high liquidity of investors and the good performance of private equity funds led to an increase in investments in the funds. Half of the funds were venture capital funds. As in previous years, private equity firms in the United Kingdom and the United States accounted for the lion's share of raised funds (85%) (Private Equity Intelligence 2006). In the United States, the private equity market traditionally has been of greater importance than in other countries.

The majority of private equity funds invest in their own countries/regions. But a growing proportion of investments are now undertaken abroad. Often, private equity firms compete with traditional TNCs in acquiring foreign companies. In 2005, they were involved in several deals that included the largest buyouts in the world (table I.7). In many cases they invested jointly.[18]

In 2005, private equity firms invested abroad in various industries and sectors: for example in the services sector, including real estate, in Europe, the banking industry in developing Asia, and finance and leisure industries in Japan. In Germany, investments in real estate amounted to more than

$13 billion (box I.6). In general, in developed countries, the sectoral distribution of FDI by private equity firms is more or less equal between manufacturing and services sectors, but, unlike FDI overall or total cross-border M&As, the primary sector does not seem to be a significant target (figure I.8). In developing countries, the focus is more on services (80% of the total value). In developed countries, these firms invest largely in the food, beverages and tobacco industry in the manufacturing sector and in business activities (including real estate) in the services sector, while in developing countries and South-East Europe and the CIS their focus is more on finance and telecommunications.

The increasing activity of private equity funds in cross-border investments raises questions about the implications of such investments for the long-term growth and welfare of the host economies. There is disagreement about the positive effects of private equity in the form of venture or risk capital (i.e. capital invested in firms with high growth potential but also a high level of risk). A recent study has shown that firms that receive external private equity financing tend to have a larger start-up size and can therefore better exploit their growth potential (Colombo and Grilli 2005). Investment in firms with high growth potential and high risk levels may appeal less to traditional investors, as the risk of such projects seems too large or too difficult to assess. Venture capital from foreign private equity firms may well help developing countries create firms that could become a Xerox, a Microsoft or an Apple of the future.

Table I.6. Cross-border M&As by collective investment funds,[a] 1987-2005
(Number of deals and value)

	Number of deals		Value	
Year	Number	Share in total (%)	$ billion	Share in total (%)
1987	43	5.0	4.6	6.1
1988	59	4.0	5.2	4.5
1989	105	4.8	8.2	5.9
1990	149	6.0	22.1	14.7
1991	225	7.9	10.7	13.2
1992	240	8.8	16.8	21.3
1993	253	8.9	11.7	14.1
1994	330	9.4	12.2	9.6
1995	362	8.5	13.9	7.5
1996	390	8.5	32.4	14.3
1997	415	8.3	37.0	12.1
1998	393	7.0	46.9	8.8
1999	567	8.1	52.7	6.9
2000	636	8.1	58.1	5.1
2001	545	9.0	71.4	12.0
2002	478	10.6	43.8	11.8
2003	649	14.2	52.5	17.7
2004	771	15.1	77.4	20.3
2005	889	14.5	134.6	18.8

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

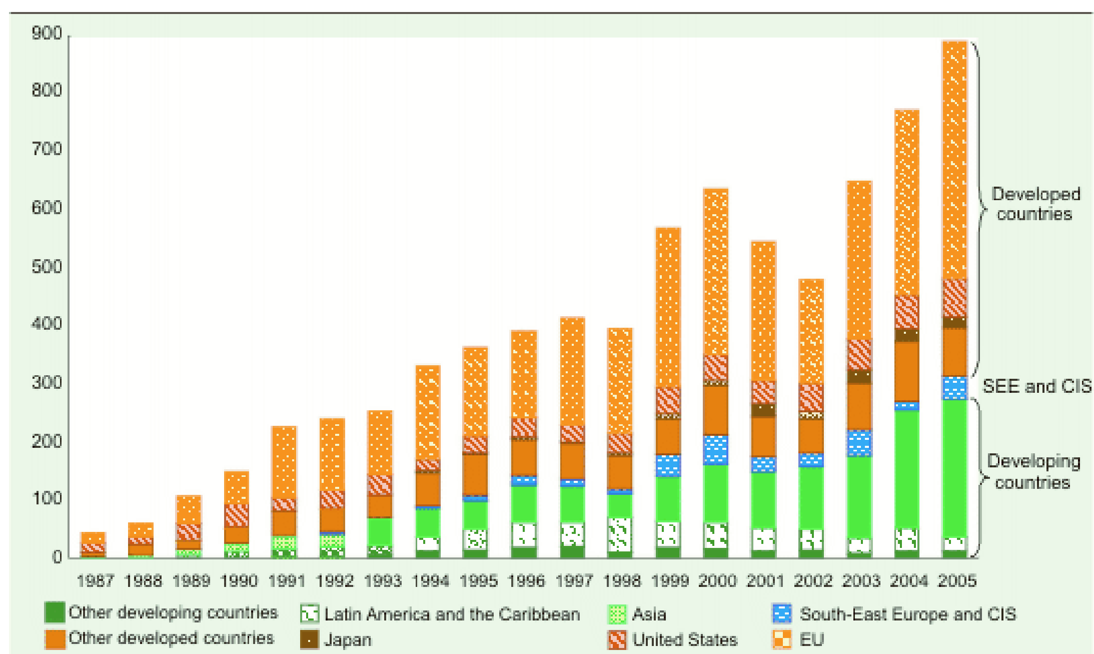
[a] Collective investment funds here refer mainly to private equity and hedge funds that are defined as "investors not elsewhere classified" under investment and commodity firms, dealers and exchanges (i.e. financial service industries excluding credit institutions, savings and loans, mutual savings banks, commercial banks, bank holding companies, investment and commodity firms, dealers and exchanges except investors not elsewhere classified — such as securities companies, commodity brokers, dealers and exchanges, investment offices, real estate investment trusts and management investment offices – and insurance firms). This classification is based on the one used by the Thomson Financial database on M&As.

However, the role of private equity funds in foreign acquisitions is particularly strongly debated when they invest in firms in distress. In a number of cases, private equity funds have been accused of putting companies up for resale within a short time period after squeezing profits out of them and laying off workers, or of slicing up and destroying companies. Sometimes, they have been referred to as "heartless asset strippers",[19] provoking a public outcry. For example, several such firms provoked public anger in the Republic of Korea (e.g. Newbridge Capital and Lone-Star, both United States private equity firms, when the former sold Korea First Bank in 2005 and the latter, Korean Exchange Bank in 2006). Similar examples are also prevalent in developed countries (e.g. Japan).

One of the differences between FDI by private equity funds and that by traditional TNCs relates to the fact that the investment horizon of the former lasts, on average, only 5-6 years, while, in theory, traditional TNCs have typically engaged in expanding the production of their goods and services to locations abroad and have longer investment horizons. But more recently, TNCs have also increasingly been driven by short-term performance targets to meet shareholders' expectations for high and rapid returns.

The prospects for fund-raising and investment by private equity funds remain good for 2006. Some firms (e.g. KKR) even started to raise funds from stock markets by issuing shares. With growing expertise, such funds are increasingly investing abroad, driving FDI financed by private equity funds. New institutional investors from developing countries are also emerging. Examples include Capital Asia (Hong Kong, China), Dubai International Capital (UAE), H&Q Asia Pacific

Figure I.7. Number of cross-border M&As by collective investment funds,[a] by target region, 1987-2005
(Number)



Source: UNCTAD, cross-border M&A database (www.unctad.org/fdistatistics).
[a] See note to table I.6 for definition of collective investment funds.

Table I.7. Selected 20 large cross-border M&As using collective investment funds,[a] announced or completed during 2004-March 2006

Rank	Year	Value in $ million	Target company	Country of target company[b]	Investor	Investors' country[a]
1	2005	13.0	TDC	Denmark	Apax, Blackstone, KKR, Providence	United States
2	2006	7.3	WNU	Netherlands	Carlyle, Blackstone, KKR, Alpinvest, Permira, Hellmann&Friedman	United States
3	2005	7.0	Viterra	Germany	Terra Firma (via Deutsche Annington)	United Kingdom
4	2004	4.4	Basell	Netherlands	Access Industries, Chatterjee Group	United States
5	2005	4.3	Amadeus	Spain	BC Partners, Cinven	United Kingdom
6	2004	3.1	Canary Wharf Group PLC	United Kingdom	Songbird Acquisition Ltd	United States
7	2005	2.9	Warner Chilcott PLC	United Kingdom	Waren Acquisition Ltd	United States
8	2004	2.2	Celanese AG	Germany	Blackstone Group LP	United States
9	2005	1.9	Masonite International Corp	Canada	Kohlberg Kravis Roberts & Co	United States
10	2004	1.8	WCM-Residential Pty	Germany	Blackstone Group LP	United States
11	2005	1.8	Ruhrgas Industries GmbH	Germany	CVC Capital Partners Ltd	United Kingdom
12	2004	1.8	ATU Auto-Teile-Unger GmbH	Germany	Kohlberg Kravis Roberts & Co	United States
13	2004	1.7	Brenntag AG	Germany	Bain Capital Inc	United States
14	2004	1.7	Picard Surgeles SA	France	BC Partners Ltd	United Kingdom
15	2005	1.6	Pirelli SpA-Cables & Sys Div	Italy	GS Capital Partners LP	United States
16	2005	1.6	Turkcell Iletisim Hizmetleri	Turkey	Alfa Group	Russian Federation
17	2004	1.5	Verizon-Canadian Directory Bus.	Canada	Bain Capital Inc	United States
18	2005	1.5	Tussauds Group Ltd	United Kingdom	Dubai International Capital	United Arab Emirates
19	2005	1.4	Chr Hansen-Food Ingredient	Denmark	PAI Partners SA	France
20	2005	1.4	Dometic International AB	Sweden	BC Partners Ltd	United Kingdom

Source: UNCTAD, based on annex table A.I.8 and newspaper accounts.
[a] See note to table I.6 for definition of collective investment funds.
[b] While the (immediate) country of target and investor is the same, the ultimate investor is based in another country.

Box I.6. Large private equity investments in the German real estate sector

In 2005, there were several high value investments by foreign private equity firms in the German real estate sector. For example, Fortress acquired NILEG Immobilien Holding GmbH for i1.5 billion ($1.9 billion), Cerberus/ Fortress bought Deutsche Wohnen for i1.0 billion ($1.3 billion) and Oaktree acquired GEHAG for i1.0 billion ($1.3 billion).

The most spectacular investment was undertaken by Terra Firma, a private equity capital firm, which acquired E.ON, a real estate firm, from one of the biggest German energy suppliers, German Viterra AG, for a publicly announced price of i7 billion ($8.8 billion), making it the largest transaction in the European real estate sector and the largest buyout in Germany.[a] The German housing market has become more attractive to foreign investors as economic conditions in that country have begun to improve and housing prices are relatively low following a decade of stagnation.

Like many investments by private equity firms, the acquisition of Viterra (which was undertaken through the German affiliate of Terra Firma, Deutsche Annington) appears to have been financed to a large extent by loans raised in local markets. Since these loans were taken by the German affiliate in domestic markets, they are not considered as involving cross-border payments, and therefore are not recorded as inward FDI in Germany. In the German balance-of-payments statistics, total FDI inflows in the real estate sector in 2005 amounted to only $0.8 billion; yet the acquisition of Viterra AG, together with other publicly announced acquisitions of German real estate companies by foreign private equity companies, amounted to over i13 billion ($16.2 billion).

Source: UNCTAD.

[a] "Terra Firma wettet auf den deutschen Aufschwung", *Frankfurter Allgemeine Zeitung*, 23 February 2006.

Hong Kong (China) and Temasek (Singapore). However, given the recent tendency of many such funds to use bank loans to finance private equity buyouts, a deterioration in the macroeconomic environment, especially a sharp increase in interest rates, could lead to difficulties for the private equity funds and slow down the dynamic development of their investment abroad.

FDI by collective investment funds is a new form of foreign investment, which raises a number of questions that deserve further research. For instance, how does FDI financed by private equity funds differ from FDI by TNCs in its strategic motivations? Who controls such funds? And what are their impacts on host economies?

4. FDI performance and potential

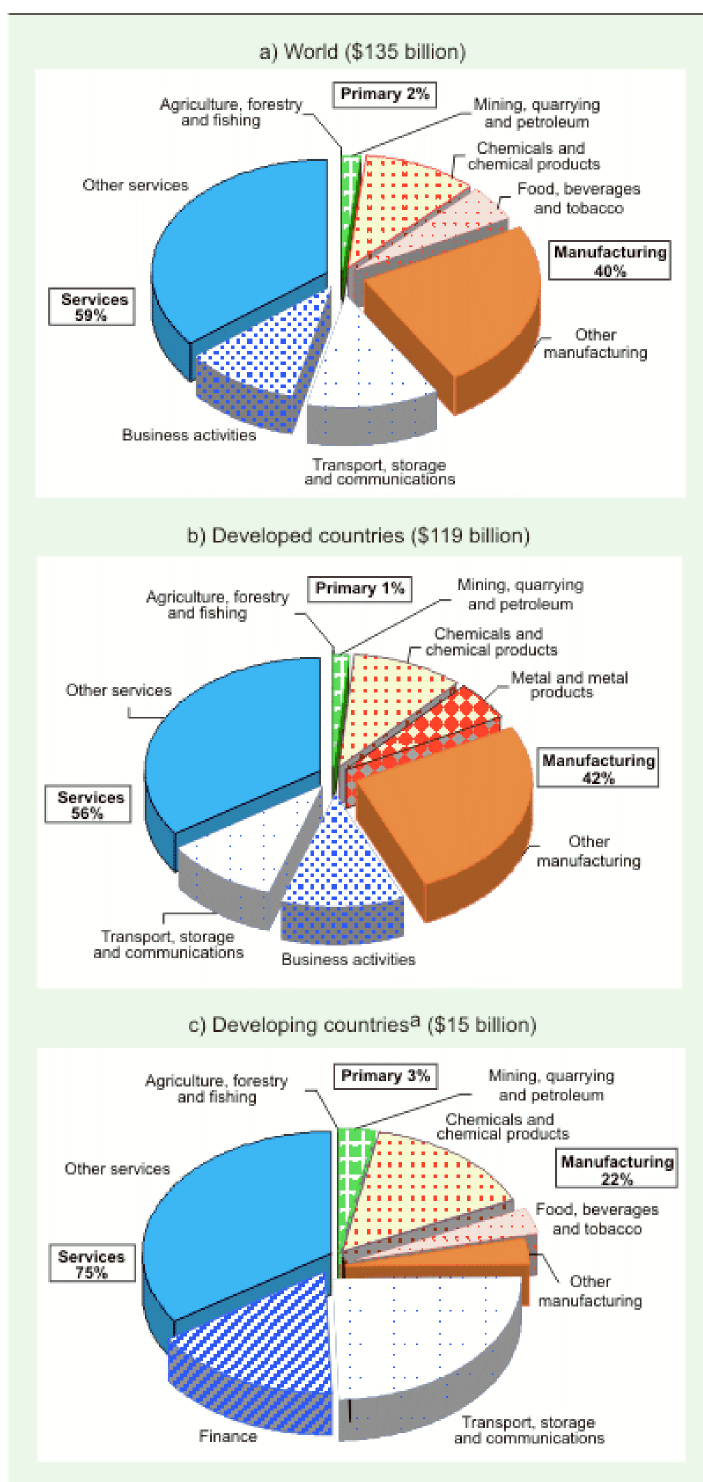
Some changes took place in 2005 (or the 2003-2005 average) of rankings by the UNCTAD *Inward FDI Performance Index,*[20] reflecting uneven developments with respect to FDI inflows (annex table A.I.9).

By country, as a result of continued large investments in its oil and gas industry, Azerbaijan still led the performance index ranking ahead of other small economies – usually well represented among the leaders – such as Brunei Darussalam, Hong Kong (China), Luxembourg, Malta and Singapore (table I.8). Estonia came fourth (having moved up from the 15th position in 2004 (or the 2002-2004 average). Among the top 20 performers by the index, 12 were developing economies and three were from the transition economies of South-East Europe and the CIS. Many high performers are oil- and gas-producing economies.

By region, the group of developed countries suffered a decline in its relative position, reflecting large falls in FDI in some countries (table I.9). Within the group, the largest declines were in the EU, although significant gains were observed for the Netherlands and the United Kingdom (annex table A.I.9). On the other hand, the developing regions, with the exception of Latin America and the Caribbean, improved their ranking by the FDI Performance Index. The highest index was that of South-East Asia, but the sharpest rise was achieved by the North African region (with Sudan, Egypt and Morocco moving up in the rankings) and West Asia. South-East Europe also improved its index in 2005 (table I.9). The two candidates for EU accession, Bulgaria and Romania, figured among the top 30 (annex table A.I.9).

Figure I.8. Cross-border M&As by private equity funds and hedge funds, by sector and main industry, 2005

(Per cent)



Source: UNCTAD.

[a] Including South-East Europe and CIS.

In contrast to changes in rankings in the performance index, there were almost no changes in the rankings based on the Inward FDI Potential Index[21] (annex table A.I.9 for rankings of all 141 countries). The top economies remain the same as in the previous year, almost in the same order. This reflects the stability of the structural variables comprising the Index. The United States and the United Kingdom ranked first and second, and 15 developed countries ranked among the top 20. Singapore, Qatar, Hong Kong (China), the Republic of Korea and Taiwan Province of China, in that order, were the developing economies that featured among the top 20 in the 2005 ranking.

Comparing their inward FDI performance and potential using the UNCTAD indices, 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

Table I.8. Top 20 rankings by Inward FDI Performance Index, 1995, 2004 and 2005[a]

Economy	1993-1995	2002-2004	2003-2005
Azerbaijan	11	1	1
Brunei Darussalam	18	2	2
Hong Kong, China	13	6	3
Estonia	15	15	4
Singapore	2	7	5
Luxembourg	..	4	6
Lebanon	116	8	7
Malta	21	30	8
Bulgaria	96	9	9
Congo	7	10	10
Belgium	..	11	11
Mongolia	94	13	12
Iceland	130	58	13
Georgia	114	16	14
United Arab Emirates	90	25	15
Sudan	112	19	16
Congo, Democratic Republic of the	131	91	17
Angola	24	3	18
Jordan	132	46	19
Trinidad and Tobago	5	14	20

Source: UNCTAD.

[a] Three-year moving averages of FDI inflows and GDP, using data for the immediate past three years including the year in question.

Table I.9. Inward FDI Performance Index, by region, 1990, 2004 and 2005[a]

Region	1988-1990	2002-2004	2003-2005
World	1.000	1.000	1.000
Developed regions	1.007	0.838	0.807
Europe	1.272	1.393	1.372
European Union	1.271	1.406	1.385
Other Europe	1.280	1.132	1.119
North America	1.129	0.472	0.484
Other developed countries	0.290	0.431	0.194
Developing regions	0.967	1.532	1.596
Africa	0.722	1.288	1.455
North Africa	0.838	1.186	1.591
Other Africa	0.643	1.356	1.372
Latin America and the Caribbean	0.948	1.705	1.625
South America	0.814	1.747	1.687
Other Latin America and the Caribbean	1.277	1.649	1.535
Asia and Oceania	1.030	1.500	1.604
Asia	1.019	1.501	1.605
West Asia	0.142	0.872	1.242
South, East and South-East Asia	1.240	1.635	1.685
South Asia	0.112	0.525	0.507
East and South-East Asia	1.632	1.899	1.962
East Asia	1.085	1.931	1.933
South-East Asia	3.172	1.780	2.073
Oceania	7.144	0.702	0.717
South-East Europe and CIS	0.444[b]	2.062	2.098
South-East Europe	0.876[b]	3.699	3.857
CIS	0.407[b]	1.732	1.760

Source: UNCTAD.

a Three-year moving averages of FDI inflows and GDP, using data for the immediate past three years including the year in question.

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

potential and performance) (table I.10). There are some surprises for the first and last groups. While the first group included many developed countries and newly industrializing economies, in 2004 (2002-2004 average), the most recent year available for this analysis, countries such as Denmark, France and Switzerland were categorized as below potential. The last group consisted mainly of poor and low-income developing economies, including LDCs and countries affected by economic or political crises.

Performance in FDI outflows relative to the size of economies, as measured by the Outward FDI Performance Index,[22] showed only a few changes in country positions in 2005 as compared with those in 2004. Iceland and Hong Kong (China) head the list, and the composition of the top 10 economies was the same as that of the previous year (2004), with six developed countries, three developing economies and one transition economy from the CIS (Azerbaijan). In general, as in the case of inward FDI performance, small economies ranked relatively high in the Outward FDI Performance Index. Chapter III further discusses developments based on this index for developing countries.

B. Policy developments

1. National policy changes

The year 2005 saw intense discussions in many parts of the world on the merits of liberalization versus the need for economic protectionism. Most countries continued to liberalize their investment environment but others took steps to protect their economies from foreign competition or to increase State influence in certain industries. In particular, the Latin American oil and gas industries were the focus of attention culminating in the decision in Bolivia to nationalize its oil and gas industry in May 2006.

A total of 205 policy changes were identified by UNCTAD in 2005 (table I.11). In terms of regional distribution, Africa accounted for 53 policy changes, followed by Asia and Oceania (48), developed countries (44), South-East Europe and the CIS (39) and Latin America and the Caribbean (21). The number of FDI-related changes in national laws was slightly lower than those reported for the past three years. This partly reflects a change in the methodology used by UNCTAD to gather the data.[23]

Most of the changes in 2005 made conditions more favourable for foreign companies to enter and operate. The types of measures most frequently adopted were related to sectoral and cross-sectoral liberalization (57 policy changes), promotional efforts (51 policy changes), operational measures (22 policy changes) and FDI admission (19 policy changes).

Fifty-one measures involved new promotional efforts, including various incentives aimed at furthering investment in certain economic activities. Greece, for example, introduced new incentives for investments in tourism and into R&D activities. Most of the changes reported were related to corporate income taxes, considered

Table I.10. Matrix of inward FDI performance and potential, 2004[a]

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

Source: UNCTAD.
[a] Three-year average for 2002-2004. Because of unavailability of data on FDI potential for 2005, the data for 2004 have been used.

promotional measures and thus included in these statistics. A significant number of countries continued to lower these rates, a measure which may not only attract FDI but also benefit domestic enterprises. Rate reductions were most significant in Europe, where especially the new EU members continued to revise their corporate tax laws.[24] There were also some cases in other regions. For example, Ecuador introduced tax breaks of 10-12 years for investment in selected industries such as agriculture or tourism.[25] India introduced a law that grants foreign investors tax incentives for investing in special economic zones.[26] Tax increases have been the exception, and were observed only in the Dominican Republic (25%–30%), Equatorial Guinea (25%–35%), Lithuania (15%–19%) and the Philippines (32%–35%) (KPMG 2006). Some countries, such as Georgia, reformed their entire tax system and introduced flat taxes, an approach adopted also in several of the new EU member countries.

Asia and Africa were the leading regions in terms of introducing further sectoral liberalization. Some countries decided to liberalize certain sectors for the first time. The Libyan Arab Jamahiriya, for example, permitted foreign banks to open branches for the first time. Other countries, such as Egypt, combined sectoral liberalization with the introduction of more favourable operational

Table I.11. National regulatory changes, 1992-2005

Item	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Number of countries that introduced changes in their investment regimes	43	57	49	64	65	76	60	63	69	71	70	82	102	93
Number of regulatory changes:	77	100	110	112	114	150	145	139	150	207	246	242	270	205
More favourable to FDI [a]	77	99	108	106	98	134	136	130	147	193	234	218	234	164
Less favourable to FDI [b]	-	1	2	6	16	16	9	9	3	14	12	24	36	41

Source: UNCTAD, database on national laws and regulations.
[a] Includes further liberalization, or changes aimed at strengthening market functioning, as well as increased incentives.
[b] Includes changes aimed at increasing control, as well as reducing incentives.

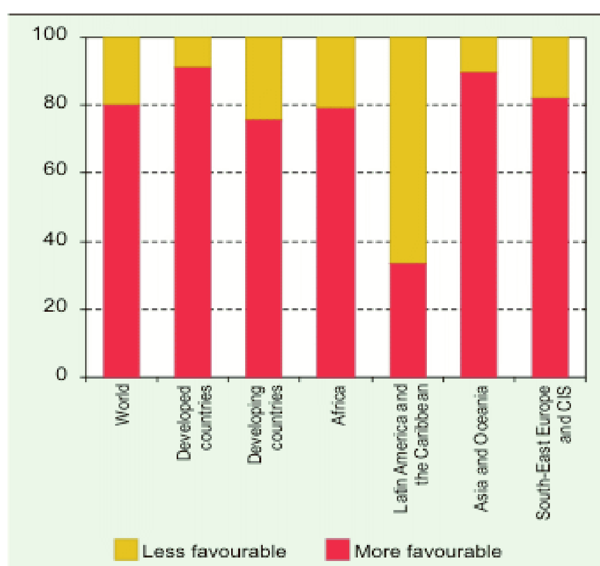
measures.[27] Nineteen countries introduced cross-sectoral liberalization, allowing foreign ownership in several economic sectors. Botswana, for example, published a privatization master plan that provides a framework for follow-up privatizations.

A number of countries also improved policies towards inward FDI. Israel linked a reform of its FDI admission procedure with the granting of expanded incentives.[28] Croatia and the former Yugoslav Republic of Macedonia set up one-stop shops for FDI admission, and New Zealand significantly raised the amount of investment for which no approval is needed (from $50 million to $100 million). Only three instances were noted of countries that enacted new policies to improve the legal protection of FDI. Colombia, most notably, introduced "legal stability contracts" to boost investor confidence.

While policy changes that were favourable to FDI still dominated in 2005, the number of changes making a host country less welcoming to FDI was the highest ever recorded by UNCTAD. In fact, the share of less favourable changes has been rising steadily, from 5% in 2002 to 20% in 2005. The share was particularly high in Latin America, where two thirds of the observed changes implied less favourable measures vis-à-vis inward FDI (figure I.9).

Figure I.9. Regulatory changes in 2005, by nature and region

(Per cent)



Source: UNCTAD, database on national laws and regulations.

New measures introduced have in many cases been linked to the exploitation of natural resources. Bolivia decided to nationalize its oil and gas sector in May 2006, while Venezuela continued to increase the control of the State-owned PDVSA over its oil production by renegotiating concession contracts with foreign investors. Consequently, a number of international oil companies agreed to sign new joint-venture contracts transferring majority ownership of their concessions to the PDVSA and accepting a higher tax rate (chapter II.A.4). In Chile, a new law imposed a tax of 5% of operating profits on mining operators that produce more than 50,000 metric tons of copper per year. Argentina extended the economic emergency laws adopted in 2002 for one more year, through 2006. This gives the Government widespread powers to adopt economic measures by decree and, in particular, allows renegotiation of privatized utilities' contracts (including tariffs).

Various measures to make the environment for investment less welcoming were observed in other parts the world as well. For example, the Government of Eritrea closed down the investment promotion agency (IPA), suspended private import-export licences and limited the free transfer of foreign exchange. Mirroring the trend to tighten control over natural resource extraction, the Central African Republic suspended for an indefinite period the issuance of new gold and diamond permits and banned foreigners from entering mining zones. Some developed countries introduced changes to defend the position of national champions. The French Government, for example, declared that foreign control of companies operating in 11 industries of national interest should be prevented.[29] In addition, a number of cross-border M&As triggered intense political discussions in countries such as France, Italy, Spain and the United States. Those discussions did not result in regulatory changes, but had a negative impact on certain cross-border mergers (see chapter VI).

The trend to increase controls on FDI has drawn the attention of the international media. UNCTAD's data also suggest that the balance of more and less favourable changes to FDI is shifting somewhat. For the time being, the trend is mainly confined to a small number of countries and relates primarily to investments in natural resources. FDI changes at the regional level are further described in chapter II.

2. Recent developments in international investment arrangements

The trend from previous years of expansion and increasing sophistication in international investment rule-making at the bilateral, regional and interregional level continued in 2005. The evolving system of international investment rules may contribute to creating an enabling framework for FDI. At the same time, managing the universe of multilayered and multifaceted international investment agreements (IIAs)[30] becomes more demanding, in terms of keeping it coherent, ensuring its effective functioning and making it conducive to national development objectives.

a. The IIA network continues to expand

The universe of IIAs continues to grow. In 2005, 70 bilateral investment treaties (BITs), 78 double taxation treaties (DTTs) and 14 other IIAs were concluded. The total number of IIAs was close to 5,500 at the end of 2005: 2,495 BITs, 2,758 DTTs and 232 other international agreements that contain investment provisions (figure I.10).

Several trends are worth noting in this context:

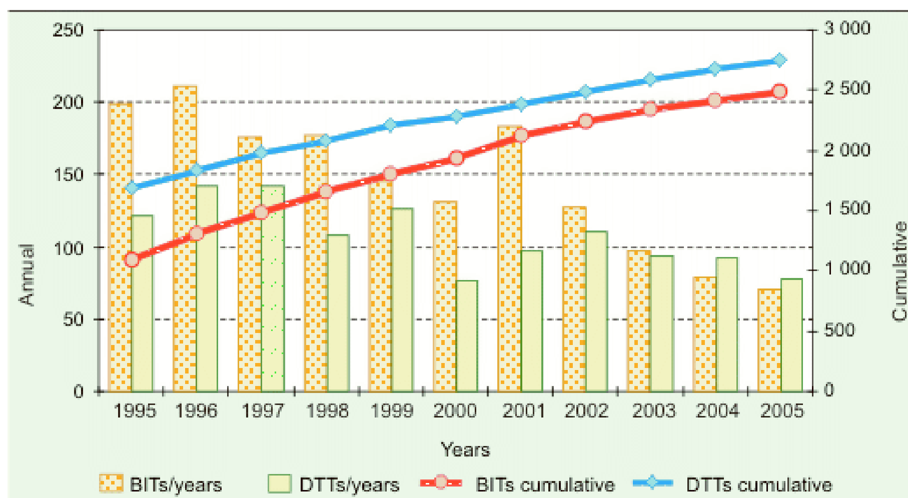
A first observation concerns the geographical distribution of IIAs. Asian countries are particularly engaged as parties to approximately 40% of all BITs, 35% of DTTs and 39% of other IIAs. Africa and South-East Europe and the CIS are generally more active than their Latin American counterparts in terms of BITs and DTTs, while Latin American countries are more active in concluding other types of IIAs, in particular free trade agreements.

A second noticeable trend is the growing involvement of many developing countries in IIAs. At the end of 2005, they were party to 75% of all BITs (figure I.11), 58% of all DTTs (figure I.12), and 81% of other IIAs. Two developing countries (China and Egypt) were amongst the top 10 signatories of BITs worldwide (figure I.13). LDCs, although host to only 0.7% of global FDI inward stock, had concluded 15% of all BITs, 6% of DTTs and 15% of other IIAs (table I.12).

IIAs between developing countries have increased substantially. For example, the total number of BITs among developing countries leapt from 42 in 1990 to 644 by the end of 2005. During the same period, the number of DTTs concluded between developing countries rose from 105 to 399, and the number of other IIAs from 17 to 86.

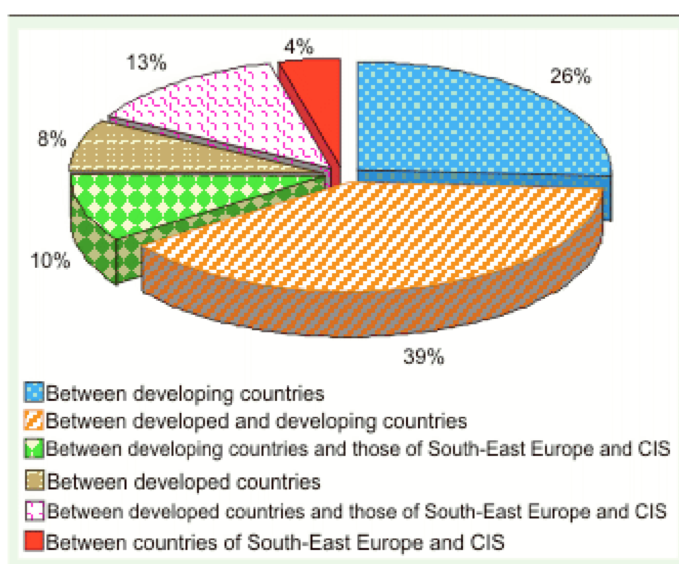
Third, recent IIAs tend to become more sophisticated in content, clarifying in greater detail the meaning of certain standard clauses and procedural rules relating to dispute settlement. Furthermore, a growing number of agreements express more clearly the public interest involved in such matters as the protection of health, safety and the environment.[31] These treaties therefore mark a step towards a better balancing of the rights of foreign investors and respect for legitimate public concerns. This may contribute to a broader acceptance of these agreements by interested stakeholders and other segments of civil society.

Figure I.10. Number of BITs and DTTs concluded, cumulative and annual, 1995-2005



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

Figure I.11. Total BITs concluded, by country group, as of end 2005



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

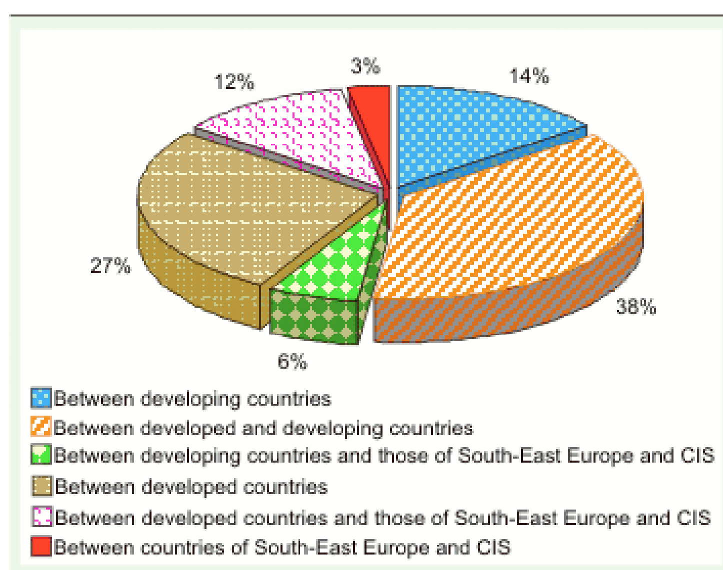
Fourth, international investment rules are increasingly adopted as an essential part of free trade agreements (FTAs) and other treaties on economic cooperation (figure I.14). These other IIAs may cover services, intellectual property, competition, labour, environment, government procurement, temporary entry for business persons and transparency, among others. This broad coverage demonstrates a trend towards an integrated approach in dealing with interrelated issues in international investment rule-making. The investment provisions included in these IIAs differ in their nature, scope and content of obligations. While the total number of IIAs other than BITs and DTTs is still relatively small, they have almost doubled over the past five years. In addition, as of 1 May 2006, at least 67 agreements were under negotiation involving 106 countries (see annex tables A.I.15 and A.I.16). This suggests there will be an even more pronounced increase in such treaties in the near future. At least five FTAs with legally binding substantive investment provisions were concluded from January to May 2006.

Finally, recent years have seen an increase in investor-State disputes. In 2005, at least 50 new cases were filed, bringing the total number of treaty-based cases to at least 226 by the end of 2005 (figure I.15). Some 136 out of a total of 226 cases were filed with the International Centre for Settlement of Investment Disputes (ICSID). Other disputes were initiated under the United Nations Commission on International Trade Laws (UNCITRAL) Arbitration Rules (67), the Stockholm Chamber of Commerce (14), and the International Chamber of Commerce (4) and ad-hoc arbitration (4), while the remaining case involved the Cairo Regional Centre for International Commercial Arbitration. At least 32 awards were rendered in 2005. While investment arbitration in general has helped to clarify the meaning and content of individual treaty provisions, some inconsistent decisions have also created uncertainty.[32] Along with the observed rise of FDI from developing economies (see Part Two of this Report) there have also been a number of investor-State disputes involving TNCs from these economies (box VI.12).

b. Systemic issues in international investment rule-making

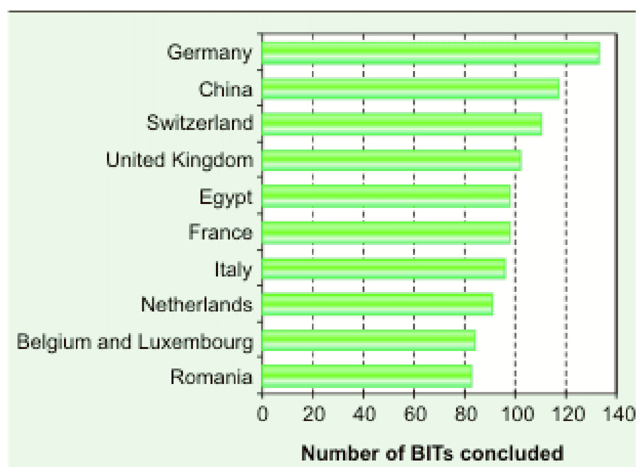
Greater diversity of IIAs in terms of their scope, structure and content reflects the flexibility that countries would like to have in choosing the partners to enter into an agreement, and to tailor

Figure I.12. Total DTTs concluded, by country group, as of end 2005



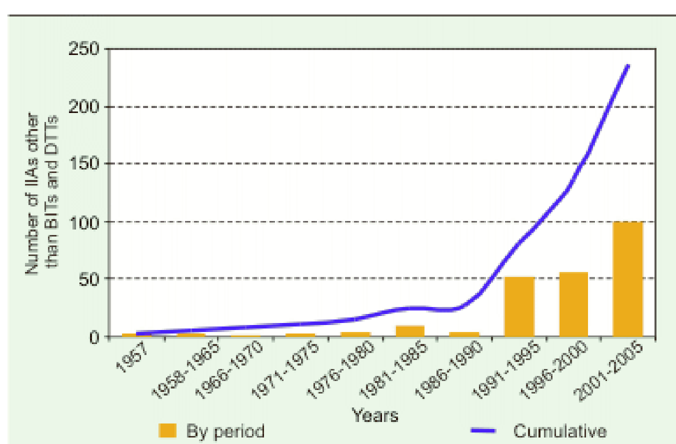
Source: UNCTAD (www.unctad.org/iia).

Figure I.13. Top 10 signatories of BITs, as of end 2005



Source: UNCTAD (www.unctad.org/iia), based on annex table A.I.10.

Figure I.14. The growth of IIAs other than BITs and DTTs, 1957 to 2005
(Number)



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

individual agreements to their specific situations, development objectives and public concerns. Furthermore, more elaborated rules may enhance legal clarity regarding the rights and obligations. Multiple coverage under more than one IIA may also contribute to improving the investment climate in the host countries for FDI by creating a synergetic effect and filling possible gaps in the overall treatment of foreign investment.

The increasing sophistication of IIAs also reflects the greater attention of policy-makers on the interface of different policy matters and the integrated treatment of those issues. By addressing investment together with other issues such as trade, services, competition, intellectual property and industrial policies in one and the same IIA, it becomes easier for countries to cover simultaneously different facets of investment activity, to set in place mutually reinforcing strategies to attract foreign investment and to avoid one policy being pursued at the expense of another.

On the other hand, the growing diversity of IIAs also means that foreign investors and governments have to operate within an increasingly complex framework of investment rules. Establishing and maintaining the coherence of the IIA network may therefore become more challenging (box I.7).

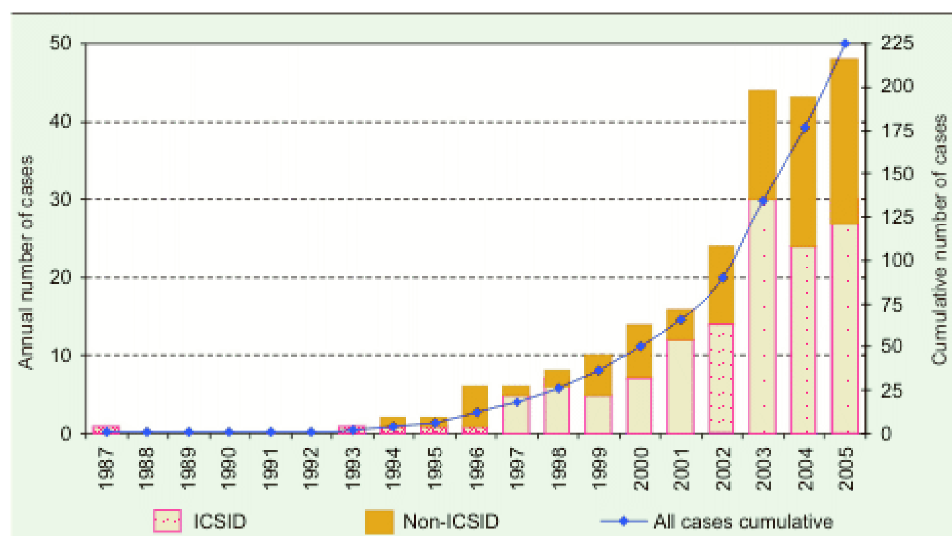
The complexity and rapid pace at which new IIAs are being concluded may create logistical problems for negotiating parties related to their lack of capacity, in particular for developing countries. Many lack sufficient financial resources and expertise to be able to assess fully and in time the implications

Table I.12. IIAs concluded, by region, cumulative and 2005

Region	BITs		DTTs		Other IIAs	
	2005	Cumulative	2005	Cumulative	2005	Cumulative
Asia and Oceania	31	1 003	36	968	12	89
Latin America and the Caribbean	13	464	9	322	5	62
Africa	21	660	17	436	2	34
South-East Europe and CIS	15	671	27	576	0	34
Memorandum						
Developed countries	45	1 511	38	2 111	7	127
Developing countries	60	1 878	53	1 604	14	185
Between developing countries	20	644	25	399	7	86
Least developed countries	16	399	5	184	2	35[a]

Source: UNCTAD.
[a] Includes agreements concluded by regional groups that have one or more LDC members.
Note: The above figures reflect multiple counting (e.g. BITs concluded between countries from Asia and Africa are included under both regions). The net total of each category of IIAs is therefore lower than the sum of the above figures.

Figure I.15. Known investment treaty arbitrations, cumulative and newly instituted cases, 1987-2005



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

Box I.7. Incoherence between IIAs

The expansion of the IIA network has given rise to various forms of potential incoherence between different agreements. For example:

- While most BITs leave it to the discretion of the host country to decide whether foreign investment should be admitted or not, FTAs often include establishment rights for foreign investors.
- Different modes of investment liberalization in IIAs may affect coherence. For instance, regional economic integration agreements (such as the North American Free Trade Agreement (NAFTA)) may establish up-front liberalization (i.e. full liberalization with a possibility to take reservations) based on a "top-down" approach, whereas the multilateral General Agreement on Trade in Services (GATS) provides for gradual market access on the basis of a "bottom-up" strategy. As a result, the degree of liberalization may be unclear for an economic activity covered by both agreements in the same host country.
- The Energy Charter Treaty includes an exception clause concerning the protection of the essential security interests of contracting parties. Many BITs do not contain similar provisions.

There may also be cases of "unintended coherence" between treaties that a country concludes with different countries. For instance, the MFN clause may, against the intention of a contracting party, incorporate into the IIA containing this clause certain procedural or substantive rights from other IIAs. This problem has been exacerbated by some recent contradictory interpretations of the scope of the MFN clause by arbitration tribunals.[a]

Another example is the so-called "umbrella" clause, which extends the protection of the IIA to "any other obligation" of the contracting parties in respect of an investment. As a result, a breach by a host country of such other obligations (e.g. one deriving from a contract with a foreign investor) may be a violation of the IIA, and the latter's dispute settlement mechanism applies - an outcome that may not be desired by a contracting party to the IIA.

The risk of incoherence is especially high for countries that lack expertise and bargaining power. In particular, they may have to conduct negotiations on the basis of divergent model agreements of negotiating partners that have stronger bargaining power.

Source: UNCTAD.

[a] See, in particular, the following cases: "Maffezini" (*Emilio Agustin Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7, Decision on Jurisdiction, 25 January 2000; Award, 13 November 2000, Rectification of Award, 31 January 2001); "Salini" (*Salini Costruttori S.p.A. and Italstrade S.p.A. v. Jordan*, ICSID Case No. ARB/02/13, Decision on Jurisdiction, 9 November 2004); "Siemens" (*Siemens v. Argentina*, ICSID Case No. ARB/02/8, Decision on Jurisdiction, 3 August 2004); and "Plama" (*Plama Consortium Limited v. Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction, 8 February 2005).

of various options in negotiations. Negotiations of IIAs having a broader scope require not only expertise on investment issues, but often also knowledge related to trade, services, competition and/or intellectual property rights.

It may also become more difficult for policymakers to gauge the full legal and economic implications of any new IIA and to identify the differences between various agreements. Furthermore, as the number of treaties with overlapping obligations increases, foreign investors may more often be in a position to claim "more favourable" treatment through the most-favoured nation (MFN) clause. The scope of applicability of this clause has become a matter of concern in the light of recent contradictory arbitral awards (box I.7).

Another issue is treaty implementation. This involves, among other things, completing the ratification process, bringing national laws and practices into conformity with treaty obligations, informing and training the local authorities that have to comply with the IIA, managing disputes that might arise under IIAs, and reassessing the implications of various agreements in light of national development priorities. Implementation of more complex IIAs involves a broader range of issues and thus requires the involvement of more domestic institutions.

One consequence is the growing need for capacity building to help developing countries in assessing the implications of different policy options before entering into new agreements, identifying the potential obligations deriving there from and implementing commitments made. Rigorous policy analysis of the evolution of the IIA universe and international consensus building on key development-related issues are other vital tasks. In this context, UNCTAD has an important role to fulfil as it has been called upon to "serve as the key focal point in the United Nations system for dealing with matters related to international investment agreements, and continue to provide the forum to advance the understanding of issues related to international investment agreements and their development dimension".[33]

C. The largest TNCs

This section looks at developments among the 100 largest non-financial TNCs worldwide, ranked by foreign assets, and for the first time this year, the top 100 TNCs from developing economies. It also includes information on the largest TNCs from the transition economies of South-East Europe and the CIS (box I.8), and an analysis of the internationalization of the 50 largest financial TNCs worldwide, ranked by a spread index based on the number of host countries and the number of foreign affiliates. Following a slowdown in their expansion in the early 2000s, coupled with reduced corporate profits, the transnational activities of the largest TNCs increased significantly in 2003 and 2004.

1. The world's 100 largest TNCs

In 2004 (most recent year for which data are available), the world's 100 largest TNCs accounted for 11%, 16% and 12%, respectively, of the estimated foreign assets, sales and employment of

Box I.8. The largest TNCs from the transition economies of South-East Europe and the CIS

Following the reclassification of the eight EU accession countries from Central Europe as developed countries, the *WIR* has discontinued its review of the top 25 TNCs from Central and Eastern Europe. The largest non-financial TNCs from South-East Europe and the CIS have always been smaller than the largest TNCs from developing countries, with the exception of the largest Russian firm Lukoil, which would rank 160th in the list of the largest TNCs worldwide (foreign assets for Gazprom are not available). Natural-resources-based firms from the Russian Federation dominate the list, but on average they are less transnationalized than the top 100 TNCs from developing economies. Eight firms from the Russian Federation are included in this list, with metal and metal products firms being the most represented (annex table A.I.13).

In the second half this top 10 TNCs are small and would not feature in the list of top 100 from developing countries. Although the average Transnationality Index (TNI) value (explained in section 2 below) increased in 2004 from 36.6 to 41.8, it remains much lower than the average TNI value for the largest TNCs from developing countries.

Source: UNCTAD.

all TNCs operating in the world, which gives an indication of the major role they play in international production. Given that their activities increased significantly, with total assets and sales increasing by 10%, 2004 proved to be a new record year (table I.13). The ratio of foreign activities to total activities also increased in 2004, with the exception of employment, which remained at almost the same level.

The motor vehicle industry dominates the first quartile of the top 100 TNCs with eight entries, and six industries – motor vehicles, pharmaceuticals, telecommunications, utilities, petroleum and electronic/electrical equipment – accounted for more than 60% of the activities of the top 100.

Overall, the rankings in the first quartile of the top 100 list in 2004 have remained relatively stable in the past few years, with General Electric, Vodafone and Ford Motor heading the list. These three TNCs had about $877 billion in foreign assets, corresponding to nearly 19% of the total foreign assets of the top 100 TNCs (annex table A.I.11). There was no change in the top 10 companies in 2004. However, there were 10 new entries in the list of top 100 in 2004: two companies – Mittal Steel (Netherlands/United Kingdom) and CITIC (China) – appeared on the list for the first time. Mittal Steel, founded and owned by the Indian Mittal family (chapter III), was created in 2004 by the merger of LNM Holdings (United Kingdom) and Ispat International NV (Netherlands), ranked 76th. CITIC, ranked 94, is the first ever entry of a Chinese TNC in the top 100.

Table I.13. Snapshot of the world's 100 largest TNCs, 2003, 2004
(Billions of dollars, thousands of employees and per cent)

Variable	2003	2004	% Change
Assets			
Foreign	3 993	4 728	18.41
Total	8 023	8 852	10.33
Foreign as % of total	49.8	53.4	3.6 [a]
Sales			
Foreign	3 003	3 407	13.45
Total	5 551	6 102	9.93
Foreign as % of total	54.1	55.8	1.7 [a]
Employment			
Foreign	7 242	7 379	1.89
Total	14 626	14 850	1.53
Foreign as % of total	49.5	49.7	0.2 [a]

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

In 2004, 85 of the top 100 TNCs had their headquarters in the Triad, the United States dominating the list with 25 entries. Five countries (the United States, the United Kingdom, Japan, France and Germany) accounted for 73 of the top 100 firms, while 53 entries were from the EU. In 2004, there were five companies from developing economies (China, Hong Kong (China), Malaysia, the Republic of Korea and Singapore), the largest number ever from this group, among the top 100. It is noteworthy that some large TNCs had their origin in a developing country, such as Anglo American (United Kingdom), ranked 36 and formed in May 1999 through the merger of Anglo American Corporation of South Africa and Minorco (Luxembourg), and SAB Miller (although not in the top 100 as it is ranked 117) which was formed out of SAB (South Africa) and Miller Brewing Company (the second largest brewery in the United States).

Taking the next ranking down (from 101 to 200) 10 more TNCs from eight developing economies appear in the ranking (from Brazil, China, Hong Kong (China), Mexico, the Republic of Korea (2), Singapore (2), Taiwan Province of China and Venezuela). TNCs from the United States and the United Kingdom account for 40% of these companies, and Japan and Germany for another 10% each.

2. The top 100 TNCs from developing economies

This year's *WIR* expands the coverage of the top TNCs from developing economies, from the top 50 to the top 100. Since UNCTAD began publishing the list of the leading developing-economy TNCs in 1995, these companies have expanded their activities abroad. However, there still remains a large gap between TNCs from the developed and developing groups. By way of illustration, the total foreign assets of the top 100 TNCs from developing economies in 2004 amounted to less than the foreign assets of General Electric alone.

Hutchison Whampoa (Hong Kong, China) maintained its leading position in 2004, with foreign assets of $68 billion, representing as much as 17% of the foreign assets of the top 100. Petronas (Malaysia), Singtel (Singapore) Samsung

Electronics (the Republic of Korea) and CITIC Group (China) occupied the next four positions (annex table A.I.12), accounting for 34% of the foreign assets of the 100 largest developing-country TNCs. All TNCs in the first quartile were already in the top 50 in 2003, and there were notable improvements in the positions of CITIC (China), Hyundai Motor Company (Republic of Korea) and Hon Hai Precision Industries (Taiwan Province of China).

In 2004, the foreign assets and foreign sales of the 50 largest TNCs increased by 36% and 58%, respectively, compared to the previous year (table I.14). The shares of foreign assets, sales and employment of the top 50 companies in those of the 100 largest TNCs from developing economies were 86%, 85% and 54% respectively. Their total assets and sales increased by 51% and 44%, respectively, but their foreign operations, as reflected in the ratio of foreign assets to total assets and foreign employment to total employment, have not increased to the same extent.

The regions and economies of origin of the largest developing-country TNCs have changed little over the past 10 years, although developing Asia has increased in importance. In 2004, Hong Kong (China) and Taiwan Province of China together had 40 of the 100 largest TNCs, followed by Singapore with 14 and China with 10. Asia's dominance in the top 100 grew, with 77 enterprises on the list. The other TNCs on the list came from South Africa (10), Mexico (8), Brazil (3), Venezuela (1) and Egypt (1). On average, TNCs from the Republic of Korea are performing better than those from other developing countries as reflected in their sales-to-assets ratio and the sales-to-employment ratio (table I.15). TNCs from South Africa, on average, would be ranked next, ahead of TNCs from other Asian economies.

The largest TNCs from developing economies operate in a wide range of industries. In 2004, the most important was the electrical/electronic equipment and computer industry (20), with all companies but one from Asia. The next in importance were shipping and transport (9), food (8) and petroleum (8).

Table I.14. Snapshot of the world's 50 largest TNCs from developing economies, 2003, 2004
(Billions of dollars, thousands of employees and per cent)

Variable	2003	2004	% Change
Assets			
Foreign	248.6	336.9	35.5
Total	710.9	1073.2	51.0
Foreign as % of total	35.0	31.4	-3.6[a]
Sales			
Foreign	204.2	323.0	58.2
Total	512.5	738.2	44.0
Foreign as % of total	39.8	43.8	4.0[a]
Employment			
Foreign	1 077.0	1 109.0	3.0
Total	3 097.0	3 364.0	8.6
Foreign as % of total	34.8	33.0	-1.8[a]

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

Table I.15. Performance measures of the largest TNCs from developing economies, 2004

Home economy	Ratio of sales to assets	Sales per employee (Thousands of dollars)
China (10)	0.57	89.5
Hong Kong, China (25)	0.43	90.5
Malaysia (6)	0.53	320.2
Mexico (8)	0.69	160.0
Republic of Korea (5)	1.14	1 050.6
Singapore (13)	0.58	80.6
South Africa (10)	1.00	204.4
Taiwan Province of China (15)	0.83	256.7

Source: UNCTAD/Erasmus University database.
Note: The above ratios are highly dependent on the industry composition, and may differ across sectors of activity. The five companies from the Republic of Korea are in electronics/electrical, motor vehicles and diversified sectors of activities, whereas sector composition is more diversified for China, Hong Kong (China), Mexico and Taiwan Province of China.

3. Transnationality of top TNCs

The Transnationality Index (TNI) developed by UNCTAD is a composite of three ratios – foreign assets/total assets, foreign sales/total sales and foreign employment/total employment. The average TNI is higher for the largest 100 non-financial TNCs, but in the recent past the TNI for the largest TNCs based in developing economies has increased and is catching up with that of the global top 100. The gap between the TNIs for the two groups narrowed until 2001, but thereafter it seemed to stabilize. In 2004, the average TNI value for the global top 100 increased by one percentage point. In the top 50 alone, the value of the TNI fell by one percentage point compared to 2003 (box I.9).

A comparison by country or region of origin of the largest TNCs (including from developing economies) in 2004 shows large discrepancies between countries and regional groups (table I.16). Among the world's largest TNCs, those from Latin America and the Caribbean, South Africa and the United States are, on average, the least transnationalized, while those from France and the United Kingdom are the most transnationalized. Among TNCs from developing economies, those from South-East Asia are, on average, more transnationalized than companies from any other developing region.

One aspect of transnationality from the operations perspective is the intensity of foreign operations according to the number of foreign affiliates. The Internationalization Index (II) shows that, on average, more than 65% of the affiliates of the world's largest TNCs are located abroad.[34] The information on foreign affiliates by TNCs' home country and industry shows that the II, like the TNI, is the highest for the top TNCs from small countries (e.g. Finland, Ireland and Switzerland), and by industry, electrical and electronic equipment and pharmaceuticals predominates(table I.17).

Table I.16. Comparison of TNI values, by region, 2003, 2004
(TNI values and number of entries)

Region/economy	Average TNI [a] 2003	Average TNI [a] 2004	Number of entries 2004
Top 100 largest TNCs	**55.8**	**56.8**	**100**
of which:			
United States	45.8	48.2	25
France	59.5	62.3	15
Germany	49.0	52.2	13
United Kingdom	69.2	70.5	11
Japan	42.8	52.2	9
Top 100 TNCs from developing economies		**50.7**	**100**
of which:			
Africa (South Africa)		48.0	10
South-East Asia		57.2	21
East Asia		53.2	55
Latin America and the Caribbean		38.1	12

Source: UNCTAD/Erasmus University database.
[a] TNI, the Transnationlity 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.

Box I.9. Expanding the coverage of leading developing-country TNCs, from top 50 to top 100: a comparison of samples

The coverage of the top TNCs from developing countries has been expanded to include 100 TNCs from developing economies. Direct comparisons with previous years covering only the top 50 TNCs are therefore not possible. By increasing the sample, the number of home countries for these 100 TNCs increased from 11 to 14 and the number of industries from 20 to 25.

TNCs from Hong Kong (China), which dominated the top 50, are even more dominant in the top 100. As a whole, the Asian region gains in importance. TNCs from Mexico and South Africa maintain the same relative importance. Industries are more diversified in the top 100 with the computers industry more than doubling its relative share.

The TNI value is higher for the top 100 than for the top 50, meaning that the 50 largest TNCs in the list are less transnationalized, on average. On the other hand, the 50 largest also have a higher Internationalization Index (II), which is the ratio of a TNC's foreign affiliates to total affiliates.

Box table I.9.1. Comparison of the country/industry composition of the largest 50 and 100 TNCs from developing economies, 2004
(Per cent)

Economy/industry	Top 50	Top 100
Number of economies	**11**	**14**
Share in total		
Hong Kong, China	20	25
Taiwan Province of China	10	15
Singapore	14	13
China	14	10
Mexico	8	8
South Africa	10	10
Number of industries	**20**	**25**
Share in total		
Diversified	14	16
Electrical/Electronics	14	11
Petroleum	14	8
Transport and storage	10	9
Food and beverages	10	7
Telecommunications	8	6
Computers	4	9
TNI	**46.9**	**50.7**
II	**51.9**	**49.9**

Source: UNCTAD.

Source: UNCTAD.

TNCs from developing economies in the petroleum industry or the metals industry are far less transnationalized than their counterparts from developed countries.

Table I.17. Comparison of II and TNI values for the top 100 TNCs from both lists, by industry, 2004

Industry	Largest TNCs		TNCs from developing countries	
	II	TNI	II	TNI
Motor vehicle	58.8	52.3	65.2	21.9
Electrical/electronics	73.0	53.0	65.2	67.3
Petroleum	61.2	53.9	25.2	32.3
Pharmaceuticals	79.2	59.1	-	-
Telecommunications	54.6	53.7	52.9	51.0
Utilities	58.8	48.7	-	-
Metals and metal products	77.1	63.7	39.9	29.5
Food and beverages	67.7	80.3	58.2	37.3
Transport and storage	82.7	41.8	52.4	61.5
All industries	65.9	56.8	49.9	50.7

Source: UNCTAD/Erasmus University database.

4. TNCs' most-favoured locations

Another aspect of transnationality is geographical reach, or the extent to which a company's operations and interests are spread in several countries or concentrated in just a few. This aspect of transnationality is relevant for several reasons: the spread of operations into many countries affects the strategic stance of the company; it also affects its ability to develop and spread knowledge and innovation. On average, the largest TNCs have affiliates in 40 foreign countries.

Information available suggests that the host country most frequently chosen by the largest TNCs for their foreign affiliates is the Netherlands: 86 of the 100 largest TNCs have at least one affiliate there. However, there are four Dutch companies in the top 100, which, by definition, cannot have foreign affiliates in their own country; and a similar situation applies to TNCs from France, the United Kingdom and the United States. "Location Intensity" takes into account the number of TNCs originating from a location/economy; it is defined as the total number of TNCs having at least one affiliate in the host country, divided by 100, minus the number of TNCs from this country listed in the top 100.

Based on this measure, the largest number of TNCs have invested in the United States, followed by the United Kingdom and then the Netherlands. The United States is also the most-favoured location for affiliates of TNCs from developing countries, followed by Hong Kong (China) and the United Kingdom (table I.18). Among developing countries, Brazil hosts the largest number of affiliates of the world's largest TNCs (81), followed by Mexico (78). The top 20 most-favoured locations of the world's largest TNCs are also among the most-favoured locations of TNCs from developing countries. Apart from locations in developed countries, the largest number of affiliates of the top 100 TNCs from developing countries are located in South-East and East Asia. This is not surprising, since most of these TNCs originate from that region and tend to locate in neighbouring countries (Rugman and Verbeke, 2004). For example, information available on the location of foreign affiliates suggests that the most frequent host region for Mexican TNCs is Latin America and the Caribbean, and for Malaysian TNCs, it is South, East and South-East Asia (table I.19).

It is noteworthy that tax-havens such as Cayman Islands, Bermuda and British Virgin Islands are also favoured.

5. The world's 50 largest financial TNCs

The rise in the value of assets of financial TNCs is attributable to growth mainly through M&As. At the end of the 1990s, international M&As involving European firms accounted for a large share of all cross-border activities. Overall, firms in the European countries engaged in fewer, but generally larger transactions than North American institutions and insurance was the leading industry in cross-border M&As (BIS 2001). In 2004, the three largest M&A deals were in the financial services industry, with the acquisition of Abbey National (United Kingdom) by the Santander Group (Spain) for $15.8 billion, followed by the acquisition of John Hancock (United States) by Manulife (Canada) and the acquisition of Charter One (United States) by Citizen Financial (United States). Other important deals involved large financial groups, acquiring banks in developing economies, such as HSBC in China and Citigroup in the Republic of Korea.

Table 1.18. Most-favoured locations of top 100 TNCs from both lists

For largest world TNCs		For largest developing-country TNCs	
Economy	Location intensity	Economy	Location intensity
United States	92.0	United States	50.0
United Kingdom	91.0	Hong Kong (China)	33.9
Netherlands	89.6	United Kingdom	33.7
Germany	87.4	China	30.0
France	83.5	Singapore	26.4
Italy	81.4	Netherlands	25.0
Brazil	81.0	Japan	22.5
Belgium	80.0	Malaysia	20.3
Switzerland	79.4	Canada	16.2
Mexico	78.0	Australia	15.0
Canada	77.3	Germany	15.0
Spain	76.4	Cayman Islands	13.7
Singapore	73.7	Taiwan Province of China	13.2
Poland	72.0	Virgin Islands, United Kingdom	12.5
Japan	70.3	Bermuda	11.2
Czech Republic	70.0	France	11.2
Australia	69.7	Brazil	10.4
Argentina	68.0	Belgium	10.0
China	66.0	Mexico	9.5
Hong Kong (China)	65.6	Poland	8.8
Austria	64.0	Czech Republic	7.5
Portugal	64.0	Italy	7.5
Denmark	61.0	Spain	7.5
Finland	55.1	Korea, Republic of	6.7
Hungary	55.0	Austria	6.2
Sweden	54.5	Colombia	6.2
Luxembourg	54.0	Denmark	6.2
Russian Federation	54.0	Panama	6.2
Malaysia	53.5	Sweden	6.2
Norway	53.5	Switzerland	6.2
Venezuela	52.0	United Arab Emirates	6.2
Turkey	50.0	Argentina	5.0
Korea, Rep. of	49.5	Chile	5.0
New Zealand	49.0	Hungary	5.0
Taiwan Province of China	49.0	Nicaragua	5.0

Source: UNCTAD.

In 2005, this trend continued with the acquisition by Unicredito (Italy) of the German Bayerishe Hypo Bank and the Bank of Austria Creditanstadt for a total of $21.6 billion. Other deals also involved developing countries, with the acquisition of the Absa Group (South Africa) by Barclays (United Kingdom) and Korea First Bank by Standard Chartered (United Kingdom).

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 (annex table A.I.14). The Internationalization Index (II) shows that, on average, 56% of the affiliates of the top 50 financial TNCs are located abroad. The index is significantly higher for the top five financial groups by total assets (65%) and for firms from Switzerland (88%) due to the small size of their home-country markets. In addition, the top 50 financial TNCs have affiliates in 25 countries, on average, whereas the five largest have affiliates in 44 countries, on average.

Table I.19. Preferred locations of TNCs from Mexico and Malaysia, 2005
(Per cent)

Host region/country	Mexico[a] Location intensity	Malaysia[b] Location intensity
United States/Canada	12	12
Europe	9	23
Japan/Australia/New Zealand	-	12
Africa	2	4
Central America and the Caribbean	40	4
South America	37	-
South, East and South-East Asia	-	45
West Asia	-	-
South-East Europe and CIS	-	-

Source: UNCTAD.
[a] Based on 6 TNCs with 42 affiliates.
[b] Based on 5 TNCs with 26 affiliates.

D. Prospects

Prospects for FDI point to a new growth in 2006. The main macroeconomic factor likely to have a favourable influence on such growth in the developing world (although regional performance may vary greatly), while the microeconomic factors include increased corporate profits, with a consequent increase in stock prices that would boost the value of cross-border M&As. Institutional factors including, in particular, the continuing liberalization of investment policies and trade regimes will also contribute.

Following strong growth in 2004, of 5.3%, world real GDP growth slowed down somewhat to 4.8% in 2005, and is projected to hold this high level in 2006 (4.9%) and 2007 (4.7%) (World Bank 2006). Growth in developing countries and economies in transition is projected to slow down moderately, from an estimated 7.2% in 2005 to 6.6% by 2007 (IMF 2006). In part, this reflects fast economic growth in China and India, where output will continue to expand at a rapid rate, though somewhat slower than in 2005. At the same time, high oil prices, rising interest rates, and building inflationary pressures are expected to restrain growth in most developing regions.

A low inflationary environment is one of the factors that have helped maintain low interest rates and loosen monetary controls in developed economies. The future path of long-term interest rates depends on success in maintaining price stability, but the monetary authorities in major economies have already begun to make measured increases in interest rates.

Trends in cross-border M&As point to strategies for increased investments by TNCs. M&As rose by 39% in value in the first half of 2006 over the same period of 2005. But the current cross-border M&A boom is partly caused by the activities of private equity and hedge funds. If FDI growth relies on such investments, rather than FDI by TNCs expanding their international production for firm-specific economic reasons, it is not certain how long this kind of growth will last.

Prospects for a new growth in FDI flows worldwide in 2006 are confirmed by a number of surveys by international organizations or research institutes (IMF 2006, World bank 2006, IIF 2006). But prospects are less certain for 2007 (IMF 2006).[35] Corporate survey findings are also optimistic as regards short-term FDI prospects. The *McKinsey Global Survey of Business Executives Confidence Index* (McKinsey 2006) has risen for the first time in two years and the *CEO Briefing* by the Economist Intelligence Unit finds that almost nine out of every ten respondents regarded the global prospects for business as either good or very good. Rising demand in emerging markets will have the greatest impact on the global marketplace over the coming three years according to the same source. A.T. Kearney's *FDI Confidence Index* (A.T. Kearney 2006) survey based on findings at the end of 2005 is cautious about prospects for FDI due to investors' concerns about corporate financial health and an unexpected economic downturn, though regional prospects are somewhat different.

Looking at prospects *by region*, the above-mentioned surveys confirm the importance of the Asian economies, in particular West Asia, as FDI locations (IMF 2006, IIF 2006). The *FDI Confidence Index* shows unprecedented levels of investor confidence in emerging markets, led by China and India. The April 2006 survey by the Japan External Trade Organization (JETRO) of Japanese affiliates operating in Asia confirms that business sentiment in the region has improved for 2006.[36] Choosing among emerging markets, CEO respondents to the *9th Annual Global CEO Survey* carried out by PricewaterhouseCoopers are investing the most in China, followed by India, Brazil and the Russian Federation, in that order. Other fast growing economies (Indonesia, Mexico and Turkey) are also at the top of the list of the most preferred locations. FDI prospects for Eastern European are also bright, but for Africa, and Latin America as a whole they are less favourable (IMF 2006, IIF 2006). Finally, according to A.T. Kearney's *FDI Confidence Index*, investors have lost confidence in Western Europe, other than the United Kingdom, due to increasing competition from emerging markets and protectionism.

Looking at prospects *by sector*, FDI in natural resources is expected to pick up further. High demand for such resources, partly caused by China's growing economy, and the opening up of new potentially profitable opportunities in the primary sector (e.g. gas and oil in Algeria) will attract more FDI into that sector. Interestingly, health care is also mentioned as the industry with the highest growth prospects in the coming years, according to *CEO briefing* (EIU 2006a). The pace of offshoring – including for R&D – will intensify, particularly in Asia and Eastern Europe, which are already experiencing the largest increase in such activities, according to the *FDI Confidence Index*.

On the policy side, liberalization is continuing, but overregulation and trade barriers are still viewed by CEOs as the most significant deterrant and the greatest challenge to the globalization of activities (PricewaterhouseCoopers 2006). While in 2005 operational risks, such as government regulations, and political and social instability, appeared to be less threatening (A.T. Kearney 2006), there are some worries about nationalism and protectionism in the years to come.

Increasing FDI from developing countries is not only driven by corporate factors, but also, and perhaps more importantly in some cases, by government policies aimed at ensuring access to strategic resources such as mineral resources. In view of the rising demand for these resources generated by growing economies such as India and China, this trend is likely to continue. At the same time, in some regions, growth-constraining structural weaknesses and financial and corporate vulnerabilities continue to hinder a strong FDI recovery. Continuing global external imbalances and sharp exchange rate fluctuations, high and volatile commodity prices as well as political tensions and even open conflicts in some part of the world pose risks that may also discourage global FDI flows.

Notes

1 However, this gap is lower than in many previous years. For instance, in 2000, flows to developed countries exceeded those to developing countries by $867 billion.

2 Based on the number of projects from the Locomonitor database. This database includes new FDI projects and expansions of existing projects both announced and realized (www.locomonitor.com). Because of non-availability of data on the value of most projects, only trends in the number of cases can be examined. Data from this database are available only from 2002 onwards.

3 For example, United States data for 2005 record outflows to the Netherlands as -$28 billion, the largest negative investment from the United States, while Netherlands data show that inflows from the United States totalled $4 billion in 2005. (Data from United States Department of Commerce for United States FDI outflows and De Nederlandsche Bank for Dutch FDI inflows.)

4 The term “developing and transition economies” refers to all developing economies and countries in South-East Europe and the CIS.

5 Based on GDP at purchasing-power parity. “Coming back”, *The Economist*, pp. 65–66, 21 January 2006. At market price, it is 25%.

6 Data on cross-border M&As are available only from 1987. In general, primary production in the 1980s and 1990s was low. Part of the 2005 growth was caused by a special deal – the acquisition of Shell Transport and Trading Co. (United Kingdom) by Royal Dutch Petroleum (Netherlands) for $74 billion. However, this deal is a financial rearrangement and has nothing to do with FDI that increases production capacity (for details, see chapter II). For cross-border M&A purchases, the share of the primary sector in 2005 was 15%, the third highest since 1987.

7 According to Locomonitor database (www.locomonitor.com), the number of greenfield investments rose from 403 in 2004 to 554 in 2005 in metals, from 177 to 204 in telecommunications and from 222 to 234 in real estate.

8 In 2004, world real GDP grew by 5.3%, a record growth rate. Worldwide economic growth moderated in 2005, but – at 4.8% – it remained well above the trend line (IMF 2006, p. 2).

9 The Direct Investment Technical Expert Group (DITEG) was established by the IMF and OECD in 2004 to make recommendations on the methodology for measuring FDI for a harmonized revision of these documents. It comprised expert representatives from 13 countries and 5 international organizations (including UNCTAD). DITEG has submitted its recommendations for consideration by the IMF Committee on Balance of Payments Statistics and the OECD Workshop on International Investment Statistics.

10 UNCTAD is also a member of this group, which includes FDI experts from OECD countries (Australia, Belgium, Canada, France, Ireland, Japan, the Netherlands, Spain, Sweden and the United States) and international organizations (OECD, IMF, Eurostat and European Central Bank (ECB)).

11 The new guidelines as spelt out in the IMF’s *Balance of Payments Manual* and the OECD’s *Benchmark Definition of FDI* on compilation of direct investment flows and positions are expected to be released in 2008. A number of them will remain unchanged or will be aligned even more closely with national accounting standards. These include: a 10% ownership threshold for establishing a direct investment relationship; use of market valuation for the measurement of direct investment stocks; resident status of SPEs in the economies in which they are registered or incorporated; recognition of a fully consolidated system for indirect FDI relationship; retention of reinvested earnings as a transaction; inter-company transactions/positions with fellow subsidiaries; and principles for industry classification. However, there will be some changes (e.g. on the application of the asset/liability principle and on the principle of permanent debt) and some new supplementary details (e.g. on M&As, greenfield investments, SPEs, extension of capital and round-tripping) that will be distinguished from standard components, and considered by countries as options when a particular issue is of interest to policymakers. Additional recommendations on specific issues are likely to be proposed in the *Benchmark Definition* to assist in the analysis of FDI.

12 This kind of transaction needs to be reflected in FDI figures in the balance of payments. But the exchange of shares in the balance of payments should balance with offsetting capital flows in other components of the capital account (portfolio investment) or FDI component, depending on how the previous shareholders of the acquired firm are treated (i.e. whether as portfolio investors or direct investors in the newly merged firm).

13 This exercise is not done routinely by the data gathering agencies because they are not necessarily interested in the issue of augmenting production capacity; nor is it done regularly by UNCTAD because M&A data are used only selectively to supplement FDI flow and stock data and data on operations.

14 Data from *Private Equity Intelligence*, 2006. There are also some different estimates. For example, Dealogic estimates $362 billion in cross-border takeovers (“Investment rivals bicker over common turf”, *Financial Times*, 30 January 2006).

[15] This figure is based on the assumption that all of these funds used in cross-border M&As are regarded (and are recorded) in FDI statistics as FDI flows.

[16] The value of FDI inflows due to cross-border investments of private equity and hedge funds, which is recorded in the balance-of-payments statistics, can deviate significantly from the publicly announced values of buyouts or venture-capital-financed investments. Private equity firms often finance investments by using large amounts of loan capital in addition to fund capital. If the loans are raised by a foreign affiliate that is already located in the economy of the targeted company, there are no cross-border financial flows between the private equity firm and the target company that could be recorded in the balance of payments.

[17] For the purpose of estimating M&As through these funds, firms in the following industries are considered as using private equity funds and hedge funds: "investors not elsewhere classified" under investment and commodity firms, dealers and exchanges (i.e. financial service industries excluding credit institutions, savings and loans, mutual savings banks, commercial banks, bank holding companies, investment and commodity firms, dealers and exchanges except investors not elsewhere classified – such as securities companies, commodity brokers, dealers and exchanges, investment offices, real estate investment trusts and management investment offices – and insurance firms). This classification is based on the one used by the Thomson Finance database on M&As.

[18] For example, Amadeus (Spain) was acquired for a publicly announced value of i4.3 billion ($5.4 billion) by BC Partners (United Kingdom) and Cinven (United Kingdom). ISS A/S (Denmark) was bought for i3.8 billion ($4.8 billion) by EQT (Sweden) and Goldman-Sachs (United States). (Since these deals were not completed by 2005, they are not included in table I.7.) At the turn of 2005-2006 the Danish telecommunications company, TDC, was bought by four private equity investors for i13.0 billion ($16.3 billion), making it the largest buyout in Europe. During 2004–2005, the increase in inward FDI in Japan was largely due to M&As worth more than $3.1 billion involving private equity firms.

[19] "Europe's new deal junkies", *The Economist*, 18 February 2006, pp. 12-13.

[20] 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. For the detailed methodology, see *WIR02*.

[21] 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 number of telephone lines per 1,000 inhabitants, and mobile phones per 1,000 inhabitants), commercial energy use per capita, share of R&D expenditures in gross national income, 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 of 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.

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

[23] The revised methodology notably leaves out a number of secondary legal fields (such as intellectual property laws) that were previously covered.

[24] The average European statutory corporate income tax rate fell somewhat from 25.32% to 25.04% (KPMG 2006). As a comparison, the average statutory corporate income tax rates in the Asia and Oceania and Latin American regions were 29.99% and 28.25% respectively.

[25] The minimum investment needed to be eligible to receive the tax breaks would be $7.5 million in some industries and $2.5 million in others. Examples of other industries were agriculture industries, oil refineries, hydroelectric generation, electronics manufacturing, air traffic control, sea ports, tourism and environmental projects.

[26] Firms investing in such zones are entitled to a 15-year income tax break consisting of a 100% exemption for the first five years, a 50% exemption for the second five years, and an exemption on a proportion of export profits for the final five years.

[27] Egypt, for example, eased the acquisition of land by foreign investors as well as their entry and residence in Egypt, and allowed the expansion of new investments in the tourism sector.

[28] Israel, for example, expanded tax benefits to both local and foreign investors and simplified the approval process for qualified investments.

[29] See BBC News, EU warns over state protectionism, 9 March 2006, The *Wall Street Journal* online, Common Market? Think Again!, 13 March 2006.

[30] This section covers BITs and DTTs as well as other IIAs that encompass bilateral, regional or interregional agreements containing provisions for the promotion, liberalization and/or protection of investment. There are various kinds of the latter agreements, such as free trade agreements (FTAs), closer economic partnership agreements (EPAs), regional economic integration agreements or framework agreements on economic cooperation. For a detailed analysis, see UNCTAD 2006.

[31] See, as a recent example, the Trans-Pacific Strategic Economic Partnership Agreement between Brunei Darussalam, Chile, Singapore and New Zealand (2005) - Article 11.22; the Closer Economic Partnership Agreement between Thailand and New Zealand (2005) - Article 15.2; and the Agreement between Japan and the United Mexican States for the Strengthening of Economic Partnership (2004) - Articles 65 and 74.

[32] For example, arbitration tribunals have arrived at conflicting conclusions with regard to: (i) the scope of investor-State dispute settlement procedures, (ii) the legal implications of the so-called "umbrella clause", (iii) the observance of so-called cooling-off periods, and (iv) the scope of the most-favoured nation (MFN) clause. See UNCTAD 2005a; Schreuer 2006.

[33] See No. 4 of the Agreed Recommendations of the 10th session of the Commission on Investment, Technology and Related Financial Issues, 6-10 March 2006 (doc. TD/B/COM.2/71).

[34] Data on the number of affiliates are from Dun & Bradstreet, *Who Owns Whom Database*, which covers majority-owned affiliates only.

[35] A small decline in FDI flows is forecast by the IMF for 2007, from $221 billion to $218 billion.

[36] This is a monthly survey conducted by JETRO in 12 Asian countries, including five ASEAN countries, on Japanese business sentiments (www/jetro.go.jp).