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UNITED
NATIONS

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United Nations
Conference
on Trade and
Development

Distr.
GENERAL

TD/B/COM.2/21
1 October 1999

Original : English

TRADE AND DEVELOPMENT BOARD
Commission on Investment, Technology and
Related Financial Issues
Fourth session
Geneva, 4-8 October 1999
Item 3 of the provisional agenda

TRENDS IN FDI AND WAYS AND MEANS OF ENHANCING FDI FLOWS TO AND AMONG DEVELOPING COUNTRIES, IN PARTICULAR LDCs AND COUNTRIES RECEIVING RELATIVELY LOW FDI INFLOWS, WITH A VIEW TO INCREASING THE BENEFITS THEY ENTAIL, AND TAKING INTO ACCOUNT THE FACTORS WHICH PLAY A PART IN PRIVATE SECTOR FIRMS' CHOICES OF INVESTMENT LOCATIONS

Report by the UNCTAD secretariat

Executive summary

This report contains a brief overview of recent trends in foreign direct investment (FDI) flows, with particular emphasis on least developed countries (LDCs), an overview of the differences and complementarities between FDI and foreign portfolio investment (FPI) flows, and a brief analysis of the determinants of FDI. It reports that besides the slowdown in world economic growth and the financial crisis in many developing countries and in the Russian Federation, global FDI inflows increased by 39 per cent, over 1997, to $644 billion. This growth was fueled by a 70 per cent increase in flows to developed countries (amounting to $460 billion) that was based on a surge in mergers and acquisitions. This increase more than offset the decline of 4 per cent in flows to developing countries in 1998, with Asia and Latin America accounting for the majority of receipts (with $85 billion and $72 billion, respectively) and Africa receiving only some $8 billion. Total 1998 FDI inflows into LDCs as a group increased by 13.5 per cent, totaling $2.4 billion. Central and Eastern Europe received $18 billion.

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Executive summary (continued)

Over the period 1991-1998, FDI and FPI represented about 90 per cent (respectively, 51 per cent and 39 per cent) of total capital flows to developing countries and countries in transition, with countries in Latin America, the Middle East, Europe and economies in transition relying mostly on FPI as a source of capital flows, Asia on FDI and Africa on official flows. Other differences and complementarities between FDI and FPI relate to their determinants and their different developmental impacts, particularly those arising from the greater volatility of FPI flows.

Three factors can be identified to explain the differences in FDI performance among countries;they play a part in the choice of firms as regards foreign investment locations and determine where they invest abroad. They are: the policies of host countries (including the core regulatory framework for FDI), the proactive measures that countries adopt to promote and facilitate investment, and the characteristics of their economies. All three factors are undergoing changes brought about by the process of globalization.

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I. TRENDS IN FOREIGN INVESTMENT

A. Trends in flows of foreign direct investment and in least developed countries

1. Against the background of a slowdown in world economic growth to 2 per cent in 1998 (from 3.4 per cent in 1997) and the financial crisis that hit many developing countries and the Russian Federation in 1997-1998, foreign direct investment (FDI) inflows increased by 39 per cent, over 1997, to a record $644 billion (annex figure 1). This growth was fueled by a 70 per cent increase in flows to developed countries that was based on a surge in mergers and acquisitions. This increase more than offset the decline of 4 per cent in flows to developing countries. Cross-border mega deals (defined as involving transaction values of over $3 billion) were the defining characteristic of the past year, with their number doubling compared to the previous year (annex figure 2). Nearly 90 per cent of majority-owned cross-border mergers and acquisitions (M&As) were concluded in developed countries, where this mode of entry is far more important than in developing countries.

2. Inflows of FDI into developed countries jumped to $ 460.4 million in 1998, an increase of 70 per cent over the previous year. The European Union strengthened its position as the largest investor as well as largest recipient of FDI flows; however, the prospect of launching the single currency in January 1999 seemed to have had only limited impact on FDI flows, according to available data. The United States remained the single largest host and home country for FDI, with inflows reaching $193 billion and outflows $133 billion. Inflows nearly doubled their 1997 level, due mainly to large-scale M&As. Inflows into Japan reached $3.2 billion and thus remained at almost the same level as in 1997. Compared to earlier years, however, M&As appear to be playing an increasingly important role. At the same time, FDI outflows from Japan declined in 1998 by 7 per cent (reaching $24 billion), influenced by depressed domestic demand and lower profitability in the wake of economic recession.

3. In contrast, total inflows into developing countries declined by 4 per cent to $166 billion, due largely to lower flows to South, East and South-East Asia (annex figure 1). FDI inflows into Asia as a whole managed to weather the storm: although inflows declined by 11 per cent over 1997, total inflows at $85 billion remained higher, in 1998, than immediately before the crisis. On the other hand, inflows into Latin America and the Caribbean reached a new record high, amounting to $72 billion. FDI inflows into Africa as a whole continued to grow at a relatively slow pace, with inflows of $8 billion in 1998; the performance of individual countries, however, was quite diverse. Total FDI inflows into LDCs as a group increased, in 1998, by 19 per cent over the previous year, totaling $2.9 billion. FDI inflows were on the rise in almost all countries of Central and Eastern Europe (at $18 billion in 1998), with the exception of the Russian Federation, where FDI was affected by that country's economic downturn and drying up of privatization-related inflows.

4. Total inflows into Africa in 1998 amounted to $8.3 billion -- a decrease compared to the record level achieved in 1997 ($9.4 billion) -- and $7.9 billion excluding South Africa (up from $7.7 billion in 1997)[1]. At the same time, the growth of inflows into Africa as a group continues to lag

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[1] Due to a change in methodologies, figures for FDI inflows into Africa for recent years are much higher than those reported in the earlier reports to the Commission and

behind the dynamics of inflows into other developing regions, with the continent accounting for only 5 per cent of total FDI inflows to developing countries. However, FDI inflows into Africa as a whole remain considerably higher than the average flows recorded in the first part of the 1990s. In addition, the performance of individual countries is quite diverse: international investors are beginning to realize profitable business opportunities which many countries of the continent offer. The largest recipients of FDI inflows in Africa in 1998 are -- as in previous years -- Nigeria with FDI inflows of $1.5 billion and Egypt with $1.1 billion. Both countries accounted for more than 25 per cent of total FDI inflows into Africa (including South Africa). Among the 20 most important recipients of FDI inflows in 1998 were also a number of least developed countries, including Angola, Equatorial Guinea, Ethiopia, Liberia, Madagascar, Mozambique, Uganda and Zambia, proving that this group also can become an attractive destination for FDI. Even more interesting, some of the LDCs, such as Ethiopia, Mozambique and Uganda, received a major part of their FDI inflows in manufacturing and service industries. Overall, the share of the 33 African LDCs in total FDI inflows into Africa grew from around 21 per cent in 1997 to 27 per cent in 1998.

5. Although the Asian region as a whole experienced a contraction and a downturn in overall private capital inflows, FDI managed to weather the financial crisis: while FDI flows into the region experienced a decline of 11 per cent (the first since the mid-1980s, due mainly to sharply decreasing inflows into Indonesia (box 1) and Taiwan Province of China), total inflows of $85 billion in 1998 remained higher than immediately before the crisis, and much higher than average annual inflows during the decade. While inflows into China remained at a level similar to that of 1997, the country's share in developing Asia's total FDI rose to 58 per cent in 1998. The decline in inflows from within the region (over 9 per cent) was compensated by an increase in FDI from the United States (by 21 per cent) and from Europe (by 3 per cent). Transnational corporations (TNCs) continued to be very active in the region, driven mainly by further FDI liberalization and the availability of cheap assets in some countries. Some TNCs are restructuring their production networks in Asia to respond to changes in supply-and-demand patterns. The shortage of capital, combined with the recognition of the role FDI can play in restoring growth and development, is leading to an even more accommodating attitude towards FDI in almost all economies in the region, including further opening of certain industries to FDI and relaxing of rules with respect to ownership, mode of entry and financing. Although the decline of FDI approvals in 1998 and the first quarter of 1999 in a number of countries indicates a trend towards declining FDI flows in 1999 -- particularly depending on whether the level of inflows into China can be maintained -- it is expected that FDI inflows into the region will remain above the average of the decade. In the longer run, FDI growth is expected to resume again, based on the fundamental determinants of FDI decisions. Cross-border majority M&As in Asia, in 1998, increased by 28 per cent in value over 1997 to $12.5 billion, although if set into relation to FDI flows into Asia, the share remained relatively low (16 per cent, compared to 46 per cent in Latin America). Before the crisis, however, this figure was significantly lower (annex figure 3).

6. Although 1998 was marked a year of turbulence for emerging markets, FDI inflows to Latin America and the Caribbean reached $71.7 billion, up by 5 per cent from the previous year. South American countries accounted for about 70 per cent of total inflows (annex figure 4). Inflows of FDI into Brazil amounted to $28.7 billion in 1998, representing a substantial increase of 53 per cent

in previous *World Investment Reports*.

over the previous year. This can be attributed to M&As, involving new foreign investors and established TNCs, as well as to privatizations, such as that of Telebras, which was sold partly to foreign investors. The United States' position as the largest single investor country, with outward flows of about $17 billion in 1998, started to be challenged by increasing inflows from the European Union since 1995. At the same time, inflows from Japan reached $5.6 billion, compared to $2.3 billion in the previous year. A comparison of foreign companies operating in the region reveals that in 1997, among the largest 100 TNCs (ranked by sales), the majority originated from the United States (44), closely followed by the European Union (37), as well as Switzerland (5) and Japan (3). Among EU investors, Spain accounted for about one third of total investment in the region in 1997; in particular, Spanish TNCs have acquired controlling stakes in important companies in the electricity industry in Chile, as well as in the oil and gas industry in Argentina.

7. Inflows of FDI into Central and Eastern Europe declined slightly in 1998 to $18.7 billion, down from $19.4 billion in 1997 (annex figure 5). While most countries experienced an increase in FDI flows, inflows into the Russian Federation declined drastically in 1998, reaching only $2 billion (or one third of the 1997 level), following the country´s general economic downturn, and due partly to a declining share of privatization-related inflows which, in 1997, accounted for more than one third of total inflows while there were practically none in 1998. In addition, only a small portion of inward FDI was efficiency seeking, as foreign investors were attracted mainly by the Russian Federation's natural resources and domestic market size, thus limiting the country´s capacity to transform its inward FDI into engines of export-led growth. European Union countries were the predominant source for inflows into Central and Eastern Europe other than the Russian Federation, followed by investors from the United States, while investment from the Russian Federation was minuscule. While FDI inflows into all countries of the region, in 1998, reached 95 per cent of their level in 1997, their performance was strikingly resilient compared with the drop in other capital inflows, except for the Russian Federation: FDI inflows into other countries of the region increased by 25 per cent, compared to 1997, at a time when portfolio and other investment inflows experienced a 40 per cent decline; in contrast, the Russian Federation experienced a similar decline in FDI inflows as in other capital inflows (65 per cent and 75 per cent, respectively).

8. While total FDI inflows into LDCs as a group, in 1998, increased by 19 per cent over the previous year, totaling $2.9 billion, the share of LDCs in inflows into developing countries remained low, at 1.7 per cent. Although this represents a slight increase over the previous year, FDI continues to be hampered by some characteristics shared by most of the LDCs, such as adverse climatic conditions, small domestic markets, export vulnerability, limited transport and communications infrastructure, insufficient domestic investment and lack of a skilled labour force, as well as lack of information on profitable business opportunities (box 2). African countries accounted for the largest share of FDI inflows into LDCs in 1998 (75 per cent). While inflows do not follow a steady pattern and fluctuate over the years, a number of countries have experienced steadily increasing inflows and are expected to attract further FDI in the near future, thus reflecting achievements in introducing a more favourable investment environment. Typically, Western European investors have been more active in the region, compared to the United States and Japan; intraregional FDI, originating especially from South Africa, plays an increasingly important role. While the share of inflows into Asian LDCs in total LDCs inflows is growing, both in absolute and in relative terms, the share of LDCs in total FDI in Asia declined from 0.6 per cent in 1996 to 0.4 per cent in 1998, affected negatively by their heavy dependence on intraregional FDI and the effect of currency depreciations in the most affected countries. Foreign investors have shown increasing

interest in the services sector and manufacturing in recent years, although the primary sector continues to be of importance for many countries, especially for resource-seeking investment. Manufacturing industries are of growing importance in light of LDCs locational advantage in low-cost labour-intensive activities. The progress of LDCs with privatization programmes allowed foreign investors to establish operations in formerly closed industries; in addition, the opening of telecommunications to allow competition in many countries has attracted foreign investment. While the primary sector continues to be of relevance, the most important industries for investment in the near future in manufacturing are textiles and food and beverages. Tourism will continue to be attractive to foreign investors, while telecommunications, as well as financial services and insurance, are expected to attract increasing FDI in the near future, according to the results of a survey among African investment promotion agencies.

B. Interlinkages between foreign direct investment and foreign portfolio investment

9. Balance of payments data on capital flows collected by the International Monetary Fund (IMF) show that over the period 1991-1998, FDI and FPI represented about 90 per cent (respectively 51 per cent and 39 per cent) of total capital flows into developing countries and countries in transition.[2] It is also interesting to note that, on a regional basis, countries in Latin America, in the Middle East and Europe and countries with economies in transition relied mostly on FPI as a source of capital flows, Asia on FDI and Africa on official flows. In Asia, for the five more advanced countries of East Asia (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand), FPI was the most important source of capital, in contrast to the rest of Asia.

10. There seems to be a pattern whereby FPI becomes an important source of capital for higher-income countries. This observation is broadly confirmed by a country breakdown. Detailed information on capital flows over the period 1993-1997 for 29 countries (for which a consistent set of data is available) indicates that the 10 countries[3] which attracted more FPI than FDI are in the higher-income bracket (with per capita GDP exceeding $2,500), with the exception of India and the Philippines. For eight of them, the volume of external finance raised through bonds was higher than that raised through equities. In addition, there is a high concentration of investment flows in general. Over the period 1993-1997, the 16 largest recipients of FPI had an amount of portfolio flows that is higher than the total of portfolio investment in all developing and transition countries. Furthermore, 12 countries are at the same time the biggest recipients of FDI and of FPI.[4]

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[2] This section is drawn from UNCTAD, "Comprehensive study of the interrelationship between foreign direct investment (FDI) and foreign portfolio investment (FPI)", UNCTAD/GDS/DFSB/5, 23 June 1999.

[3] These countries are Argentina, Brazil, India, Mexico, the Philippines, the Republic of Korea, the Russian Federation, South Africa, Thailand, and Uruguay. For Mexico, FDI and FPI are of equal importance.

[4] These twelve countries are Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Indonesia, Mexico, Poland, and Thailand.

11. FPI tends to be more volatile than FDI. This is confirmed by a comparison of the coefficient of variation, which is a measure of the variability, of FDI and FPI. Annex table 1 shows the coefficients of variation of capital flows and their components (FDI, FPI and other investment, which is mainly bank loans) over the period 1990-1998. For the 29 countries reported, the values of the coefficients of variation are the highest for the category “other investment” in 16 countries, they are the highest for FPI in nine countries, and for FDI in only four countries.[5] Comparing the coefficients of variation of portfolio equity securities and portfolio debt securities, it turns out that debt securities are more volatile than equity securities, in 19 out of 29 cases.

12. The salient characteristics concerning FDI and FPI, reflecting both their complementarities as well as their differences, can be identified as follows:

* Complementarities: FDI and FPI address different financing needs: FDI is owned by TNCs, while FPI is used more by domestic companies/entities. FDI is firm and sector specific, while FPI is more fungible.

* Unlike FDI, portfolio investors do not have managerial responsibilities in their investment and very often do not have a physical presence in host countries.

* Other developmental impacts: FDI can facilitate the transfer of technology and market access, while FPI can help to strengthen the process of domestic capital market development. FPI has a greater macroeconomic impact (through changes in asset prices and liquidity in the financial sector), while FDI can have a significant impact at the microeconomic level, shaping the productive structure of a host country.

* The decision by TNCs to undertake FDI in one particular country is influenced mainly by that country’s determinants, while FPI can be affected by factors external to host countries, such as financial policies in capital-exporting countries, the state of liquidity on international capital markets, and changes in the pattern of diversification of international portfolio.

* Volatility: FPI is more volatile than FDI, although hedging behaviour by TNC subsidiaries can also exacerbate balance-of-payments crisis. Foreign direct investors hedge their exchange risks by matching their assets with liabilities in different currencies through bank loans and portfolio investment. Thus, although the physical assets remain in the country, TNCs can move out their financial investment.

* Accessibility: only a handful of (the same) countries are hosts to large amounts of FDI and FPI.

II. FOREIGN DIRECT INVESTMENT DETERMINANTS AND DEVELOPMENT

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[5] Among the four countries of the last group, Kuwait and Saudi Arabia are oil-exporting countries, and during the period under consideration, went through a major political crisis (the Gulf War).

13. To explain the differences in FDI performance among countries, described in the preceding section, it is necessary to understand the factors that play a part in the choice of firms as regards investment locations abroad. Three broad factors determine where TNCs invest abroad: the policies of host countries (including the core regulatory framework for FDI), the proactive measures countries adopt to promote and facilitate investment, and the characteristics of their economies (annex table 2).

A. Policy framework for foreign direct investment

14. The core enabling framework for FDI consists of rules and regulations governing entry and operations of foreign investors, standards of treatment of foreign affiliates and the functioning of markets. Complementing core FDI policies are other policies that affect foreign investors' locational decisions directly or indirectly, by influencing the effectiveness of FDI policies. These include trade policy and privatization policy. Policies designed to influence the location of FDI constitute the "inner ring" of the policy framework. Policies that affect FDI but have not been designed for that purpose constitute the "outer ring" of the policy framework. The contents of both rings differ from country to country, as well as over time.

15. Core FDI policies are important because FDI will simply not take place where it is forbidden. However, changes in FDI policies in the direction of greater openness may allow firms to establish themselves in a particular location, but they do not guarantee this. Since the mid-1980s, an overwhelming majority of countries have introduced measures to liberalize FDI frameworks. This has provided TNCs with an ever-increasing choice of locations and has made them more selective and demanding as regards other locational determinants. One outcome is a relative loss in effectiveness of FDI policies in the competition for investment: adequate core FDI policies are now simply taken for granted.

16. Another outcome is that countries are increasingly paying more attention to the inner and outer rings of the policy framework for FDI. The key issue for inner-ring policies is policy coherence, especially the joint coherence of FDI and trade policies. This is particularly important for efficiency-seeking FDI as firms integrate their foreign affiliates into international corporate networks. At the same time, the boundary line between inner- and outer-ring policies becomes more difficult to draw as the requirements of international production make higher demands on the efficacy of the policy and organizational framework within which FDI policies are implemented. Thus, macroeconomic policies (which include monetary, fiscal and exchange-rate policies) as well as a variety of macro-organizational policies become increasingly relevant. As the core FDI policies become similar across countries as part of the global trend towards investment liberalization, the outer ring of policies gains more influence. Foreign investors assess a country's investment climate not only in terms of FDI policies per se but also in terms of macroeconomic and macro-organizational policies. Among the policy measures that can have a direct effect on FDI is membership in regional integration frameworks, as these can change a key economic determinant: market size and perhaps market growth.

B. Business facilitation measures

17. It is in the context of a greater similarity of investment policies at all levels that business facilitation measures enter the picture. They include investment promotion, incentives,

after-investment services, improvements in amenities and measures that reduce the "hassle costs" of doing business. While these measures are not new, they have proliferated as a means of competing for FDI as FDI policies converge towards greater openness. Furthermore, business facilitation measures have become more sophisticated, increasingly targeting individual investors, even though this involves high human capital and other costs. Among these measures, after-investment services can be singled out because of the importance of reinvested earnings in overall investment flows and because satisfied investors are the best advertisement of a country's business climate. Financial or fiscal incentives are also used to attract investors even though they typically enter only location-decision processes when other principal determinants are in place.

C. Economic determinants

18. Once an enabling FDI policy framework is in place, economic factors assert themselves as locational determinants. They fall into three clusters, corresponding to the principal motives for investing abroad: resource (or asset) seeking, market seeking and efficiency seeking.

19. Historically, the availability of natural resources has been the most important FDI determinant for countries lacking the capital, skills, know-how and infrastructure required for their extraction and sale to the rest of the world. The relative importance of this determinant has declined because the importance of the primary sector in world output has declined. In addition, large indigenous enterprises have emerged in developing countries with the capital and skills to extract and trade natural resources. Moreover, TNC participation in natural-resource extraction is taking place more through non-equity arrangements and less through FDI. Nevertheless, for a number of countries the value of FDI in natural resources remains high.

20. National market size, in absolute terms or relative to the size and income of the population, has been another important traditional determinant, leading to market-seeking investment. Large markets can accommodate more firms and allow each of them to reap the benefits of scale and scope economies, one of the principal reasons that regional integration frameworks can lead to more FDI. High market-growth rates stimulate investment by foreign as well as domestic investors. Much of the inward FDI of the 1960s and 1970s was drawn by large national markets for manufacturing products, which were sheltered from international competition by tariff barriers and quotas. Large national markets were also important for those services whose non-tradability made FDI the only mode of delivery to consumers. Such investment, however, was initially small because FDI frameworks for services were typically restrictive, excluding foreign investors in many fields such as banking, insurance and most infrastructural services. Largely immobile low-cost labour was another traditional economic determinant of FDI location, particularly important for efficiency-seeking investment.

D. Impact of globalization

21. The forces driving globalization are also changing the ways in which TNCs pursue their objectives for investing abroad. Technology and innovation have become critical to competitiveness. Openness to trade, FDI and technology flows, combined with deregulation and privatization, have improved firms' access to markets for goods and services and to immobile factors of production and have increased competitive pressures in previously protected home

markets, forcing firms to seek new markets and resources overseas. At the same time, technological advances have enhanced the ability of firms to coordinate their expanded international production networks in their quest for increased competitiveness. More and more firms are therefore developing a portfolio of locational assets to complement their own competitive strengths when they engage in FDI, as witnessed by the growing number of firms that are becoming transnational.

22. All these factors are changing the relative importance of different economic determinants of FDI location. The traditional determinants have not disappeared; rather, they are becoming relatively less important in FDI location decisions. The traditional motives for FDI have not disappeared either; they are being incorporated into different strategies pursued by firms in their transnationalization process. These have evolved from the traditional stand-alone strategies, based on largely autonomous foreign affiliates, to simple integration strategies, characterized by strong links between foreign affiliates and parent firms, especially for labour-intensive activities, as well as links between TNCs and unrelated firms via non-equity arrangements. Under simple integration strategies, unskilled labour becomes the principal locational determinant. Complementing it are other determinants, such as the reliability of the labour supply and adequate physical infrastructure for the export of final products. Costs feature prominently, but host country markets do not: it is access to international markets, privileged or otherwise, that matters.

23. Although this type of FDI is not new, it began to prosper under the conditions of globalization. Much of the investment in export-processing zones and labour-intensive industries has been in response to simple integration strategies, driven by cost-price competition and, more importantly, the removal of trade (and FDI) barriers in an increasing number of countries and technological advances that permit quick changes in product specifications in response to changes in demand. However, as labour costs declined in relation to total production costs and as FDI became more mobile in response to simple integration strategies, countries had to offer additional locational advantages over and above the availability of low-cost unskilled labour to attract FDI. Productivity and some level of skill, as well as good infrastructure facilities, gained in importance as locational determinants for this type of investment. Access to international markets also became more important. Losing such access could mean losing this type of investment. This contributed to the efforts of many developing countries seeking to gain permanent access to the markets of developed countries through trade agreements or regional integration arrangements. As services became more tradable, particularly in their labour-intensive intermediate production stages such as data entry, they too began to relocate abroad in response to simple integration strategies. The locational advantages sought by such service TNCs included computer literacy and a reliable telecommunication infrastructure. Again, this contributed to the upgrading of the locational advantages that countries could offer to TNCs pursuing simple integration strategies, in their efforts to attract the more sophisticated activities that TNCs were now locating abroad.

24. With more and more TNC intermediate products and functions becoming amenable to FDI, TNCs strategies are evolving from simple to complex integration. Complex integration strategies can involve, where profitable, splitting up the production process into specific activities or functions and carrying out each of them in the most suitable, cost-competitive location. More than ever in the past, complex integration strategies allow TNCs that pursue them to maximize the competitiveness of their corporate systems as a whole on international portfolio of location assets.

25. To attract such competitiveness-enhancing FDI, it is no longer sufficient for host countries to possess a single locational determinant. TNCs undertaking such FDI take for granted the presence of state-of-the-art FDI frameworks that provide them with the freedom to operate internationally, that are complemented by the relevant bilateral and international agreements and that are further enhanced by a range of business facilitation measures. When it comes to the economic determinants, firms that undertake competitiveness-enhancing FDI seek not only cost reduction and bigger market shares, but also access to technology and innovative capacity. These resources, as distinct from natural resources, are people made -- they are "created assets". Possessing such assets is critical for firms' competitiveness in a globalizing economy. Consequently, countries that develop such assets become more attractive to TNCs. It is precisely the rise in the importance of created assets that is the single most important shift among the economic determinants of FDI location in a liberalizing and globalizing world economy. In addition, the new configuration also includes agglomeration economies arising from the clustering of economic activity, infrastructure facilities, access to regional markets and, finally, competitive pricing of relevant resources and facilities.

26. One implication for host countries wishing to attract TNCs undertaking competitiveness-enhancing FDI is that created assets can be developed by host countries and influenced by governments. The challenge is precisely to develop a well-calibrated and preferably unique combination of determinants of FDI location, and to seek to match those determinants with the strategies pursued by competitiveness-enhancing TNCs. It must be remembered too that created assets also enhance the competitiveness of national firms. Thus, policies aimed at strengthening innovation systems and encouraging the diffusion of technology are central because they underpin the ability to create assets. Also important are other policies that encourage the strengthening of created assets and the development of clusters based on them, as well as policies that stimulate partnering and networking among domestic and foreign firms and allow national firms to upgrade themselves in the interest of national growth and development.

E. Developmental impact

27. Developing countries are interested in improving their FDI determinants to attract FDI because they want to benefit from FDI as much as possible, that is, maximize its positive contributions to development and minimize its negative effects. Both development and TNCs' activities have been affected by the increasing importance of knowledge-intensive production, rapid technological change, shrinking economic space and the much greater openness of countries. In distinction from the past, for example, today most developing countries consider FDI an important resource for development. There is a role for government policies to play in countries that want to benefit from this resource, but instruments of government policy have changed within the new context, which has emerged as a result of these changes, not to mention government policy objectives that have to be reformulated to meet new requirements. As regards TNCs, the new context has created for them new opportunities and pressures. They have expanded rapidly, their number has increased significantly and they have changed their strategies: all this not only has altered host-country FDI determinants, but has also changed the modalities through which TNCs impact host-country economies.

28. The traditional contribution, and impact, expected from TNCs was to supplement domestic savings with foreign savings, thus increasing the supply of finance for development. Today, as

access to financial markets and various types of financing has been liberalized in many developing countries, FDI inflows are compared with other types of flows as regards their developmental role. As countries' abilities to develop depend increasingly on how well they cope with the technological challenge and how they integrate with the world economy, contributions to technological development, skills and management techniques and export competitiveness of host developing countries have become much more important. At the same time, developing countries are committed to development that proceeds in a sustainable manner, conserving the environment and ensuring that resources are available to future generations. TNCs are well placed to make a contribution to development because they are key actors in these areas. Indeed, as FDI comprises a bundle of assets, its impact can go far beyond its individual components and can extend to the restructuring of entire industries or even enhancing the competitiveness of the entire economy. At the same time, FDI may have negative impacts on developing countries, crowding out domestic investors or shifting the balance of some benefits from FDI through transfer pricing.

29. Given the increasing interest of developing countries not only in attracting FDI but also in benefiting from it, the special topic of the *World Investment Report 1999* focuses on the extent to which FDI can make a contribution in each of the core areas of economic development and how this contribution can be enhanced. It makes also an overall assessment of the impact of FDI on economic development and discusses in an integrated manner policies to maximize the positive, and minimize the negative, aspects of this impact.

Box 1. Flows of foreign direct investment into the five most seriously crisis-affected countries in Asia

The five Asian countries most affected by the crisis (Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand) experienced an overall decline in foreign direct investment (FDI) of some $2 billion, or 12 per cent, in 1998. FDI inflows into these countries, at $15.4 billion, were above the average of flows for the period 1991-1995 ($10.8 billion), and only modestly below the peaks recorded in 1996 and 1997.

Individual national performances varied greatly: inflows into the Republic of Korea showed the highest increase last year, five-fold compared to its average performance during the first half of the decade, followed by Thailand with an almost four-fold jump to $7 billion over the same period, while Malaysia experienced a decline. Indonesia, in contrast, suffered from divestment for the first time since 1974, compared to average inflows of $2.3 billion during the first half of the decade and an average $5.5 billion in 1996-1997. The distinctiveness of the Philippines was manifested by its continuing strong export performance and its relatively sound financial sector.

Indications are that FDI has been flowing into a wide range of industries in the five countries. In Thailand, the only country for which systematic data by industry are available (until September), significant FDI flows to financial institutions (which were about 10 times higher in 1997 than in 1996, and continued at a similar level in 1998) reflected significant buy-outs by foreign firms. While this industry is now the single largest recipient, accounting for nearly one fifth of total FDI inflows, the machinery and transportation equipment industry also has seen increasing FDI inflows, both in absolute and in relative terms.

When compared with foreign bank lending and foreign portfolio equity investment before and during the financial crisis, FDI flows into the five countries as a group are remarkably resilient. Among the reasons for this resilience are the following: corporate networks of integrated international production that have already existed in Asia, allowing some TNCs to compensate for declining domestic sales through increased exports spurred by devaluations; TNCs taking advantage of cheaper asset prices; in some cases, parent firms increasing investment stakes in their existing affiliates; as well as some TNCs having increased capital investment in response to the relaxation of FDI regimes that has taken place after the financial crisis.

In 1999, FDI inflows into the five countries are likely to remain within the range of those during the 1990s ($10-17 billion), although the performance of individual countries may differ: the investment climate in Indonesia may require more time to recover; in contrast, the value of approved manufacturing projects in Malaysia registered a 14 per cent increase in 1998. However, measures to deal with the severity of the impact of the crisis continue to be necessary.

Box 2. The joint UNCTAD-ICC project on investment guides and capacity-building for the least developed countries

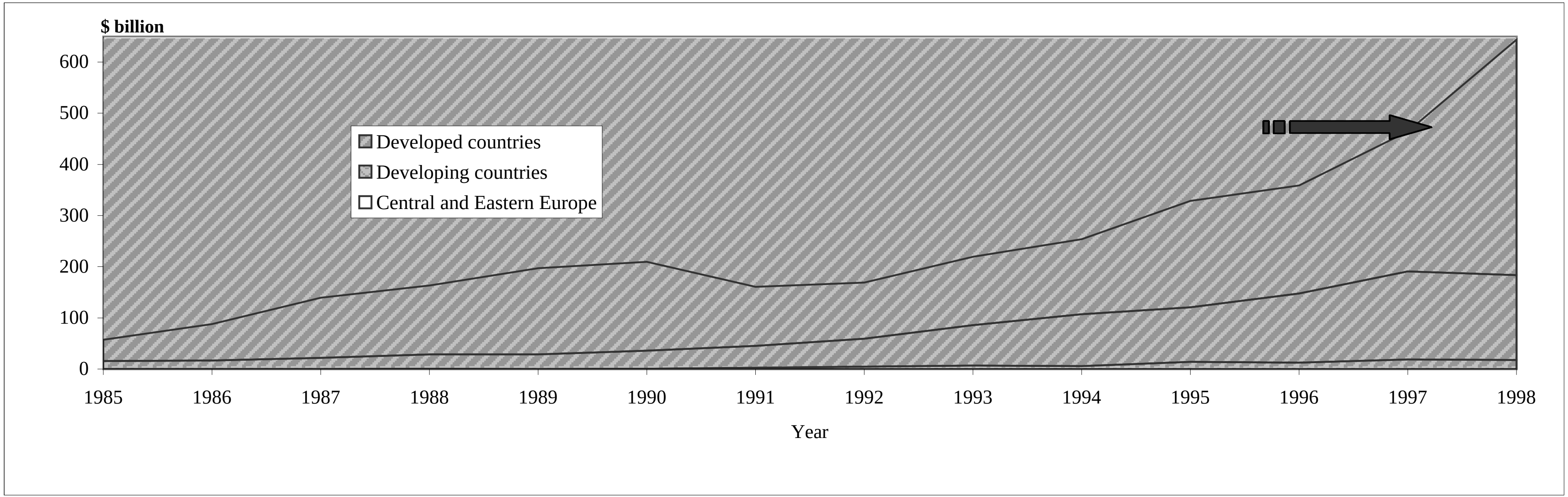
The joint UNCTAD-ICC project on investment guides and capacity-building for the least developed countries (LDCs) was launched at a meeting between the Secretary General of the United Nations, Mr. Kofi Annan, and the international business community, represented by the International Chamber of Commerce (ICC), in February 1998. The UNCTAD-ICC project is a response to the fact that LDCs are receiving less than 0.5 per cent of global foreign direct investment (FDI) flows, even though most LDCs have removed many obstacles for foreign investors and are now actively seeking FDI. The project attempts, first, to supply potential foreign investors with an objective and up-to-date overview of investment conditions in participating LDCs in the form of an investment guide. (Few proper investment guides -- as compared to promotional materials -- have been compiled for LDCs: as of June 1999, there were only three LDC investment guides (out of a total of 261) produced by the four top international accounting firms -- Arthur Anderson, Ernst & Young, KPMG and PricewaterhouseCoopers.) Secondly, the project incorporates capacity-building in LDCs in the area of investment promotion; and, thirdly, the project launches a long-term dialogue between LDC Governments and the business community.

The project was inaugurated in Ethiopia in January 1999. The workshop produced a revised and expanded draft of the guide for Ethiopia that was discussed and finalized at a second workshop in April 1999. This second workshop also offered an opportunity for discussions on the setting up of a Business Advisory Council to assist the Ethiopia Investment Authority in its efforts to create a more hospitable environment for FDI. These discussions led to the drafting of provisional terms of reference for the council and the announcement by the Ethiopian Investment Authority that it would be taking steps to set up the council.

Advanced copies of the investment guide for Ethiopia were presented at a UN-ICC meeting on 5 July 1999. The investment guide is intended to offer an overview of Ethiopia as an investment location and broadly describe the current investment climate, including the regulatory environment, where possible in a comparative framework. Work on other countries included in the pilot phase is scheduled to start this year. Work on the guide for Mali commenced in April 1999.

ANNEX

Figure 1. World inflows of foreign direct investment by groups of countries, 1985-1998



Source : UNCTAD, FDI/TNC database.

Figure 2. Cross-border merger-and-acquisition transactions with values over \$3 billion, 1996-1998

1996 — 8

. Carena Developments Ltd - Olympia and York Companies USA (5.6)
. Fresenius AG - National Medical Care Inc. (4.2)
. Aegon NV - Providian Corp. (3.5)
. The Thomson Corp. - West Publishing Co. (3.4)
. Hoechst AG - Roussel-Uclaf S.A. (3.4)
. Muenchener Rueckversicherungsgesellschaft - American Re Corp. (3.3)
. Sophus Berendsen A/S - BET PLC (3.2)
. Credit Local de France S.A. - Credit Communal de Belgique S.A. (3.1)

1997 — 15

. Zurich Versicherungs GmbH - BAT Industries PLC-Financial (18.4)
. Roche Holding AG - Corange Ltd. (10.2)
. Allianz AG Holding Berlin - AGF (10.0)
. ICI PLC - Quest International, 3 others (8.0)
. Assicurazioni Generali SpA - Aachener und Muenchener (6.2)
. Tyco International Ltd - ADT Ltd. (5.3)
. Merrill Lynch & Co. Inc. - Mercury Asset Management Group (5.3)
. Rhone-Poulenc SA(France) - Rhone-Poulenc Rorer Inc. (4.8)
. ING Groep NV - Banque Bruxelles Lambert SA (4.5)
. Nordbanken(Venantius/Sweden) - Merita Oy (4.3)
. Investor Group - Victoria Loy Yang A Power (3.8)
. Ameritech Corp. - TeleDanmark A/S (Denmark) (3.2)
. Lafarge SA - Redland PLC (3.0)
. EI du Pont de Nemours and Co. - Imperial Chem Ind-White Pigment (3.0)
. Metro AG (Metro International) - SHV Makro NV (Metro AG) (3.0)

1998 — 32

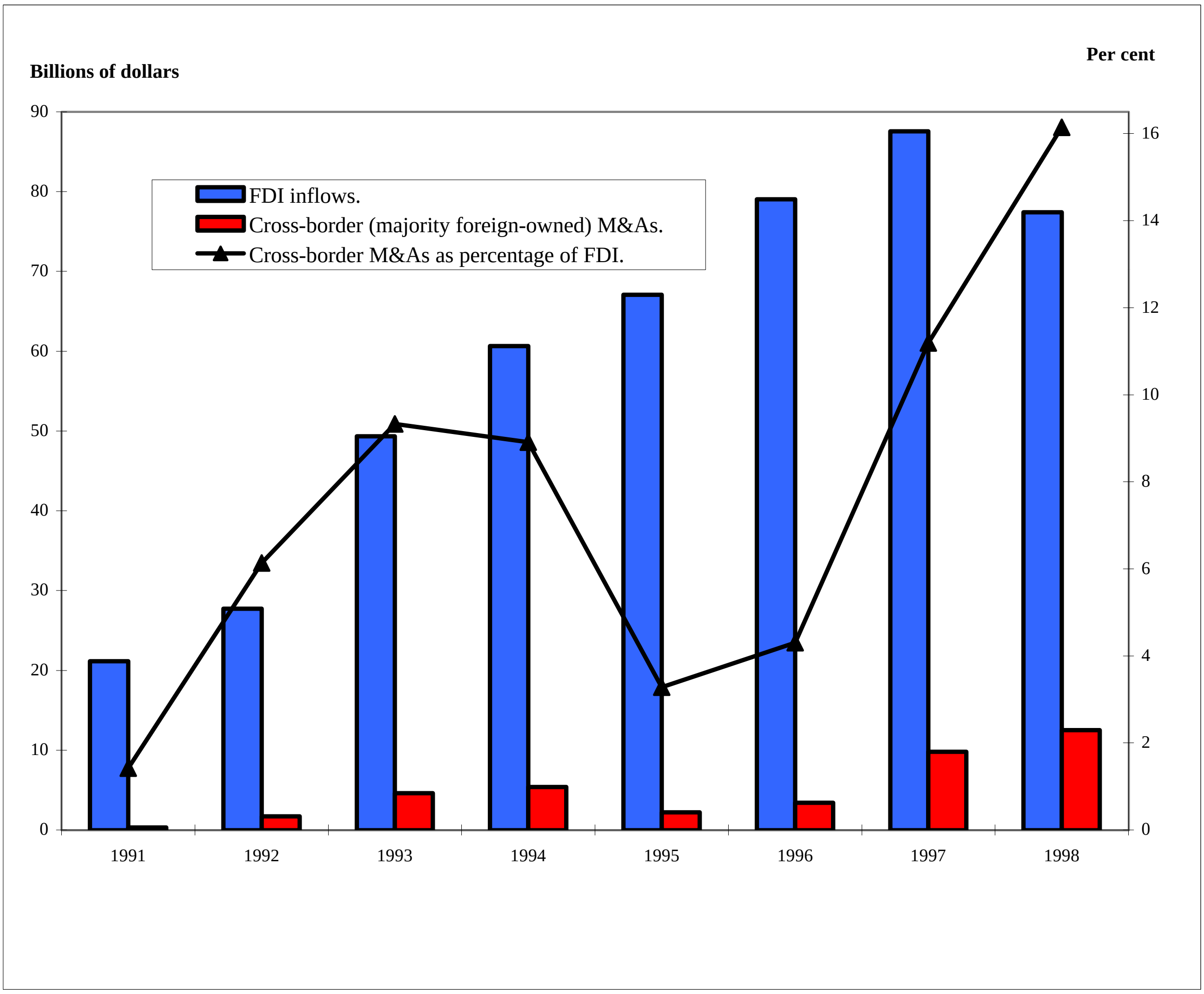
. British Petroleum Co PLC - Amoco Corp. (55.0)
. Daimler-Benz AG - Chrysler Corp. (40.5)
. ZENECA Group PLC - Astra AB (31.8)
. Hoechst AG-Life Sciences Divs - Rhone-Poulenc SA-Life Sciences (21.2)
. Scottish Power PLC - PacifiCorp (12.6)
. Total SA - Petrofina SA (11.5)
. Universal Studios Inc. - PolyGram NV (Philips Electronics) (10.3)
. Deutsche Bank AG - Bankers Trust New York Corp. (9.1)
. Northern Telecom Ltd(BCE Inc) - Bay Networks Inc. (9.0)
. Texas Utilities Co. - Energy Group PLC (8.8)
. VIAG AG - Alusuisse-Lonza AG (8.6)
. Enso Oy - Stora Kopparbergs Bergslags AB (6.9)
. Teleglobe Inc. - Excel Communications Inc. (6.9)
. Astra AB - Astra Merck Inc. (Merck & Co.) (6.1)
. Suez Lyonnaise des Eaux - Societe Generale de Belgique (5.9)
. Total SA - Petrofina SA (5.3)
. Aeropuertos Argentina 2000 - Argentina-Airports(33) (5.1)
. Alcatel Alsthom CGE - DSC Communications Corp. (5.1)
. British Telecomm-Worldwide Ast - AT&T-Worldwide Assets, Ops (5.0)
. Investor Group - TELESP (Telebras/Brazil) (5.0)
. Hong Kong Monetary Authority - HSBC Holdings PLC (4.7)
. Pearson PLC - Simon & Schuster-Educ, Prof (4.6)
. B&Q PLC(Kingfisher PLC) - Castorama Dubois (4.1)
. BC Telecom(Anglo-CA Telephone) - Telus Corp. (4.1)
. National Grid Co PLC - New England Electric System (3.8)
. Akzo Nobel NV - Courtaulds PLC (3.7)
. Owens-Illinois Inc. - BTR PLC-Global Packaging (3.6)
. Schlumberger Technology Corp. - Camco International Inc. (3.3)
. AXA-UAP - Royale Belge SA (3.2)
. Electricite de France (EDF) - London Electricity (Energy Po) (3.2)
. Investor Group - Telesp Celular Participacoes (3.1)
. Bass PLC - Saison Holdings BV (3.0)

Source: UNCTAD, based on data provided by Thomson Financial Securities Data Company, Inc. (New York).

Note: Figures inside parentheses are the transaction value.

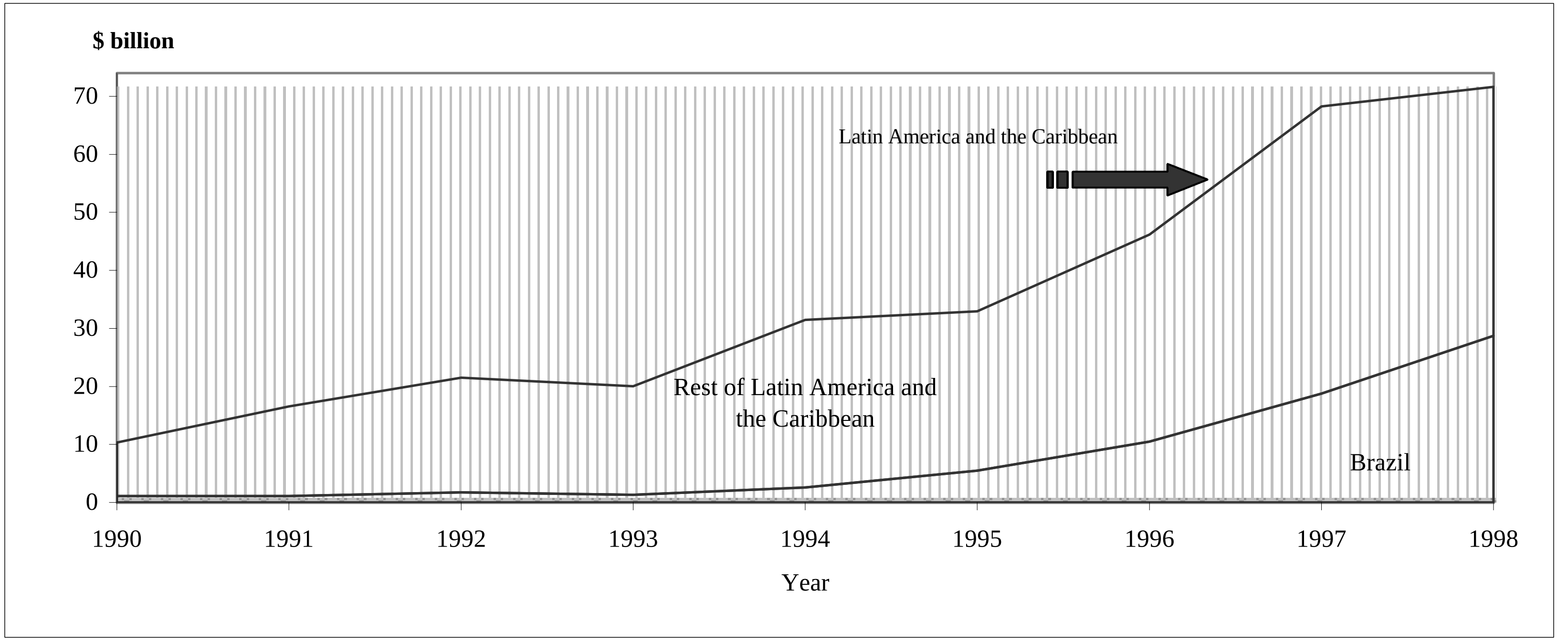
	1991	1992	1993	1994	1995	1996	1997	1998
FDI inflows.	21	28	49	61	67	79	88	77
Cross-border (majority foreign-owned) M&As.	0	2	5	5	2	3	10	13
Cross-border M&As as percentage of FDI.	1	6	9	9	3	4	11	16

Figure 3. South, East and South-East Asia: Cross-border mergers and acquisitions in relation to inflows of foreign direct investment, 1991-1998



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

Figure 4. Inflows of foreign direct investment into Latin America and the Caribbean, 1990-1998

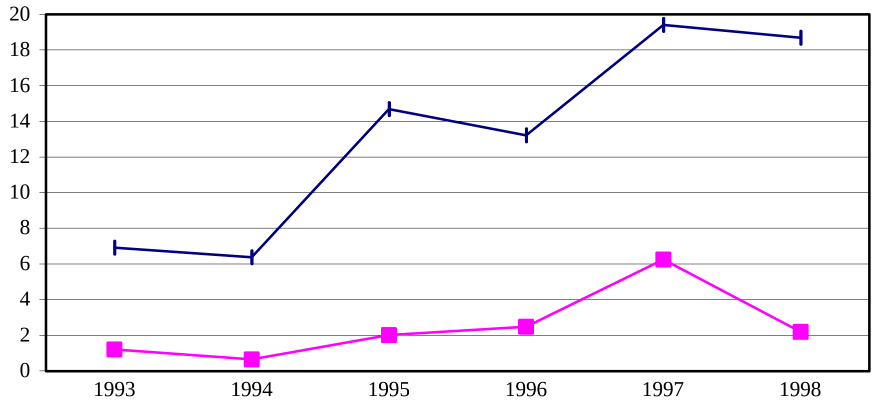


Source: UNCTAD, FDI/TNC database.

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Rest of Latin America and the Caribbean	9.2	15.4	19.8	18.7	28.9	27.4	35.7	49.5	42.9
Brazil	1.1	1.1	1.7	1.3	2.6	5.5	10.5	18.7	28.7
Latin America and the Caribbea	10.3	16.5	21.5	20.0	31.5	32.9	46.2	68.3	71.7

Figure 5. Inflows of foreign direct investment into Central and Eastern Europe, 1993-1998

(Billion dollars)



	1993	1994	1995	1996	1997	1998
Total CEE	6.908	6.378	14.69	13.212	19.408	18.695
Russian Federation	1.211	0.64	2.016	2.479	6.243	2.183

Total CEE   Russian Federation

Source: UNCTAD, FDI/TNC database.

Table 1. Russian Federation, European Union and United States as sources of inward FDI stocks of selected Central and Eastern European countries, latest year available

(year and per cent)

	Source economy		
	Russian Federation	European Union	United States
Host country and year			
Bulgaria, 1998	2.5	62.7	7.3
Croatia, 1998	0.5	41.4	41.6
Czech Republic, 1997	0.1	81.1	6.5
Estonia, 1998	1.8	76.5	5.2
Hungary, 1997	0.8	70.1	18.2
Latvia, 1998	8.7	52.6	10.7
Lithuania, 1998	n.a.	57.0	16.0
Poland, 1997	0.2	76.8	12.1
Romania, 1998	0.1	60.2	6.6
Slovakia, 1998	n.a.	70.5	11.0
Slovenia, 1997	0.1	75.2	4.9
Ukraine, 1997	6.7	25.3	18.3
Estimated average of all CEE countries, excluding Russian Federation	1.4	72.4	8.7

Source: UNCTAD, FDI/TNC database.

Table 2. Host country determinants of foreign direct investment

Host country determinants	Tpe of FDI classified by motives of TNCs	Principal economic determinants in host countries
I. Policy framework for FDI * economic, political and social stability * rules regarding entry and operations * standards of treatment of foreign affiliates * policies on functioning and structure of markets (especially competition and M&A policies)	A. Market seeking	market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences • structure of markets
* international agreements on FDI * privatization policy * trade policy (tariffs and non-tariff barriers) and coherence of FDI and trade policies * tax policy II. Economic determinants	B. Resource/asset seeking	• raw materials • low-cost unskilled labour • skilled labour • technological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication)
III. Business facilitation * investment promotion (including image-building and investment-generating activities and investment-facilitation services) * investment incentives * hassle costs (related to corruption, administrative efficiency, etc.) * social amenities (bilingual schools, quality of life, etc.) * after-investment services	C. Efficiency seeking	• cost of resources and assets listed under B, adjusted for productivity for labour resources • other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products • membership of a regional integration agreement conducive to the establishment of regional corporate networks

Source: World Investment Report 1998: Trends and Determinants, p. 91.