Prospects for Foreign Direct Investment and the Strategies of Transnational Corporations, 2005-2008

CHAPTER 2

UNITED NATIONS
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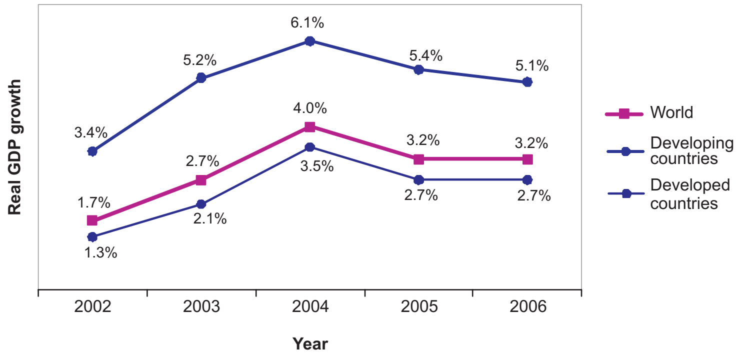
II. Investment environment for future FDI

A. Economic determinants for future FDI

Recent growth forecasts suggest that the global macroeconomic climate will be largely favourable to FDI in the short and medium term (figure II.A.1). Most regions are expected to maintain robust gross domestic product (GDP) growth, with Asia at the forefront. Important threats to growth and FDI in turn are ongoing increases in interest rates and spiralling petroleum and commodity prices.

Figure.II.A.1. Global GDP growth rates, 2002-2006



Source: World Bank, Global Economic Prospects 2005.

Note: The figures for the years 2005 and 2006 are estimates.

Global growth rates are expected to fall slightly from a peak of 4% in 2004, to an average of 3.2% in 2005 and 2006. The figures, at least for the world as a whole, are still higher than in 2002 and 2003 (World Bank 2005a). As in previous years, growth in developing countries is expected to outstrip that of the developed world. While the former are expected to see a growth rate of over 5% in 2005 and 2006, the latter are likely to average a rate of 2.7%. There is, however, significant variability in growth among countries in each of the groups.

The United States economy is expected to grow by slightly more than 3% in both 2005 and 2006, while Western Europe and Japan are expected to be less dynamic. Growth in the euro area is forecast at 2.6% per year, dragged down by the sluggishness of its three largest economies, France, Germany and Italy. These three are all expected to see annual growth of just 1-2% over the next two years (Eurostat 2005). On the other hand, most of the smaller European Union (EU) countries, particularly the new Central and Eastern European members, are expected to record healthy growth of at least 4%. Japan's economy is likely to grow by only 1.8% in 2005 and 1.6% in 2006.

South Asia, East Asia, and Eastern Europe and Central Asia are all expected to experience growth of over 5.5% in 2005 and 2006 (World Bank 2005a). Every other developing region is expected to expand by between 3.5% and 5% per year. Developing countries are, therefore, becoming increasingly the primary engine of global economic growth.

Since there is generally a stable and positive relationship between GDP growth and global FDI flows, this positive macroeconomic performance bodes well for national FDI prospects. On the supply side, FDI is affected by the availability of investment capital, generated by corporate profits or loans, which in turn are affected by domestic economic conditions, including growth. On the demand side, growing overseas markets lead TNCs to invest more, while depressed markets inhibit them.

Over the past two decades, booms in global FDI have followed periods of high economic growth, while declines have followed recessions or periods of slow growth. The decline in FDI flows in 2001 and 2002 followed rapid increases in FDI growth during the late 1990s. There was a similar pattern during the late 1980s and early 1990s, as well as in 1982-1983. The positive recent economic trends suggest that an FDI upturn is in the works following the recent investment recession.

While short-term growth forecasts are largely positive, the macroeconomic outlook is not entirely rosy. Firstly, gross fixed capital formation (GFCF) figures for the period 2005-2006 point to a slowdown in overall investment in member countries of the Organisation for Economic Co-operation and Development

(OECD). The OECD average is expected to drop from 5.9% in 2004 to 2.65% in 2005 and 0.8% in 2006. Secondly, while inflation is expected to remain under control in most regions, interest rates are expected to increase. This is particularly true in the United States, where rates for 6-month dollar denominated loans are expected to increase from 1.6% in 2004 to 3.5% in 2005 and 4.6% in 2006 (World Bank 2005a). Such a surge may dampen FDI expectations over the next two years. Thirdly, there are no indications of an imminent drop in petroleum prices. Forecasts for 2005-2006 suggest the price of crude oil will be high (United States Energy Information Administration 2005). The latter is bound to have an adverse effect on a variety of manufacturing and services industries, although the higher prices are likely to generate additional FDI in natural resources.

Another issue that has to be considered in the macroeconomic framework is the fluctuation in the value of the dollar vis-à-vis other currencies, which is likely to have an effect on cross-border investment flows between the United States and the rest of the world, be it in the form of equity, earnings or inter-company. For foreign-based TNCs, United States assets have been cheaper in recent years. For foreign affiliates of TNCs based in the United States, it also means that this is a good time to repatriate intra-firm dollar denominated debt or foreign earnings. The net impact on FDI flows will depend of course on the magnitudes of these two effects.

Firm-level indicators suggest the microeconomic environment will be largely favourable to FDI expansion over the next few years. Firstly, robust economic growth and strong demand has raised corporate profits in a range of industries. This has helped to increase the volume of capital available for investment. The growth in profits may not remain at an exceptional level as was the case in 2003-2004, but the profitability of the largest TNCs remains healthy in the short term. According to UNCTAD's calculations, profits in the world's largest TNCs[2] are likely to continue to increase over the next three years, but at a slower pace.

The average net profits of the top five hundred companies in the United States continue their ascent, charting a record-breaking $8.2 trillion in revenues and $513.5 billion in profits in 2004, according to Fortune Magazine. Of the forty-two industries analyzed by Fortune, thirty-eight registered profit growth in 2004 (Fortune Magazine, April 2005). The average net profits of the thousand largest Asian companies (mainly TNCs from Japan, China, Hong Kong (China), Malaysia, the Republic of Korea and Taiwan, Province of China), also rose, at a high rate of 52% (Asia Week 2005).

The positive profit outlook is also reflected in another set of microeconomic indicators business confidence levels. Several surveys of CEOs and investment experts from various regions have portrayed cautious optimism about future investment. The *McKinsey Global Survey of Business Executives Confidence Index* (McKinsey 2005), for example, revealed a positive attitude among the 9,300 business executives surveyed, though their forecasts were generally less upbeat than a year ago. The *PriceWaterhouseCoopers 8th Annual Global CEO Survey* (PwC 2005) found rising confidence in future levels of revenue growth over the next twelve months. The proportion of CEOs who were "very confident" or "somewhat confident" rose from 72% in 2002 to 84% in 2003 and 91% in 2004. In response to growing competition, nearly 40% of the CEOs are engaging in offshoring or planning to do so.

B. Policy determinants for future FDI

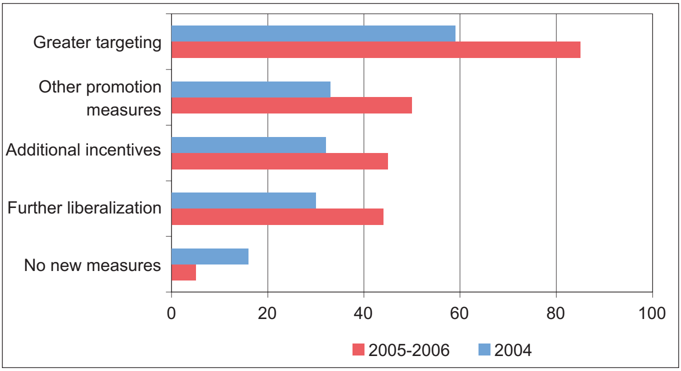
Investment liberalisation continues apace, and has in fact intensified at both national and international levels. This is likely to contribute to increased FDI flows in years to come. Competition to attract FDI through various promotion and facilitation measures has also escalated further.

National level

Generally, countries are responding to increased global competition for FDI by becoming more proactive in their investment promotion efforts. The number of countries implementing investment-related policies, and the range of measures they used, both grew in 2004. Measures included further liberalisation, additional incentives and often investor targeting (figure II.B.1). Only 16% of the IPAs surveyed indicated that their countries did not introduce any additional investment promotion measures over the past year.

A total of 269 FDI-related regulatory changes were introduced in 102 countries in 2004. The vast majority (87%) were designed to make host countries more attractive to foreign companies (UNCTAD 2005a). A clear example of this was a reduction in corporate tax rates, which fell on average in the OECD from 29.7% to 26.5% (UNCTAD 2005a). The largest reduction was made by Romania, from 26% to 16%, followed by Uruguay and Bulgaria.

Figure II.B.1. Policy measures to attract FDI, 2004-2006
(Per cent of response by IPAs)



Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

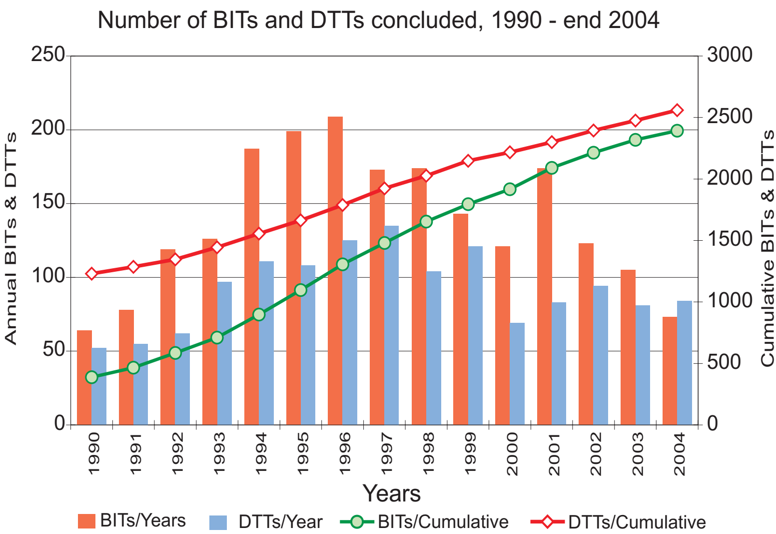
According to the GIPA 2005 survey, more than 50% of the responding countries planned to intensify their investment promotion efforts for 2005-2006. Furthermore, given the limited resources at their disposal, most countries intend to use more targeted policies that are also viewed as yielding better results and being more cost-effective. These findings suggest that global and regional competition for FDI is increasing, and will continue to do so in the future.

International level

International investment agreements continue to proliferate at the bilateral, regional and interregional levels. Through their liberalisation, protection and promotion provisions, these constitute an international enabling framework for investment. On average, in 2004, more than three agreements were signed each week.

As part of this trend, the number of bilateral investment treaties (BITs) continued to expand. During 2004, 73 new BITs were concluded, bringing the total number in force to 2,392 (figure II.B.2). Several countries, including Germany, China, Switzerland and the United Kingdom, have now signed over 100 such agreements. 84 double taxation treaties (DTTs) involving 80 countries were also concluded in 2004, bringing the total number in existence to 2,559.

Figure II.B.2. Number of BITs and DTTs concluded, 1990- 2004
(Cumulative and year by year)



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

Investment rules are also increasingly being incorporated into free trade agreements (FTAs), regional integration agreements (RIAs) and economic partnership agreements (EPAs). They usually contain commitments to liberalise, protect and/or promote cross-boarder investment flows in addition to a range of trade liberalisation and promotion provisions.[3] The number of agreements with investment components has been growing steadily and, by June 2005, more than 215 had been concluded.

A number of other agreements are likely to help facilitate FDI, especially to developing countries. Preferential trade arrangements, for example, can encourage trade-related, or “barrier-hopping” investment. Market access measures for African countries, such as the African Growth and Opportunity Act (AGOA), the Everything But Arms initiative (EBA) and Japan’s so-called 99% rule[4] can help attract foreign investors seeking to gain access to markets in the United States, EU and Japan. Equally, the Kyoto Protocol’s Clean Development Mechanism (CDM) could result in increased FDI to developing countries. It creates an incentive for firms to make environmentally friendly investments in developing countries. The CDM covers a wide range of industries and the first projects have already come to fruition.

In summary, developments at both national and international level point towards continued long-term growth in FDI. The expanding body of agreements will increasingly facilitate international investment and present new opportunities for developing countries. At the same time, competition for FDI is growing as countries are introducing more policy measures to attract FDI.

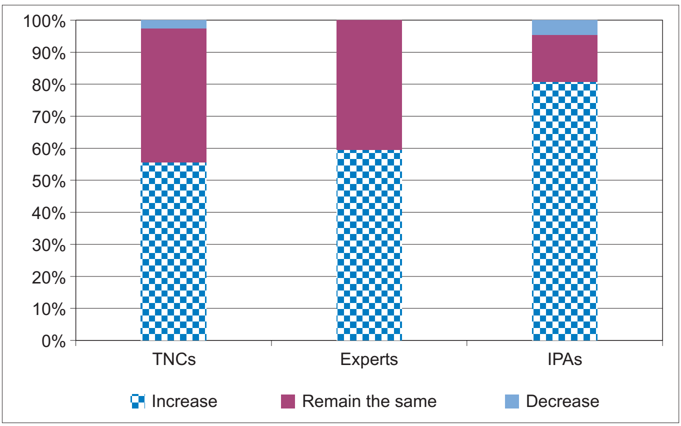
III. Global FDI prospects and TNC strategies

A. Global FDI prospects

The principal findings of the GIPA 2005 survey augur well for FDI prospects. After its rebound in 2004, global FDI is likely to continue rising in the coming years. Indeed, the majority of the FDI experts, TNCs, and IPAs surveyed predicted that FDI would continue to grow in both the short and medium term. While forecasts remain positive, however, they are not as optimistic as those in the GIPA 2004 survey.

More than half of the TNCs and expert respondents, and four-fifths of IPAs, expected short-term (2005-2006) growth in FDI flows, while almost all remaining respondents expected levels to remain steady (figure III.A.1a). Only a small fraction of respondents thought that FDI would decrease in the immediate future. The survey results represent a vote of confidence in the prospects for short-term FDI flows.

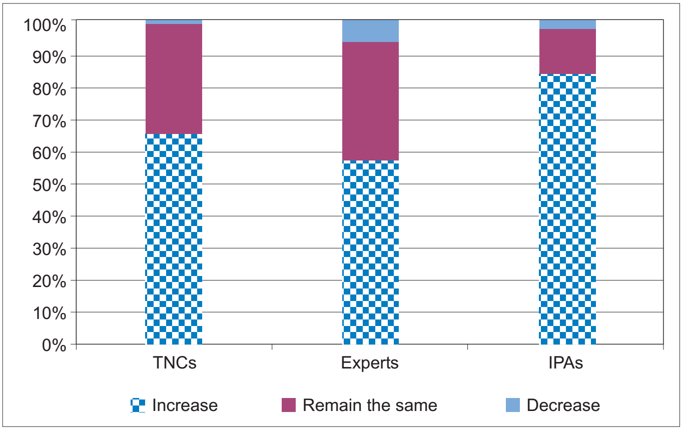
Figure III.A.1a. Global prospects for FDI, 2005-2006
(Per cent of responses)



Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

Opinions on medium-term (2007-2008) FDI prospects are even more optimistic (figure III.A.1b). Some 57% of experts, 65% of TNCs and 83% of IPAs expected FDI to increase through 2007-2008. Again, most of the remaining respondents expected FDI levels to remain the same, and only a few foresaw a decline.

Figure III.A.1b. Global prospects for FDI, 2007-2008
(Per cent of responses)



Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

These results are broadly in line with those of the GIPA 2004 survey, though a greater proportion, but still a minority, of this year's respondents predict that FDI will remain stable rather than grow. This caution is due in part to the slowdown in economic growth in some major developed economies and structural weakness in some regions.

B. Most attractive global FDI locations

There were a number of surprises in the investment locations that were selected as "most attractive". Four of the top five countries, as ranked by TNCs, are not from the developed world (figure III.B.1). China is considered an attractive location by 87% of TNCs, by a margin of 36 from the next country in line. This is impressive, even for a country which has been one of the world's largest FDI recipients for quite some time. India's high ranking is even more remarkable, given that FDI flows to that country have been modest until recently. The United States is the only developed country in the top five locations. Germany, Canada and the United Kingdom made it into the top ten, but traditionally important FDI destinations, such as France, the Netherlands and Italy, were not included. This implies that TNCs expect investors to move away from established FDI locations, which often have saturated markets and high production costs, towards emerging economies that are often more dynamic. This finding is also supported by overall trends in FDI flows in 2004, which saw developing countries taking the lead in the global FDI recovery (UNCTAD 2005a).

Figure III.B.1. Most attractive global business locations, 2005-2006
(Per cent of responses)

Responses from TNCs

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

Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

C. FDI prospects by industry

Prospects for FDI vary significantly by industry, according to the 2005 survey.[5] The outlook for the services sector is more positive than that for the manufacturing or primary sectors. IPAs and experts shared *gross modo* the views in regard to the prospects of specific industries. IPAs were at times more optimistic than experts in their assessment across sectors.

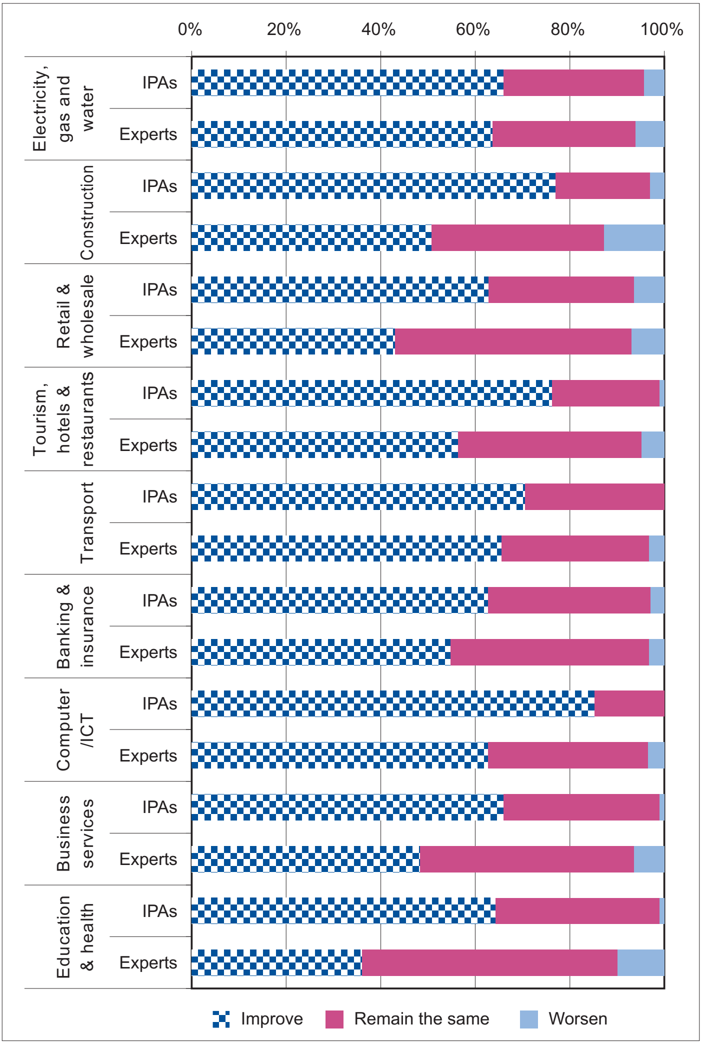
FDI growth is expected to be led by services in computing and ICT, public utilities (such as the generation and distribution of electricity, water and gas), transportation, followed by tourism, hotels and restaurants, construction, banking and insurance, retail and wholesale and business services, all of which were noted by more than 40% of both IPAs and experts (figure III.C.1).

In manufacturing, the greatest FDI growth is expected in electrical and electronic products, machinery and equipment, and metals and metal products (figure III.C.2). There is less optimism regarding FDI in textiles and clothing, rubber and plastic products, non-metallic minerals and media and publishing. It is interesting to note that in contrast to the 2004 survey, the optimism is quite concentrated in a few industries in the manufacturing sector.

In the primary sector, FDI in mining and petroleum is expected to increase in response to higher prices and strong demand for natural resources (figure III.C.3). Higher oil and commodity prices induce TNCs to take up new exploration projects, or to step up production in existing ones. Downbeat predictions for the agriculture industry might be due to ongoing trade disputes and slow liberalisation in this area.

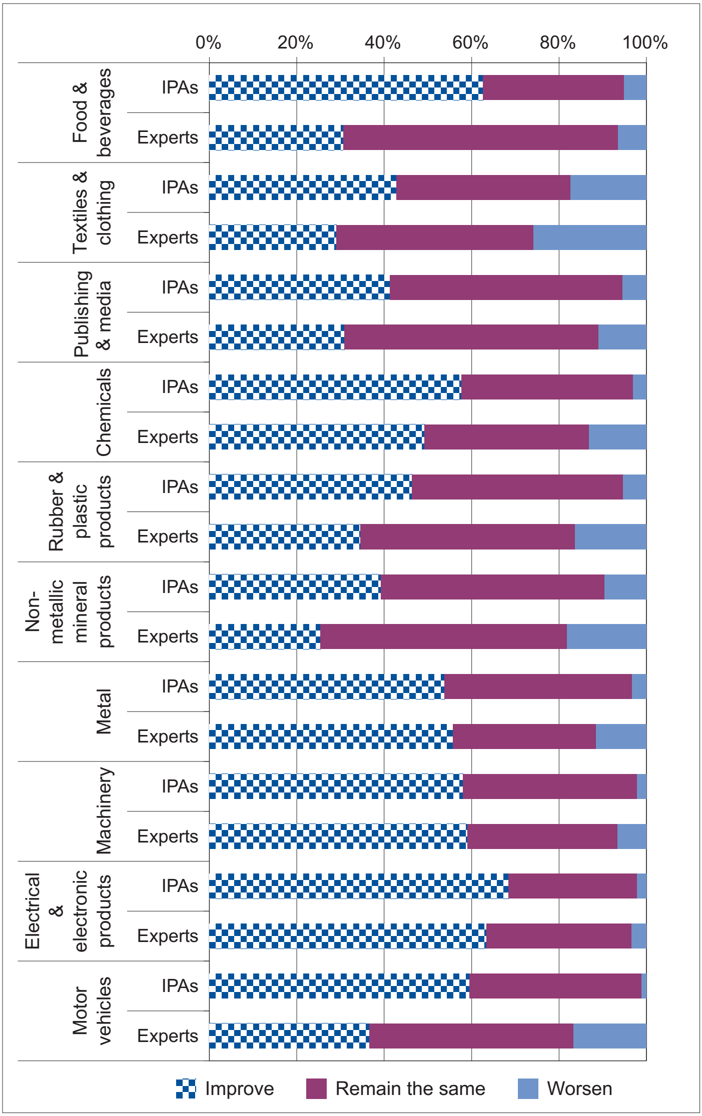
In sum, the findings of the GIPA 2005 survey are broadly in line with those of the 2004 survey. One major difference is that this year's respondents expect a greater divergence in the prospects for individual sectors compared with the 2004 survey. As well, the gap between the prospects for FDI in the services sector and those for FDI in other sectors has widened, as compared with the 2004 survey.

Figure III.C.1. Global FDI prospects in services sector, 2005-2006
(Per cent of responses)



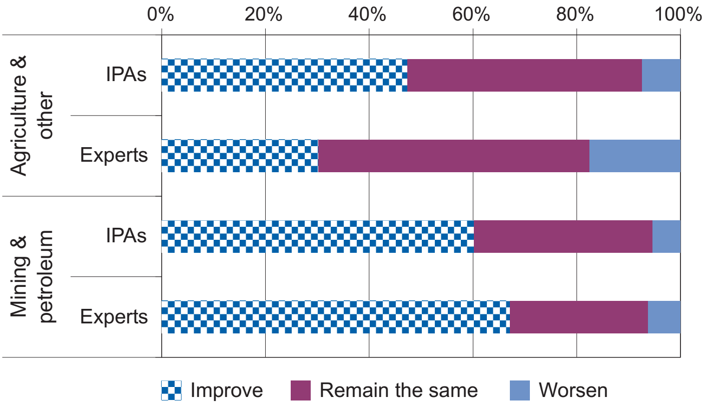
Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

Figure III.C.2. Global FDI prospects in manufacturing sector, 2005-2006
(Per cent of responses)



Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

Figure III.C.3. Global FDI prospects in primary sector, 2005-2006
(Per cent of responses)

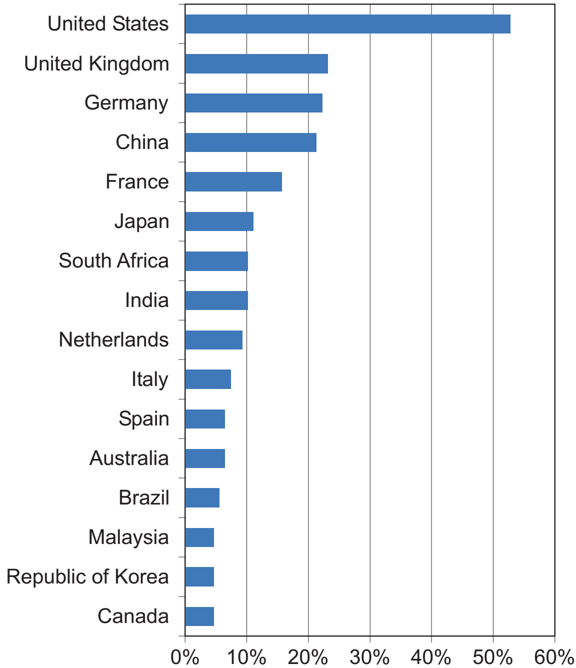


Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

D. Predicted sources of FDI

In the short term, the IPAs surveyed expect the United States to be by far the most important source of global FDI flows, followed by the United Kingdom, Germany and China. The overall ranking is interesting because along with China, several other developing countries feature in the top 15 (figure III.D.1). These include South Africa, India, Brazil, Malaysia and the Republic of Korea. It is important to note that this is not a ranking of the magnitude of FDI outflows. Instead, the survey asks IPAs from which three countries they expect to receive the largest investment in 2005-2006. This finding confirms the current trend of TNCs from developing countries increasingly becoming global players and investing abroad.

Figure III.D.1. Expected leading sources of FDI, 2005-2006
(Per cent of responses)



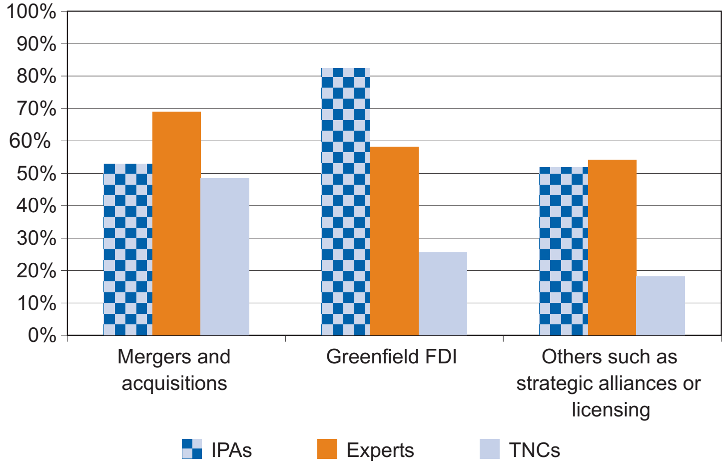
Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

E. Prospects for TNC strategies: mode of entry

More than 50% of the three groups of respondents combined expected mergers and acquisitions (M&As) to be the primary vehicle for FDI in 2005-2006. In contrast, most IPAs expected greenfield investment to be the most important (figure III.E.1). This reflects the fact that most IPA respondents were from developing countries in which greenfield FDI tends to dominate. Non-equity investment, such as investment through strategic alliances or licensing, is also expected to remain important, although TNCs seem less convinced of this. The emphasis of TNCs on M&A

activity contrasts with the GIPA 2004 findings, according to which TNCs expected equal use of each mode of investment.

Figure III.E.1. Expected modes of global investment, 2005-2006
(Per cent of responses)



Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

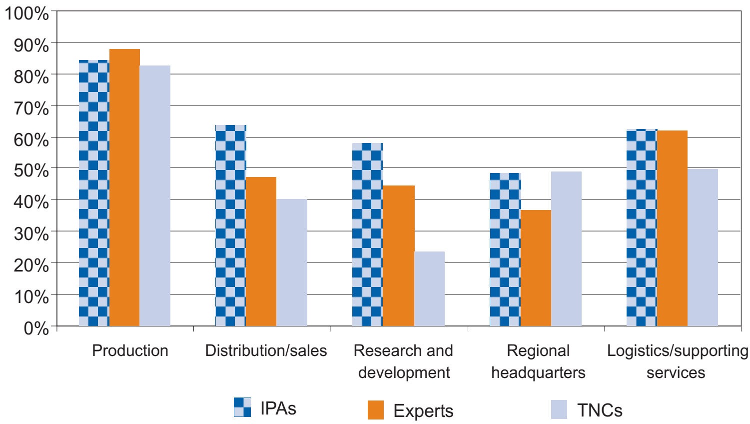
F. Prospects for TNC strategies: relocation of corporate functions

There was a broad consensus among IPAs, TNCs and experts that production would be the corporate function most likely to be relocated. Well over 80% of those surveyed expected production-related activities to be transferred overseas (figure III.F.1)

After production, logistics and support services are the next most frequently expected functions to be relocated abroad. This is followed by distribution and sales. Regional headquarters and research and development are the least likely corporate functions to be relocated abroad.

TNCs expected to see less relocation of R&D activities than IPAs and experts. Only 20% of TNC respondents expected R&D to be relocated, in contrast with more than 40% of experts and almost 60% of IPAs. This finding is particularly interesting given the recent trend towards the globalization of R&D, and reinforces the notion that since R&D involves knowledge vital to a firm's competitiveness, it is in need of maximum protection, and it is therefore less likely to be transferred overseas. A separate UNCTAD survey of the world's largest R&D spenders shows that the share of R&D funded by foreign companies will increase by 2009, with China, the United States and India as the top three recipients of FDI in R&D (UNCTAD 2005a).

Figure III.F.1. Most expected corporate functions to be relocated, 2005-2006
(Per cent of responses)

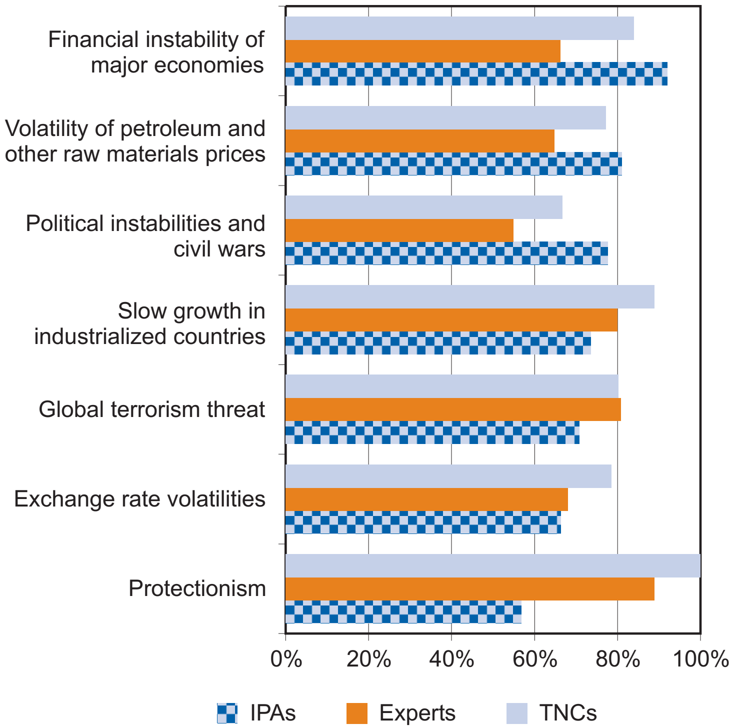


Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

G. Risks to global FDI flows

Interestingly, views on what constitutes major threats to global FDI prospects differ among the three survey groups. Protectionism and slow growth in industrialised countries were the issues TNCs and experts felt were the most threatening to FDI growth (figure III.G.1). Indeed, every TNC respondent felt that trade wars had the potential to undermine FDI growth in 2005-2006.

Figure III.G.1. Major risks to FDI flows, 2005-2006
(Per cent of respones)



Source: UNCTAD prospects assessment 2005, www.unctad.org/fdiprospects.

Note: Percentage of respondents that considered each factor as “important” or “very important.”

For IPAs the biggest concern was the financial instability of major economies and the volatility of raw material prices. This difference in views underlines the fact that IPAs are more in tune with host country domestic political and economic issues and less focused on broader global issues. This might also explain why political instability and civil war is the third greatest concern of IPAs, while the other two survey groups of respondents ranked it as the least important.