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RESEARCH NOTE NUMBER 3

Prospects for FDI Flows and TNC Strategies, 2004-2007

World's largest transnational companies opt for expansionary strategies

Executive summary

The world's largest transnational corporations (TNCs) are optimistic as regards growth prospects for foreign direct investment (FDI), with over three quarters of the companies in an UNCTAD survey expecting FDI flows to increase over the short and medium term.

The recovery, however, is likely to be uneven, with significant improvement in FDI flows expected only in Asia, and Central and Eastern Europe. For developing countries as a whole, the optimism is much more cautious with 41% of responding TNCs expecting an increase in FDI inflows, while half of the respondents expect no major change in FDI prospects in the short term.

The top locations in terms of FDI prospects and opportunities in their respective regions are China, Brazil, Poland, South Africa and the United States. Greenfield, M&As and other modes of FDI entry are all favoured equally, but M&As are the preferred mode of entry in the developed world. International expansion of production activities is anticipated to remain prominent, but distribution and sales and logistics/support functions are also expected to continue their international expansion.

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I. Introduction

The UNCTAD survey of TNCs was conducted during February-April 2004. It covered 335 TNCs from UNCTAD's list of the top 200 TNCs based in developed countries, top 100 TNCs from developing countries and top 25 TNCs from Central and Eastern Europe (CEE). The list also included the top 10 TNCs ranked by foreign assets in service industries. Some 24% of the TNCs covered by the survey responded.

It is important to note that the respondent companies are among the most internationalized of the largest TNCs as per UNCTAD's transnationality index, a composite index based on the shares of foreign assets, foreign employees and foreign sales in total assets, total number of employees and total sales, respectively. The combined total assets of the responding TNCs were over $1.9 trillion in 2002, of which 38% (or over $725 billion) were located outside their countries of origin. Aggregated total sales of these companies in 2002 stood at over $2.1 trillion, of which over $727 billion were attributed to their foreign affiliates. These TNCs employed over 5.1 million persons worldwide, 42% of which (2.2 million) worked in their foreign affiliates. [2]

The TNCs surveyed were asked for their views not only on their own investment plans, but also on overall trends in their respective industries. Thus, their assessment of the FDI prospects provides useful insights into the plans of a much larger group of companies. TNCs monitor closely the future investment strategies of other companies in the same industry in formulating their own strategies, which places them in a unique position to assess broad future trends in FDI flows. All this suggests that the information gathered from the participating companies is highly relevant and indicative of the investment plans of thousands of TNCs around the globe.

II. Overall assessment of FDI prospects during 2004-2007

The world largest TNCs are optimistic about the short-term (2004-2005) and medium-term (2006-2007) prospects for FDI globally. Over three quarters of the surveyed companies expected FDI flows to increase in both short and medium terms. Only 4% expected deterioration in the short term; that share increased to 9% in the medium term (figure 1).

This general optimism is due to a number of reasons. The recovery in economic growth and stronger demand in a range of industries have improved corporate profits over the past year, thus increasing the availability of investible funds in the near future. The profits of the responding TNCs have increased by more than 20% in the past two years.[3] Other sources have also reported a dramatic rise in corporate earnings. For example, the average net profits of the 500 largest companies in the United States increased by 540% in 2003, after heavy losses during the previous two years. [4] Similarly, average net profits of the 1,000 largest Asian companies (mainly TNCs from Japan, China, Hong Kong (China), Malaysia, the

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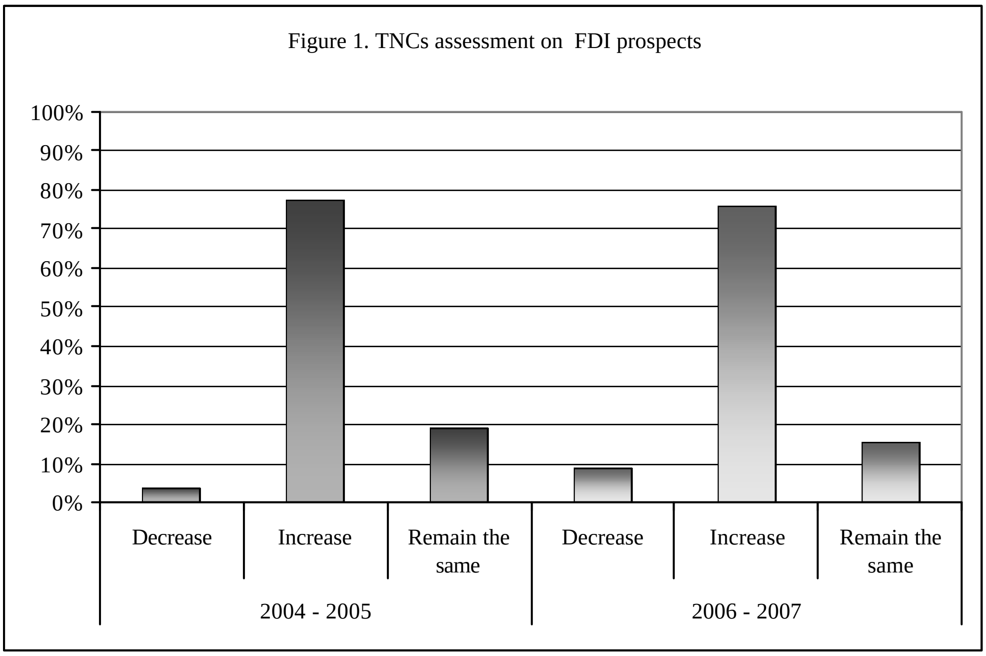
[2] The actual figures should be substantially higher as some of the respondent companies did not report on certain aspects of their operations.

[3] These figures were available for 67 of 79 of the responding companies.

[4] *Fortune 500*, 3. 2004

Republic of Korea and Taiwan Province of China) also increased significantly by 128% in 2002. [5]



Source: UNCTAD-DITE, Global Investments Prospects Assessment (GIPA) 2004.

The turnaround in corporate profits has not only relieved financial constraints, thus encouraging FDI, but also fostered conditions for better stock market performances and portfolio equity flows. Improved stock market performances can boost the value of cross-border M&As, as well as the ability of TNCs to raise funds for investment by issuing new stock, or by borrowing on the value of their assets. In other words, financial conditions augur well for greater FDI in the near future.

Positive prospects for economic growth in developed and developing countries have increased the confidence of TNCs in expansionary strategies. Furthermore, the relatively low level of interest rate in major investment source countries reduces the costs of corporate financing for new investment projects. During the past three years, firms have worked off many of the financial imbalances accumulated in the late 1990s – notably excess capacity and large inventories (World Bank, 2004). All this can boost further FDI flows.

III. Assessment of FDI prospects by region

While the findings augur well for an overall FDI recovery, they do not imply that it would be spread evenly over all regions and countries. For developing countries as a whole, about half of the respondents expected no major change in 2004 and 2005. In fact, only in Asia and the Pacific and CEE did the majority of respondents expect a substantial improvement in FDI prospects (figure 2). For developed countries, more than 40% anticipated

[5] *Asia Weekly*, 1, 2004.
[6] These figures were available for 67 of 79 of the responding companies.

an improvement in FDI prospects; within this country grouping the picture was mixed, with respondents expecting FDI prospects to be better for North America than for Western Europe.

Asia and the Pacific. Almost three fifths of the respondents expected FDI to increase in the region. This result is clearly inspired by China's continuing success in attracting FDI projects. But there is also a large number of TNCs that see India and Thailand as attractive locations for future investment. For *West Asia*, the picture appears less optimistic compared to the rest of the Asian region, with 13% of the respondents expecting deterioration in FDI prospects.

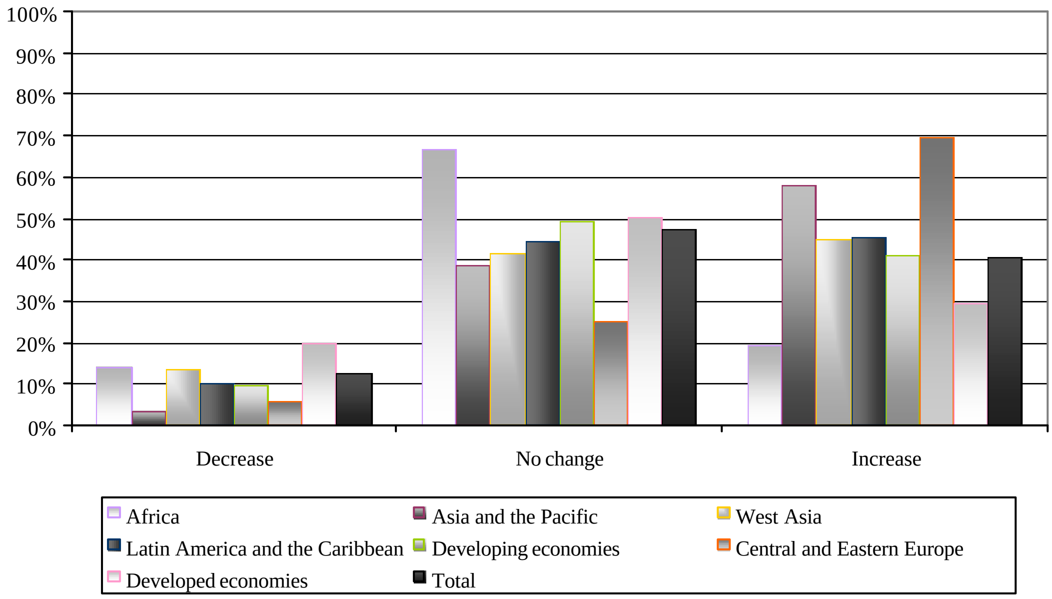
Africa. Only a fifth of the respondents expected increasing FDI flows into that region. The majority of respondents (67%) expected flows to remain steady. This shows that the African continent is not yet on the strategic map of the overwhelming majority of the world's largest TNCs or that companies prefer a non-equity engagement, for example management contracts with local investors, to reduce political and economic risk, which is generally perceived to be higher in Africa than elsewhere. This holds true particularly for companies headquartered in developed countries.

Latin America. The expectations of the respondent TNCs were mixed. Equal numbers expected the region to receive increased FDI flows and the same level of flows.

Developed countries. Within the group of *developed countries*, respondents were more pessimistic about FDI prospects for Western Europe than for North America and Japan. Only one-third of the respondents expected brighter prospects for FDI in Western Europe, while 20% predicted deterioration. The slower economic recovery in the region may be one of the reasons for the pessimism. Almost a fifth of the respondents expected FDI in Western Europe to decline in their respective industries, while fewer respondents expected an actual decline in FDI in North America and Japan.

Central and Eastern Europe. This region attained the highest score with more than two-thirds of the respondents expecting FDI to increase during 2004-2005. This optimism was fueled by the accession of several CEE countries to the European Union, and the spill-over effects on other less developed non-EU countries in the region.

Figure 2. FDI prospects by region for 2004-2005



Source: UNCTAD-DITE, Global Investments Prospects Assessment (GIPA) 2004.

IV. The top destinations for FDI

The largest recipients of FDI flows in each region were expected to continue to be the most likely destinations of FDI in the future, with some important exceptions. In Asia, for instance, India was ranked right behind China, even though it has yet to become a major FDI recipient in Asia (table 1). Thailand's third place is also somewhat surprising considering that there are several countries in Asia that have received more FDI than Thailand in the past.

In Africa, South Africa and Nigeria are the only sub-Saharan countries on the list of the top five destinations for the continent as a whole. The other three top destinations are North African countries (Egypt, Morocco and Algeria). The responses suggest that the greater a country's natural resources, rather than the level of stability of its economy and political system, the more likely the country is to receive increased FDI in the future.

In Latin America, the traditional FDI powerhouses - Brazil, Mexico, Argentina and Chile – are at the top of the list, with Venezuela in fifth place. Brazil leads the way in Latin America by a huge margin.

In the CEE region, Poland ranks in top place, ahead of Russian Federation, due to its accession to the EU. The high rankings of Hungary and the Czech Republic can also be attributed in part to EU accession. The rankings, however, point to the emergence of a more complex picture than just a mere accession versus non-accession divide in the CEE countries. For example, Romania, a non-accession country, ranks among the top five in the region. These results could revive discussions on the applicability of the "flying geese" model describing industrial restructuring in South East Asia to the CEE countries (UNCTAD, World Investment Report 2003). The accession countries continue to receive FDI with an increasing share of upgraded and high-value added investments; while investments based mainly on low labour costs are gradually shifted to other countries in the region, including Romania, where an accession-driven pressure on prices and wages has not yet set in.

In the case of developed countries, the positions assigned by the respondents to Canada and Japan among the most attractive destinations are somewhat surprising, especially since Japan has only relatively recently began to seek FDI actively. Japan's high ranking might be explained by the renewed trust of investors and the country's economic recovery after years of stagnation.

Table 1: The five most attractive locations for FDI in 2004-2005, by region

Region / Countries	Africa	Asia and the Pacific	Latin America and the Caribbean	Central and Eastern Europe	Developed Economies
Top 1	South Africa	China	Brazil	Poland	United States
Top 2	Egypt	India	Mexico	Russian Federation	United Kingdom
Top 3	Morocco - Nigeria	Thailand	Argentina	Hungary - Czech Republic	Canada
Top 4	----	Viet Nam - Republic of Korea	Chile	----	Germany
Top 5	Algeria		Venezuela	Romania	Japan

Source: UNCTAD-DITE, Global Investments Prospects Assessment (GIPA) 2004.

These results, however, should be interpreted with caution. They do not mean that the respondents expect the countries in top places to receive the largest FDI flows in absolute terms. Rather the results point to the business opportunities for firms in their respective industries, even if their scale of operations in those developing countries is smaller.

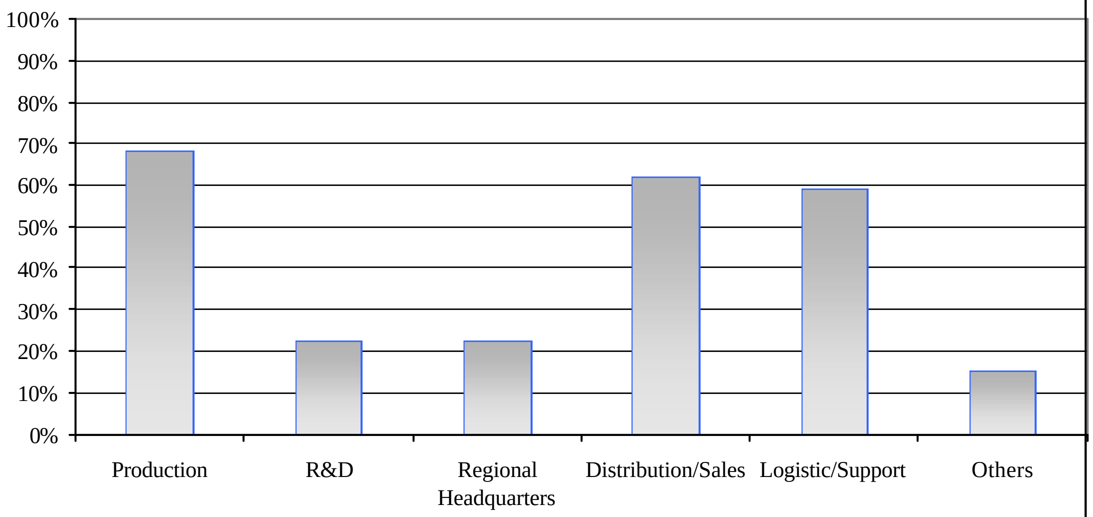
V. Prospects for relocation of corporate functions

Production, referring to manufacturing activities, was the corporate function most likely to be relocated abroad according to the respondents, followed by 'distribution and sales' and 'logistics and support services' (figure 3). This is not surprising, as manufacturing production activities have long been at the forefront of TNCs' relocation strategies. However, the findings also indicated that some of the services-related business functions such as 'distribution and sales' and 'logistics/support services' (which may not necessarily be high value-added) were expected to be located in foreign affiliates on a large scale.

What does this mean for the ongoing discussion about the off-shoring of jobs from developed to developing countries? Although a substantial number of firms expect relocation to take place, this process is expected to gain momentum only with regard to selected corporate functions. Hence, as confirmed by the survey results, there are some corporate functions, in particular those related to research and development and regional headquarters functions which remain difficult to relocate as they depend on very specific conditions offered only by a few locations.

It is important to note that the respondents' ranking of corporate functions according to the likelihood/expectation of their relocation depends upon the individual industries to which the responding TNCs belong. Thus, 40% of the companies that expected a relocation of 'research and development' facilities were from the chemical and pharmaceutical industries. Likewise, more than a quarter of the responses predicting a relocation of "regional headquarters" came from automobile companies. For the other corporate functions – "production", "distribution and sales" as well as "logistics and support services" the industry distribution was much more balanced with no single industry standing out.

Figure 3. Corporate functions likely to be relocated in 2004-2005

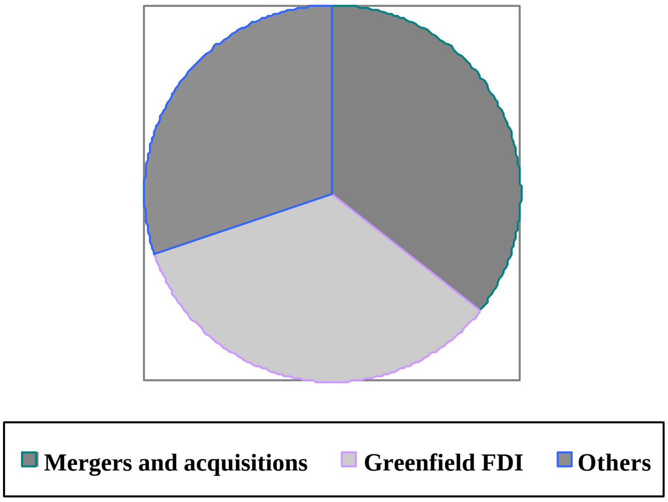


Source: UNCTAD-DITE, Global Investments Prospects Assessment (GIPA) 2004.

VI. Prospects for various investment modes

Mergers and acquisitions (M&As), greenfield investment and other modes such as licensing or strategic alliances were all almost equally important as forms of internationalization (figure 4), according to the findings of the survey. It is interesting to note that "other modes" of internationalization were important in almost all regions, next to greenfield investment in the case of developing countries, and M&As in the case of developed countries.

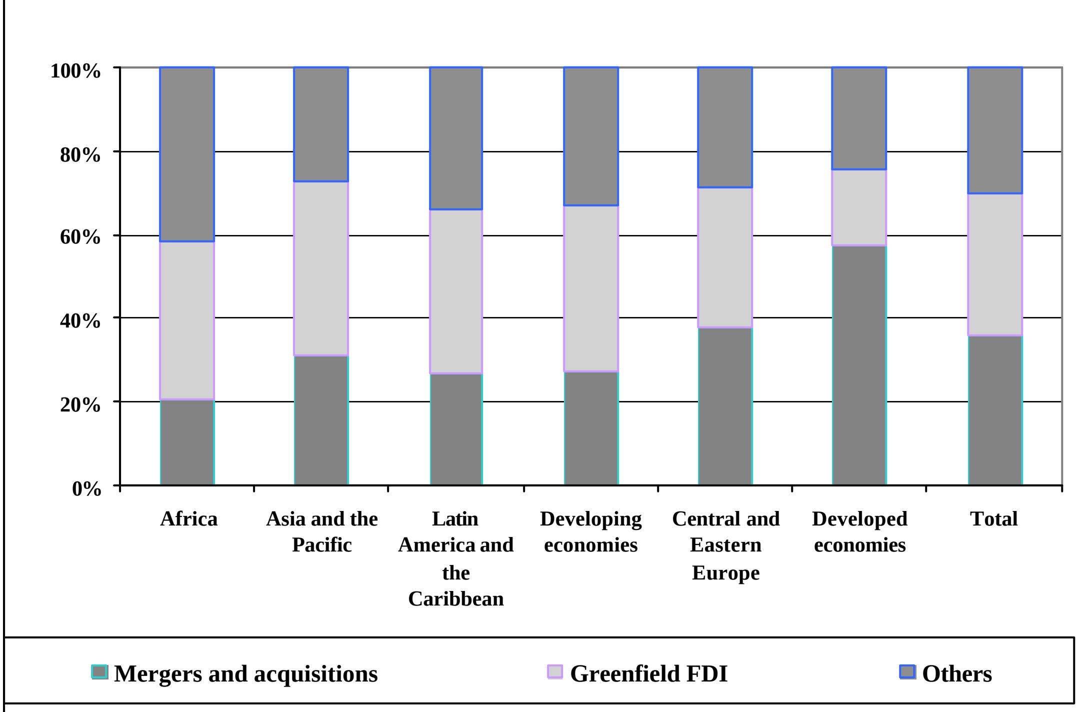
Figure 4. Preferred modes for FDI in 2004-2005 worldwide



Source: UNCTAD-DITE, Global Investments Prospects Assessment (GIPA) 2004.

M&A deals are expected to remain the dominant form of international expansion in developed countries (57% of respondents), followed by other modes (25%) and greenfield investment (18%). For CEE, M&As and greenfield investments (nearly 35%) are expected to be equally significant. In developing countries, greenfield was fequently mentioned as a mode of entry (40%), but M&As (27%) and other modes of investment (33%) commanded important shares. A similar pattern was observed for Latin America. For Asia and the Pacific, greenfield investment was the main mode of entry. In Africa, other modes of investment were prominent (41%), suggesting that many TNCs, at least those from outside the region, may prefer to engage in non-equity arrangements (figure 5).

Figure 5. Preferred modes of FDI and internationalisation of business in 2004-2005



Source: UNCTAD-DITE, Global Investments Prospects Assessment (GIPA) 2004.

VI. Concluding remarks

This TNC survey complements two other worldwide surveys carried out by UNCTAD for the purpose of assessing global FDI prospects. Almost in parallel with this survey, UNCTAD sent similar questionnaires to national investment promotion agencies (IPAs) and a group of selected international FDI location experts to ascertain their views on the prospects for FDI . The results of the other two worldwide surveys have already been published and can be found at http://www.unctad.org/fdiprospects. An overall assessment synthesizing the key findings of the three individual surveys, as well as UNCTAD's own analysis, will be published later in 2004.

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Global Investment Prospects Assessment (GIPA)
UNCTAD

The Global Investment Prospects Assessment (GIPA) project of UNCTAD is designed to assess short- and medium-term prospects for FDI. It analyses expected future patterns of FDI flows at the global, regional, national and industry levels as seen from the perspectives of global investors, host countries and international FDI experts. It also analyses the evolving trends in the strategies of TNCs as well as the FDI policies.

GIPA is designed to fill a gap in research and policy analysis, equipping governments and business alike with a critical instrument for the proactive development of policies and strategies, as opposed to after-the-fact assessment of FDI and related matters.

In addition to its own research into various leading macro- and micro- economic indicators, as well as policy developments, UNCTAD bases its assessments on the findings of three large-scale surveys:

- A worldwide survey of the largest TNCs with headquarters in developed and developing countries and in Central and Eastern Europe regarding TNC strategies and investment plans.
- A worldwide survey of international FDI experts who typically assist TNCs in their overseas location decisions regarding their observations on future trends in FDI flows and policies.
- A worldwide survey of national investment promotion agencies regarding their perceptions of FDI prospects and the investment policies and promotion strategies of their respective countries and regions.

These surveys complement each other and allow for direct comparison of the results obtained.

GIPA is conducted by a team comprising:

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