United Nations Conference on Trade and Development

World Investment Report

2004 The Shift Towards Services

United Nations
New York and Geneva, 2004

CHAPTER II

REGIONAL FDI TRENDS: A MIXED PICTURE

FDI to developed countries continued to decline in 2003, despite signs of an imminent recovery, and flows to Central and Eastern Europe (CEE) fell sharply. At the same time, developing countries as a group saw increased inflows, reversing the trend during the previous two years. However, the picture differed considerably by region and country. In the developing world, Africa and Asia and the Pacific received larger inflows than in 2002, while they fell in Latin America and the Caribbean for the fourth consecutive year. In the developed world, FDI flows to "other Western Europe" increased while those to the EU, the United States and Japan decreased (annex table B.1). In CEE, flows to large host countries that have almost completed their privatization programmes fell, while those to other countries rose. In general, prospects for FDI in 2004 are promising for all regions.

A. Developing countries

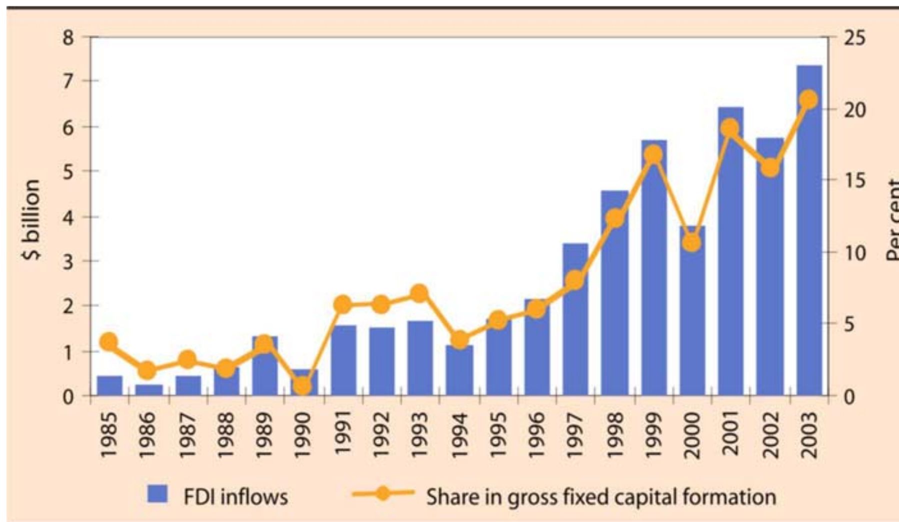
In 2003, FDI flows to the developing countries as a group picked up, following two years of decline. The increase in Africa's FDI inflows was driven mainly by natural resources, and was spread more evenly among countries as well as industries than the previous increase in 2001. Flows to Asia and the Pacific rebounded, attracted by strong domestic growth in some countries, with an increase in efficiency-seeking FDI to competitive locations in the region. In faster growing East and South-East Asia, it was concentrated in services, while FDI in manufacturing fell and that in primary remained stable. In Latin America and the Caribbean, on the other hand, the downturn persisted due to several factors in particular, a slowdown in privatization (a key factor behind increased FDI flows to Latin America during most of the 1990s), economic and political uncertainties in some countries and the relocation of production from some Latin American countries to lower-cost locations such as China. Nonetheless, with regional and global economic conditions improving, the outlook for FDI flows in 2004 to all three developing regions is favourable. Moreover, developing countries have taken additional steps to liberalize and reform their national and regional policy frameworks for FDI, and this too boosts prospects for increased inflows.

FDI flows to the least developed countries (LDCs) remained low. In the case of Africa's 34 LDCs, all except three oil-producing countries (Equatorial Guinea, Angola, the Sudan) received less than $1 billion dollars in 2003, with 26 of them receiving no more than $200 million. The same applied to Asia and the Pacific, where all but two of the region's 15 LDCs received less than $100 million in flows in 2003, and 11 of them less than $50 million. The only LDC in Latin America and the Caribbean, Haiti, continued to record a small amount of FDI. While flows to LDCs seem low, when viewed in relation to their gross fixed capital formation, they are more significant for their host economies than they are for other developing countries that have received larger absolute amounts of FDI: as a percentage of gross fixed capital formation in LDCs, FDI inflows amounted to 21% in 2003 (figure II.1), compared to 11% for other developing countries. Increasing these flows to assist the development efforts of LDCs remains an objective not only of national governments but also of the international community. This is reflected in both national policy-making in LDCs and international initiatives.

1. Africa: a turnaround

FDI inflows to Africa in 2003 grew by 28%, to $15 billion, in contrast to the fall in 2002 of 40%. But the volume was still below the peak recorded in 2001 (figure II.2). The recovery was led by investment in natural resources and facilitated by the continued liberalization of FDI policies. FDI inflows as a percentage of gross fixed capital formation also grew, from 12% in 2002 to 14% in 2003, the second highest level in the past decade (figure II.2). However, the picture varied for different countries: there was an increase in inflows in 36 countries and a decline in 17. The value of M&A sales also grew, from $4.7 billion in 2002 to $6.4 billion in 2003 (annex table B.8). The resource-rich countries

Figure II.1. LDCs: FDI inflows and their share in gross fixed capital formation, 1985-2003



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

were once again the main attraction for TNCs. Although Africa's potential for obtaining FDI through privatization has diminished in several countries, the prospects for 2004 are quite good, mainly because of bullish commodity markets (in diamonds, gold, oil, platinum). As regards outward FDI, Africa (except for South Africa) remains a minor player (chapter I).

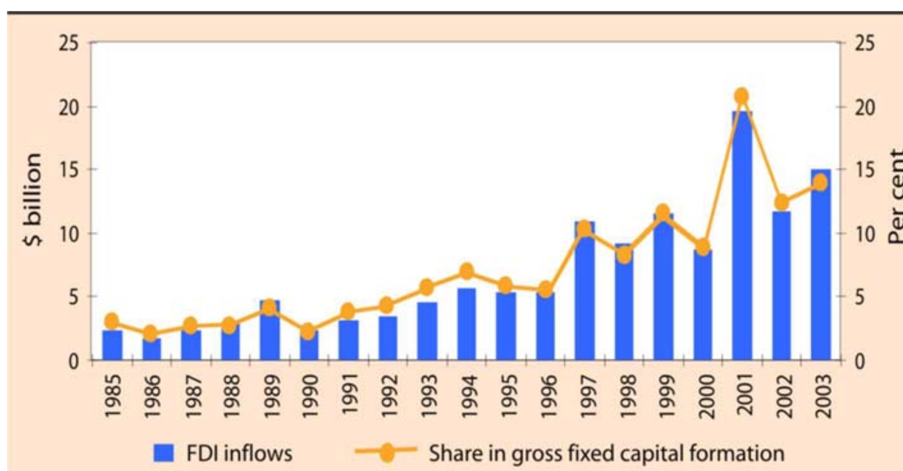
a. Inflows regain momentum

FDI inflows to Africa increased from $12 billion in 2002 to $15 billion in 2003. This performance was noteworthy for three reasons:

- The growth rate of 28% was higher than that of the other groups of countries, developed and developing.
- Several small African economies shared in the growth of FDI. As a result, the distribution of inflows was more broad-based than in any year since 1999, with 22 countries receiving more than $0.1 billion compared to 16 in 2001 (tables II.1 and II.2).
- Oil accounted for the bulk of the increase, especially in Equatorial Guinea.

A number of LDCs were among the top ten countries attracting the most FDI in 2003. These included Angola, Chad, Equatorial Guinea and the Sudan (figure II.3). Petroleum exploration and extraction received the most FDI in Algeria, Angola, Chad, the Libyan Arab Jamahiriya, Nigeria and the Sudan. The highest growth rates in inflows were registered in Djibouti, Equatorial

Figure II.2. Africa: FDI inflows and their share in gross fixed capital formation, 1985-2003



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

Table II.1. Africa: frequency distribution of host countries, by range of FDI inflows, 1999-2003
(Number)

Range	1999	2000	2001	2002	2003
More than $6 billion	–	–	1	–	–
$2-5.9 billion	1	–	2	–	1
$1-1.9 billion	3	1	2	4	4
$0.5-0.9 billion	3	3	3	4	5
$0.1-0.4 billion	11	17	8	14	12
$0-0.09 billion	32	30	35	30	31
Less than $0 billion	3	2	2	1	–
Total	53	53	53	53	53

Source: UNCTAD, based on annex table B.1.

Guinea, Kenya, the Libyan Arab Jamahiriya, Madagascar, Malawi and Morocco, where total inflows were at least twice higher in 2003 than in 2002 (annex table B.1).

Among the countries in the league of the top ten recipients, Morocco was the number one recipient (figure II.3): inflows rose from $480 million in 2002 to $2.3 billion in 2003, thanks to privatizations (e.g. Altadis, the Franco-Spanish tobacco group purchased the Régie des Tabacs Marocains for € 1.7 billion).

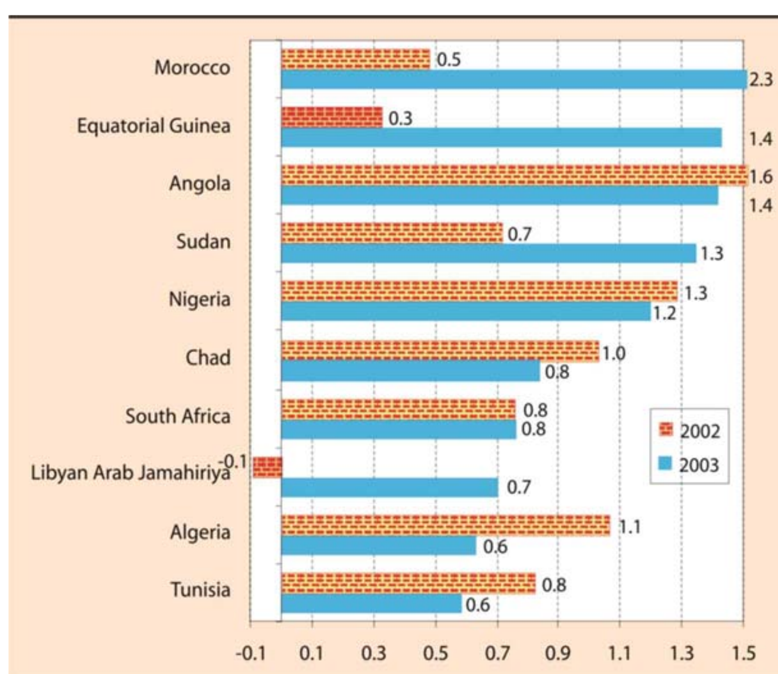
Based on UNCTAD's *Inward FDI Performance Index* in 2001-2003, the value for Africa was 1.2 in the period 2001-2003, up from

Table II.2. Africa: country distribution of FDI inflows, by range, 2003

Range	Economy
More than $2 billion	Morocco
$1-1.9 billion	Angola, Equatorial Guinea, Nigeria and the Sudan
$0.5-0.9 billion	Algeria, Chad, Libyan Arab Jamahiriya, South Africa and Tunisia
$0.1-0.4 billion	Cameroon, Congo, Democratic Republic of the Congo, Côte d'Ivoire, Egypt, Ghana, Mali, Mauritania, Mozambique, Uganda, United Republic of Tanzania and Zambia
Less than $0.1 billion	Benin, Botswana, Burkina Faso, Burundi, Cape Verde, Central African Republic, Comoros, Djibouti, Eritrea, Ethiopia, Gabon, Gambia, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mauritius, Namibia, Niger, Rwanda, São Tomé and Principe, Senegal, Seychelles, Sierra Leone, Somalia, Swaziland, Togo and Zimbabwe

Source: UNCTAD, based on annex table B.1.

Figure II. 3. Africa: top 10 recipients of FDI inflows, 2002, 2003[a]
(Billions of dollar)



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

[a] Ranked on the basis of the magnitude of 2003 FDI inflows.

0.7 in 2000-2002 (table I.4). Specifically, 24 countries improved their rankings, 3 remained the same and 9 saw a decline. Morocco performed best among African countries, improving its ranking from 62 in 2000-2002 to 32 in 2001-2003, an upward climb of 30 points. Most of this improvement can be attributed to more FDI-friendly policies in the country. On the *Inward FDI Potential Index*, 18[1] African countries improved their rankings, 2 achieved the same level[2] and 16 saw a fall (annex table A.I.7).[3] The last group included two countries (the Libyan Arab Jamihiriya and Nigeria) that were among the top ten recipients of FDI in Africa. Africa's inward FDI performance, however, is weak because key industries remain underdeveloped: the margin of under-performance is large mostly in some natural-resource-rich, particularly oil-producing, economies. This could change as trade preferences offered by the United States under its African Growth and Opportunity Act (AGOA) take effect and international sanctions on the Libyan Arab Jamahiriya come to an end.

From the perspective of financing Africa's development needs, FDI inflows continued to make up a large part of Africa's external resource receipts (figure II.4), at 46% of total external net resource flows in 2002. Average FDI inflows during 2000-2002 were higher than official net resource flows as well as portfolio and commercial bank loans combined (the latter were negative). Over the period 1990-2002, FDI inflows as a proportion of overall resource flows have thus gained some ground, albeit with fluctuations (figure II.4).

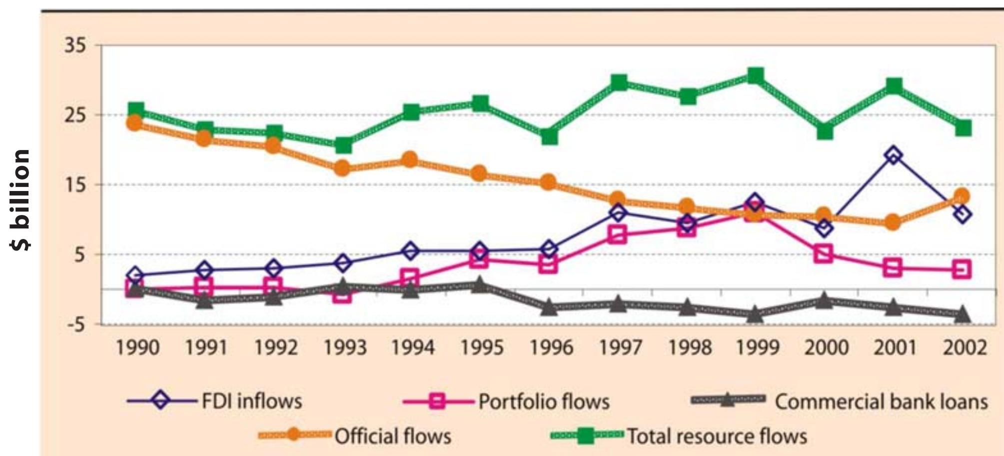
b. Policies increasingly liberal

African countries continued to liberalize their FDI policies, increase their efforts to attract more FDI or initiated action in these respects. Burundi, Kenya, Nigeria and Rwanda resumed economic reforms, privatization and liberalization, further reducing their restrictions on foreign investors. Much of the privatization was related to infrastructure development. The Rwanda Privatisation Secretariat, for instance, announced in November 2003 that Rwandatel, the State-owned telecom company, is to be sold, without any restriction on the participation by foreign investors. A number of other African countries also made changes in various aspects of their FDI policies (boxes II.1-II.3).

National efforts were complemented by the conclusion of BITs and DTTs. Of the 35 BITs concluded in 2003 by African countries, 13 were between African countries themselves; the rest were signed mainly with European countries (in particular, Italy, Luxembourg, the Netherlands, Switzerland). African countries also concluded nine DTTs, five of these between African countries and the others with Belarus, Germany, Oman and Ukraine. This brought the cumulative numbers to 567 BITs and 374 DTTs (figure II.5).

A number of negotiations were started in 2003 to establish FTAs between groups of African countries and other countries/regions, particularly the United States and EU (annex table A II.1). Also, the number of African countries designated as eligible for the benefits of the AGOA initiative

Figure II.4. Africa: total external resource flows, by type of flow, 1990-2002



Source: UNCTAD, based on World Bank 2004.

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

Box II.1. Africa: examples of FDI-related policy changes in selected countries, 2003-2004

- Algeria (box II.2), Benin, Botswana, Ghana, Kenya , Lesotho and Zambia[a] undertook, or are in the process of undertaking, Investment Policy Reviews (IPRs), with a view to improving their investment climate.
- Angola enacted a new law on private investment allowing projects to be undertaken with the participation of both domestic and foreign private investors.
- The Democratic Republic of the Congo adopted an investment law reinforcing its mining code and abolishing the previous requirement to approve investment projects in an ad hoc manner, often by the executive, or by various bodies acting without consultation.
- Djibouti introduced a new law on port operations barring foreign companies from key handling and transit operations in its international port, and limiting them only to undertake stevedoring and forwarding services at the port in conjunction with Djiboutian business partners.
- Ethiopia amended its investment law to allow the private sector to participate in all areas except electric power development and distribution, postal service delivery and air transport using over 20 seater planes, which are solely reserved for the Government. The new law allows foreign investors to generate power using wind, biomass and other sources - lifting earlier restrictions on them to invest only in the hydroelectric power generation. It also lowered the investment capital requirement for foreign investors from $500,000 to $100,000, further lowering the capital requirement to $50,000 for foreign investors launching projects in joint ventures. The law allows investors participating in production and service delivery to import their capital equipment free of tax, and spare parts with 15 % tax.
- Ethiopia, Mali, Mauritania (box II.3) and Uganda[b] published investment guides to attract foreign investors.
- The Libyan Arab Jamahiriya amended its law to encourage foreign capital investment; cancelled investment registration requirements in its industrial register and its registers of importers and exporters and established a separate incorporation and registration procedure for investment (see also box II.5).
- Madagascar has earmarked a number of operations for privatization (or is privatizing or offering concession management), including its fuel refining and distribution industry, Airlines (Air Madagascar), northern railway company, southern railway, telecommunications, cotton, sugar and electricity and water industries.
- Sierra Leone issued a petroleum law offering foreign and domestic investors generous fiscal terms: a 30% income tax and a 6.5% offshore royalty.

Source: UNCTAD, based on national sources.

[a] See, respectively, UNCTAD 2004d, UNCTAD forthcoming b, UNCTAD 2003b, UNCTAD 2003c, UNCTAD forthcoming c, UNCTAD 2004e, and UNCTAD forthcoming d.

[b] See, respectively, UNCTAD-ICC 2004a, UNCTAD-ICC 2004b,UNCTAD-ICC 2004c, UNCTAD-ICC 2004d.

Box II.2. Algeria: policy reforms may keep FDI high

Algeria was the third biggest FDI recipient in Africa in 2002, and the largest in the Maghreb region. This was mainly due to macroeconomic stabilization and economic liberalization implemented by the Government in the early 1990s. However, its FDI inflows declined by 40% in 2003 (from $1.1 billion in 2002 to $634 million in 2003). So far Algeria has not fully benefited from the downstream effects of FDI in terms of local enterprises' competitiveness, job creation, domestic capital and technology transfer. Historically, high levels of investment went to oil and gas exploration. More recently, steel, chemicals, pharmaceuticals and telecommunication have started to attract FDI.

An UNCTAD Investment Policy Review (IPR)[a] was undertaken in 2003 to help Algeria remove impediments to more stable FDI inflows. It encouraged the Government to continue its efforts at macroeconomic stabilization and economic liberalization, strengthen its regulatory framework and implement proactive strategies for

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Box II.2. Algeria: policy reforms may keep FDI high (concluded)

investment promotion, at the national and sectoral levels. In particular, whereas the Investment Code of 1993 and the Ordonnance 2001 achieved important goals,[b] the UNCTAD IPR suggested further reforms of the regulatory and institutional framework. Algeria could benefit from additional measures such as a modernized investment code, enhanced transparency in investment procedures and more effective judicial procedures, in particular in the area of arbitration.

The IPR also identified areas in which Algeria has good prospects to leverage its competitive advantage: ICT, electronics, mining, banking and finance, infrastructure and agribusiness. Promotional activities, including targeting, could help to attract high-quality FDI into these areas.

Several recommendations of the IPR were already implemented in 2004 in cooperation with UNCTAD. They include the use of an investor tracking software at the Agence nationale de développement de l'investissement, an evaluation of the Agency's needs in terms of proactive investment promotion techniques and capacity building in investor aftercare activities.

Source: UNCTAD 2004d.

[a] IPRs are intended to familiarize governments and the international private sector with an individual country's investment environment and policies. Apart from those mentioned in the text, IPRs have been completed for the following African countries: Egypt (1999a), Ethiopia (2002a), Mauritius (2001a), the United Republic of Tanzania (2002b) and Uganda (2000a).

[b] Restrictions on foreign ownership of capital no longer apply, the fundamental principle of freedom of investment and key international standards of treatment and protection were introduced, the right to repatriate profits is granted to foreign investors and an "Agence nationale de développement de l'investissement" was created.

Box II.3. Mauritania: better opportunities set to boost FDI

FDI inflows into Mauritania are small, although they have increased quite rapidly, from $118 million in 2002 to $214 million in 2003. FDI in the oil and telecom industries has accounted for most of the recent surge. Mauritania is an example of a country with potential for more FDI, where the Government is working to attract inflows into sectors that still remain unexploited. The recently completed investment guide on Mauritania by UNCTAD and the International Chamber of Commerce (ICC)[a] shows that the country's wealth lies primarily in seafood products and mining. Mauritania is also rich in mineral resources, notably iron ore, copper, cobalt, diamonds, gold, gypsum and phosphates, but so far only iron ore is being exploited industrially. Oil reserves are estimated at 140-180 million barrels, and production is scheduled to begin in 2005. The country has implemented a plan to enhance the capacity and competitiveness of the mining industry to attract FDI.

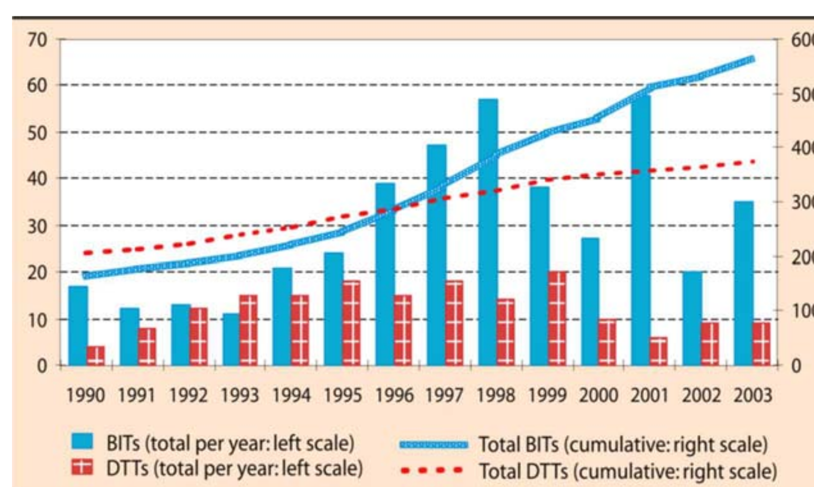
Mauritania's exclusive economic zone contains rich fishery resources. Current annual catch is 600,000 tons, but the estimated potential yield is 1.6 million tons per year. In 2001, the fishing agreement between the EU and Mauritania was renewed for another five years. Agriculture also offers investment opportunities, particularly because Mauritania is the tropical country closest to Europe, and could provide the European market with fresh produce. It also has considerable tourist potential: situated on the edge of the Sahara Desert, it offers magnificent dunes, over 700 kilometres of coastline, pristine beaches and rich cultural diversity. In addition, the country enjoys favourable access to international markets. Under the Cotonou Agreement, Mauritanian products are given non-reciprocal preferential treatment in EU markets. Furthermore, because of its LDC status, Mauritania is eligible for the advantages bestowed by the EU's Everything-but-Arms initiative and also qualifies for AGOA preferential treatment.

Source: UNCTAD-ICC 2004c.

[a] UNCTAD has published, in cooperation with the ICC, a series of investment guides on selected LDCs. Such guides provide information on general conditions, potential areas for investment and regulations governing investment in LDCs. Apart from those mentioned in the text, see also UNCTAD-ICC 2001, on Mozambique.

increased from 34 in 2000 to 37 in 2003.[4] At the end of 2003, 18 countries met the rules-of-origin required to take advantage of the provisions of the initiative.[5] Botswana and Namibia qualified for the "special provision" which permits lesser developed AGOA beneficiary countries to utilize fabric manufactured anywhere in the world, and a new bill, the AGOA Acceleration Act of 2004, was enacted to extend the overall programme until 2015.[6]

Figure II.5. Africa: number of BITs and DTTs concluded, 1990-2003



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

The AGOA Acceleration Act of 2004 improved the likelihood of TNCs already engaged in apparel and textile production in Africa to stay longer. However, unless African exporters increase their productivity, they still may not survive full global competition, in spite of continuing tariff advantages (Lall 2003). The fact that no other labour-intensive activities, such as footwear, toys, sports goods or electronics have moved to Africa suggests that it is primarily the quota system and high tariffs for apparel applied to other regions that are attracting FDI apparel production in Africa.

Additional measures were also taken to facilitate foreign investment. In September 2003, the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group and the African Trade Insurance Agency[7] started to offer risk insurance to long-term FDI in Africa for physical damage resulting from war and terrorism and for debt-related projects and trade transactions. As of June 2004, 46 African countries were members of MIGA, and three (Guinea-Bissau, Liberia, Niger) were in the process of fulfilling membership requirements.

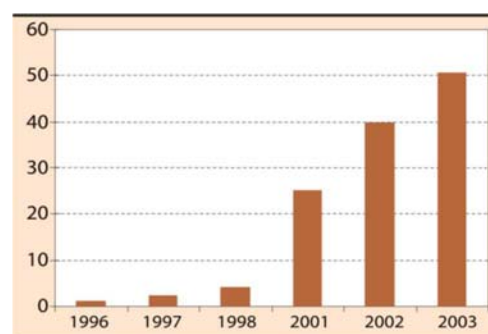
c. Natural resources and services dominate

Depending on the country, 50-80% of FDI in Africa is in natural-resource exploitation. FDI in manufacturing and agriculture in the region lags behind that in services, with some exceptions. In Mozambique, for example, BHP Billiton (South Africa) is building a second aluminium plant for $1 billion, and in South Africa, the Council for Scientific and Industrial Research (CSIR) and the Boeing Company inaugurated the world's first Ka band telemetry, tracking and command facility.

FDI in services is increasing, particularly in telecommunications, electricity, management and trade. A large part of the increase is attributable to privatization programmes. FDI in telecommunications was mainly in mobile phone services. In South Africa, FDI in telecommunications and information technology has overtaken that in mining and extraction. The number of Africans subscribing to mobile phone services, mostly offered by TNCs (box II.4), grew from 1.2 million in 1996 to 51 million in 2003 (figure II.6).

Non-equity relations between State-owned firms and TNCs are also increasing in the services sector. For example, the Government of

Figure II.6. Africa: mobile phone subscribers, 1996-2003
(Millions of subscribers)



Source: ITU (www.itu.int/ITU-D/ict/statistics).

Box II.4. Private mobile operators in Africa

While fixed-line telecommunications remain largely in the hands of State-owned incumbents in Africa, mobile telecommunications are largely offered by private operators. Some are affiliates of global firms (e.g. Vodafone, France Télécom/Orange), but many are affiliates of TNCs based in Africa (e.g. MTN, Orascom – box table II.4.1). Both types of firms are investing in other African countries. The six largest African mobile operators cover 28 African economies and had more than 33 million subscribers in 2003, representing two-thirds of the total for Africa (ITU 2004, p. 5). These market leaders have shown a strategic interest in investing within Africa. They have experience and resources to tackle large markets such as Algeria, the Democratic Republic of the Congo, Nigeria and Tunisia. They are gradually moving away from the high-end subscribers, reaching larger groups of residential clients, outside capital cities.

The largest mobile operators of the region are relatively profitable on their African segment, partly due to the fact that they are not saddled with high debts as a result of excessive bids for licences to offer third generation (3G) mobile services (ITU 2004, p. 5). The profitability of the five operators, for which geographical segment information is available, reached an average of almost 12% in 2003 in Africa (box table II.4.1).

Some of the region's smaller and riskier markets tend to attract lesser known TNCs. For example, the Lebanese Investcom has started mobile operations in Burundi, Congo, Ghana, Guinea and Liberia. Telkom Malaysia in turn has acquired mobile operations through participations in South Africa and Guinea.

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Source: UNCTAD, based on ITU 2004.

the United Republic of Tanzania contracted Eskom of South Africa to manage the Tanzania Electricity Supply Company. The Nigerian National Electric Power Authority also signed a partnership agreement with Eskom to develop its repair capabilities, execute transmission line projects and participate in rehabilitation, operation and transfer projects. This is part of the gradual effort to privatize electricity in the country. In Zimbabwe, the State-owned utility has awarded Eskom a contract to manage its main power station.

However, the privatization of services has faced problems, particularly owing to the absence of adequate regulatory frameworks. For example, in Guinea, the electricity company was returned to State control in 2002 following the departure of its foreign partners, Saur of France and HydroQuébec of Canada, due to regulatory difficulties (EIU 2003). In Ghana, Telekom Malaysia's management contract was not renewed after the company apparently failed to meet targets for installing telephone lines and improving the infrastructural and financial base of the company in 2003. In Rwanda, the Engen Corporation (South Africa/Malaysia) left just three years after its arrival for reasons attributed to a difficult operating environment (EIU 2003).

d. Prospects are positive

UNCTAD projects FDI inflows in Africa to increase further in 2004. A large part of this increase will come from investment in natural resource exploitation, and will be driven by higher economic growth, a buoyant global commodities market and improving investor perceptions.

Higher economic growth forecast for sub-Saharan Africa in 2004 (4.2% according to the IMF (2004)) underlies the expected improvement in the level of FDI. Strengthened growth in South Africa, in particular, will be important, especially since South Africa is becoming an important source of FDI for the region. In North Africa, privatization drives in the Libyan Arab Jamahiriya and Egypt will help attract FDI. The extension of AGOA (AGOA Acceleration Act 2004), as well as the allowance for the 37 participating African countries to continue importing raw materials from elsewhere (typically Asia) in order to manufacture final

Box table II.4.1. Africa's largest mobile operators, ranked by the number of subscribers in the region, 2003

Firm	Vodacom[a]	MTN Group	Orascom Telecom	Orange	Celtel International	Millicom International	Total
Headquarters	South Africa	South Africa	Egypt	France	Netherlands	Luxembourg	
Ownership	Vodafone (35%), Telcom SA[b] (50%), VenFin (South Africa; 15%)	Private owners (55%)[c], publicly traded shares (45%)	Privately owned	France Télécom (99%)	Institutional investors[d]	Kinnevik (Sweden, 35%); rest is publicly traded	
Subscribers (million)	10.2	8.9	5.6	5.6	2.5	0.7	33.5
Revenue ($ million)	2 482	2 434	1 119	..	446	85	6 566
Profits ($ million)	278	258	123	..	74	36	769
Profitability (%)	11.2	10.6	11	..	16.6	42	11.7
Number of countries in Africa	5	6	7	5	13	5	28
Host countries	Democratic Republic of the Congo, Lesotho, Mozambique, United Republic of Tanzania	Cameroon, Nigeria, Rwanda, Swaziland, Uganda	Algeria, Chad, Congo, Democratic Republic of the Congo, Tunisia, Zimbabwe	Botswana, Cameroon, Côte d'Ivoire, Egypt, Madagascar	Burkina Faso, Chad, Congo, Democratic Republic of the Congo, Gabon, Kenya (2004), Malawi, Niger, Sierra Leone, Sudan, United Republic of Tanzania, Uganda, Zambia	Ghana, Mauritius, Senegal, Sierra Leone, United Republic of Tanzania	

Source: UNCTAD, partly based on ITU 2004, p. 5.

[a] Financial data refer to fiscal years ending in March.

[b] Thintana Communications, a consortium of SBC Communications (United States) and Telekom Malaysia, owns 30% of Telcom SA. The Government of South Africa owns 39.3%. The rest is subscribed by portfolio investors.

[c] Johnnic, an investment holding company (South Africa, 36%), ICE Finance, an investment company (Netherlands, 18%), others (1%).

[d] AIG Infrastructure Fund, African Merchant Bank, Blakeney Management, Bessemer Venture Partners, Capital International, CDC Capital Partners, Citigroup, Communication Venture partners, Corporacion Financiera Alba, DEG, FMO, Fonditel, International Finance Corporation, Old Mutual, Palio, Standard Bank of London, Zephyr Management, LP Fund.

products for another three years will also contribute to the region's FDI appeal.

As to commodities, oil prices rose by over 40% in the period 2003-2004, and prices of gold, diamonds and platinum have also been quite high.[8] As a result, such natural-resource-rich countries as Algeria, Angola, Equatorial Guinea, the Libyan Arab Jamahiriya, Mauritania, Mozambique, Nigeria and the Sudan are expected to receive more FDI. For example, ExxonMobil Corporation has announced contracts worth $1.7 billion for an offshore project in Nigeria; the French-owned Total Oil Nigeria PLC has announced plans to invest about $10 billion in the Nigerian oil industry over the next six years. The large coal deposits in Enugu in Eastern Nigeria are also attracting foreign investors. Oil TNCs are re-entering the Libyan Arab Jamahiriya as international sanctions end (box II.5).

In the longer term, structural problems, such as low labour productivity and insufficient infrastructure, will hamper the growth of FDI, especially in export-oriented manufacturing. Policies for human resource development and capacity building are imperative, as are incentives for firms to invest more in export-oriented manufacturing. Some progress has been made in this respect as far as the latter is concerned, in response to the various preferential trade arrangements in place. But there is scope for improvement.

Surveys of the investment community also give rise to cautious optimism (e.g. UNIDO 2003). One-fifth of the respondents to UNCTAD's 2004 survey of the world's largest TNCs (UNCTAD 2004c) expected FDI in Africa to increase in 2004-2005, with two-thirds expecting flows to remain steady (figure II.7). TNCs perceived South Africa to be the most attractive destination for FDI, with Egypt, Morocco and Nigeria also ranking high (UNCTAD 2004c). The survey of international location experts conducted by UNCTAD (UNCTAD 2004a) showed South Africa as the most attractive country, followed by Angola and the United Republic of Tanzania. According to these experts, foreign investors saw opportunities in non-metallic products, food and beverages, and textiles and clothing; in the services sector,

Box II.5. The Libyan Arab Jamahiriya: the end of sanctions and the resumption of FDI

After the United Nations imposed sanctions in 1992, most investors abandoned or withdrew their assets from the Libyan Arab Jamahiriya. With an end to sanctions, the country may become a major destination for FDI, owing to its large reserves of oil.

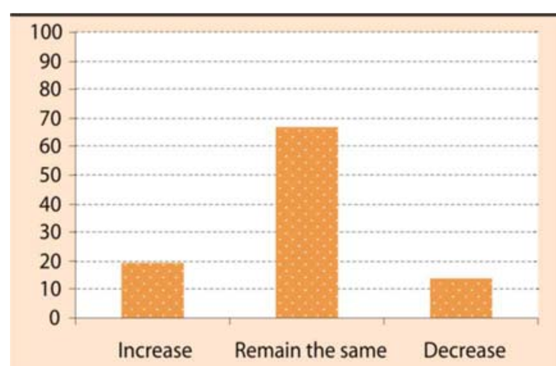
United States oil companies – key investors prior to the sanctions – are now allowed to hold talks on standstill agreements covering assets they hold in the country that they have been unable to operate since 1986. India's ONGC Videsh (OVL) has joined hands with the Turkish Petroleum Overseas Company for a project in the country. Norsk Hydro (Norway) already has activities in oil and energy production, while Statoil (Norway) is considering exploration and development possibilities.[a] Tekhnopromexport (Russian Federation), LG Petrochemicals (Republic of Korea) and Abengoa and Cobra (Spain) are engaged in electricity and power generating projects worth over $1.5 billion. The construction of a $10 billion project to carry Egyptian natural gas to the Libyan Arab Jamahiriya for power generation and water desalination, and another to carry oil from the country to Alexandria in Egypt, is under way. An affiliate of Eni (Italy) has a $500-$550 million contract to build and install an offshore natural gas platform northwest of Tripoli, while a consortium led by Japan's JGC, and including France's Sofregaz and Italy's Technimont, has contracts worth $1 billion for engineering, procurement and construction. Based on the value of active projects, it is estimated that the Libyan Arab Jamahiriya will attract $6-7 billion of FDI in 2004-2005.[b]

Source: UNCTAD, based on information from the United States Energy Information Administration/Department of Energy and other sources.

[a] webbolt.ecnext.com/coms2/description_ 25077_STATOIL310304_TRN.

[b] Estimates based on 60-70% of the projects already awarded to TNCs and due for completion before 2005 in oil refineries for $3.5 billion, power generation for $2 billion and the West Libya gas project for $5.6 billion. The Libyan Arab Jamahiriya does not allow 100% private foreign ownership; the usual share is 30-40% State ownership.

Figure II.7. Africa: prospects for FDI inflows, 2004-2005, as reported by TNCs
(Per cent of respondents)



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

they identified energy services and banking and insurance.

IPAs will do what they can to attract new investment, especially by intensifying investor targeting, introducing more incentives to lure investors and further liberalizing their investment regimes (figure II.8). In doing so, they expect to look to new sources of FDI. South Africa and China were most frequently mentioned (UNCTAD 2004b). But, of course, the traditional ones (e.g. the United Kingdom, France) will remain important.

To conclude, 2003 was better than 2002 for FDI inflows into Africa, and prospects for the immediate future are promising. The structure of FDI in Africa remains skewed towards primary products, although inflows to services are rising. International initiatives such as AGOA, the Everything-but-Arms Initiative, the ACP-EU Cotonou agreements and New Partnership for Africa's Development (NEPAD) could help boost the region's FDI performance. African IPAs appear focused on greater targeting as a preferred policy measure to attract more FDI, but low labour productivity in the region is constraining FDI in export-oriented manufacturing. To change this situation, governments need to pursue policies for human resource development and capacity building, improve the infrastructure in key areas and provide better incentives for firms – domestic and foreign – to invest more in export-oriented manufacturing. Official development assistance has an important role to play here, especially in LDCs.

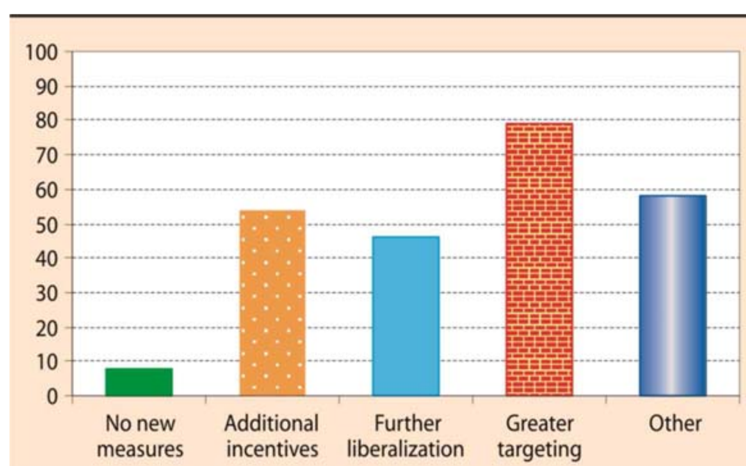
2. Asia and the Pacific: a rebound

a. A mild upturn

FDI flows to the region rebounded in 2003. Total inflows rose from $94 billion in 2002 to $107 billion in 2003, ending the downturn that started in 2001. However, the pattern was uneven. High-growth economies attracted more FDI, aided by their improving economic and policy environment, while countries suffering from political tensions attracted less. The outbreak of the Severe Acute Respiratory Syndrome (SARS) had only limited effects on FDI inflows. Out of 55 economies for which data are available, 34 received higher flows than in 2002, and 21 lower inflows (annex table B.1). Regional integration is encouraging intraregional investment and facilitates the expansion of production networks by TNCs. The policy framework for FDI continued to improve. Prospects are promising, owing to an upturn in the global economy, a healthier outlook for key industries and favourable subregional developments and country-specific factors.

Asia and the Pacific attracted more FDI than most other regions, thus remaining the largest recipient of FDI in the developing world. FDI inflows as a percentage of gross fixed capital formation rose, from 8% in 2002 to 9% in 2003 (figure II.9). But FDI remained concentrated: ten economies accounted for about 90% of all inflows. The distribution of flows by size and range of inflows has been largely stable, with the majority of economies receiving less than $1

Figure II.8. Africa: expected policy measures to attract FDI, 2004-2005, as reported by IPAs
(Per cent of respondents)

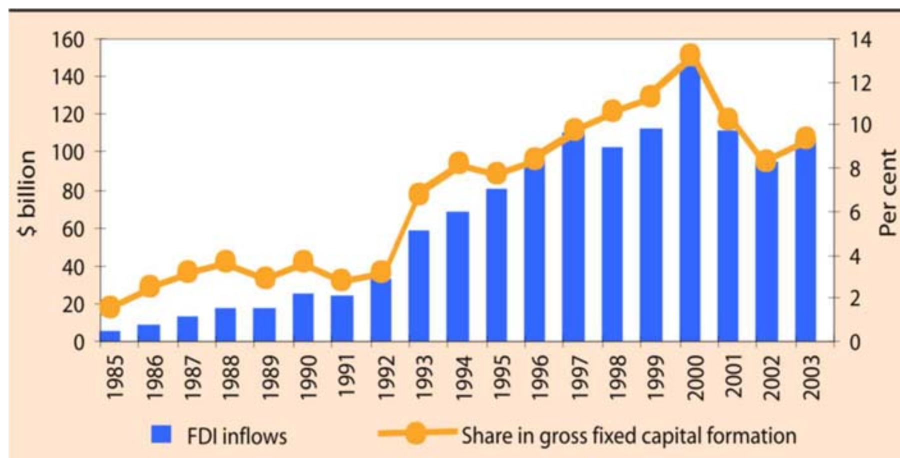


Source: UNCTAD (www.unctad.org/fdiprospects).

billion (tables II.3 and II.4). However, UNCTAD's Performance Index indicates that some of the smaller economies received proportionately more FDI (annex table A.1.5). The top ten recipients in 2003 were headed by China, Hong Kong (China), Singapore, India and the Republic of Korea, in that order (figure II.10).

The following are some salient features of the subregional distribution of FDI inflows in 2003:

Figure II.9. Asia and the Pacific: FDI inflows and their share in gross fixed capital formation, 1985-2003



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

- Flows to *North-East Asia*[9] rose from $67 billion in 2002 to $72 billion in 2003. Falling inflows to Macao (China) and Taiwan Province of China (partly because of SARS) were partially offset by higher flows to China,[10] Hong Kong (China), the Republic of Korea and Mongolia. The significant increase in cross-border M&As in Hong Kong (China), from $1.9 billion in 2002 to $6.1 billion in 2003, mitigated a downturn in flows to that economy (annex table B.7). In the Republic of Korea, FDI was driven by large M&As in finance (e.g. Lone Star Fund (United States) acquired a 51% stake of Korea Exchange Bank for $1.2 billion) and telecommunications (e.g. Investor Group (United States) purchased a 40% stake of Hanaro Telecom for $0.5 billion).
- Excluding Luxembourg,[11] China was the largest FDI recipient in the world, with inflows of $53.5 billion. The number of cross-border M&As in China increased from 107 in 2002 to 214 in 2003,[12] contributing to the surge in FDI flows. Relocation of investment to and expansion of operations in China by TNCs remained strong. It is not clear how a revaluation of the yuan – if it were to take place – would affect FDI inflows. Much would depend on the extent of a revaluation, and the response of the Chinese economy and of TNCs to the resulting changes in import costs and export prices.
- Regional economic growth and an improved investment environment contributed to a 27% increase in FDI flows to *South-East Asia,* which comprises countries of the *Association of South-East Asian Nations (ASEAN)*,[13] from $15 billion in 2002 to $19 billion in 2003. The impact of SARS on FDI flows to the region was limited.[14] Flows to Brunei Darussalam,[15] Singapore, Thailand and Viet Nam rose thanks to improved economic conditions and better investment climates. The magnitude of disinvestment in Indonesia was considerably smaller than that of 1999-2001. The successful privatization of a number of State assets (e.g. Bank Danamon, Bank International Indonesia) generated $0.6 billion in FDI (equity flows) in 2003, mitigating an otherwise sizeable decline. Repayments of intra-company loans by foreign affiliates fell in the subregion.
- *South Asia*[16] received $6.1 billion in FDI, up from $4.5 billion in 2002. FDI to India,

Table II.3. Asia and the Pacific: frequency distribution of host economies, by range of FDI inflows, 1999-2003
(Number)

Range	1999	2000	2001	2002	2003
More than $5 billion	5	4	3	3	3
$2-4.9 billion	3	4	6	4	6
$1-1.9 billion	3	3	2	7	3
$0-0.9 billion	38	38	40	39	41
Less than $0 billion	8	8	6	4	4
Total	57	57	57	57	57

Source: UNCTAD, based on annex table B.1.

Table II.4. Asia and the Pacific: economy distribution of FDI inflows, by range, 2003

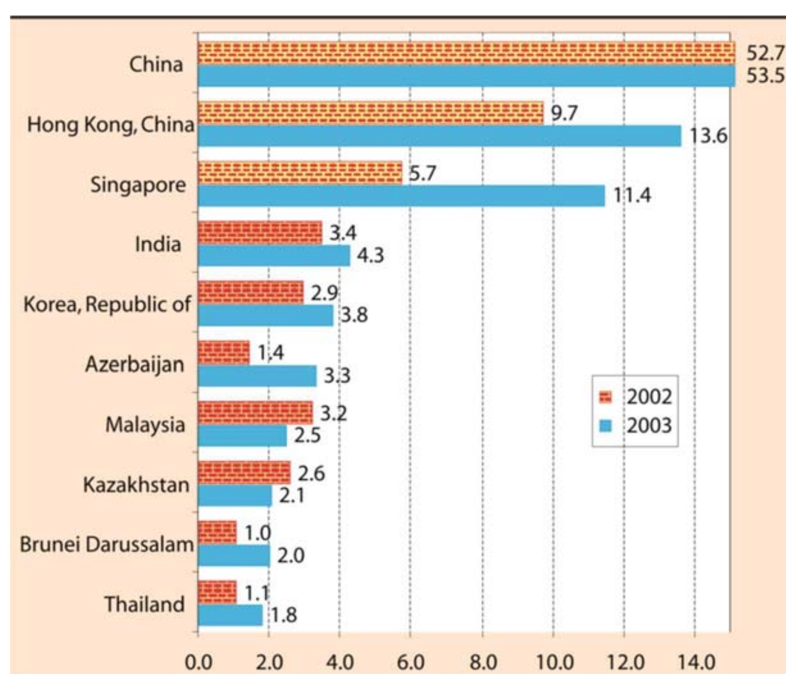
Range	Economy
More than $5 billion	China, Hong Kong (China) and Singapore
$2-4.9 billion	Azerbaijan, Brunei Darussalam, India, Kazakhstan, Republic of Korea and Malaysia
$1-1.9 billion	Pakistan, Thailand and Viet Nam
$0-0.9 billion	Afghanistan, Armenia, Bahrain, Bangladesh, Bhutan, Cambodia, Cyprus, Fiji, Georgia, Islamic Republic of Iran, Iraq, Jordan, Kiribati, Kuwait, Kyrgyzstan, Lao People's Democratic Republic, Lebanon, Macao (China), Maldives, Mongolia, Myanmar, Nepal, New Caledonia, occupied Palestinian territory, Oman, Papua New Guinea, Philippines, Qatar, Samoa, Saudi Arabia, Sri Lanka, Syrian Arab Republic, Taiwan Province of China, Tajikistan, Tonga, Turkey, Turkmenistan, Tuvalu, United Arab Emirates, Uzbekistan and Vanuatu
Less than $ 0 billion	Indonesia, Democratic People's Republic of Korea, Solomon Islands and Yemen

Source: UNCTAD, based on annex table B.1.

the dominant host country in this subregion, grew by 24%, reflecting its strong growth and continued liberalization. The services sector, in particular information and communication technology (ICT) industries, was the most dynamic for FDI inflows (see Part Two). Except for Afghanistan and Bhutan, flows to the other countries rose, and significantly so in Bangladesh, Nepal and Pakistan. In Sri Lanka privatization helped boost FDI flows.[17]

Figure II.10. Asia and the Pacific: top 10 recipients of FDI inflows, 2002, 2003 [a]

(Billions of dollars)



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

[a] Ranked on the basis of the magnitude of 2003 FDI inflows.

- *Central Asia*[18] also recorded an increase in FDI inflows, from $4.5 billion to $6.1 billion. Resource-rich countries such as Azerbaijan attracted more FDI than others, mostly in oil and gas. Georgia and Kyrgyzstan also received higher flows. Those to Kazakhstan declined by 20%, from $2.6 billion in 2002 to $2.1 billion in 2003.
- Additional investment in oil contributed to the upturn in FDI flows to *West Asia,*[19] from $3.6 billion in 2002 to $4.1 billion in 2003. The increase in flows to Bahrain, Jordan, Kuwait, Oman and Saudi Arabia accounted for much of the subregion's improved performance. However, regional tensions and uncertainty are likely to have held back a higher increase. And the subregion continues to face competition from locations in Africa and Central Asia.
- Flows to the *Pacific islands* doubled, from $0.1 billion in 2002 to $0.2 billion in 2003, with most countries benefiting from higher inflows. Papua New Guinea in particular, saw a sharp rise in flows from $21 million in 2002 to $101 million. The increase in M&As in this country, amounting to $82 million (up from $28 million in 2002), was the main explanation.

One common element stands out: countries with high economic growth, such as China, India and some ASEAN countries, generally attracted more FDI.

Unlike in Latin America in the 1990s, privatization has not been a major factor driving FDI in the Asia-Pacific region. Most FDI in Asia is in the form of greenfield investment. However, some countries – India, Indonesia, the Republic of Korea, Pakistan, Turkey – have increased their efforts to privatize State assets (including through FDI) in order to raise revenue and strengthen industrial development.

Intra-regional investment is expanding, in part because of the shift of production from higher to lower cost locations. FDI within and between North-East[20] and South-East Asian economies accounted for 49% of flows in these subregions in 2001-2002, up from 38% in 1999-2000. Regional integration arrangements also influenced investment within them and accelerated the process of knitting the subregions into more widespread production networks (*WIR03* p. 47, p. 51; Wee and Mirza 2004; Ernst 2004). With regard to outward FDI, China and India are becoming relatively important investors (chapter I), joining Malaysia, the Republic of Korea, Taiwan Province of China and Singapore.

b. Policies improved further

The policy environment in Asia and the Pacific continued to become more FDI friendly in 2003 and early 2004 (box II.6). A total of 26 economies introduced favourable national policy measures in 2003, compared to 23 in 2002.

The number of BITs and DTTs concluded by economies in Asia and the Pacific declined in 2003: 36 BITs and 23 DTTs were concluded, compared to 45 and 27, respectively, in 2002 (figure II.11). To mention a few, Viet Nam signed BITs with Japan and the Republic of Korea, and a DTT with Pakistan; India signed BITs with Armenia, Djibouti, Hungary and the Sudan; Hong Kong (China) signed DTTs with Belgium, Germany, Macao (China), Norway and Singapore; and China signed a DTT with Kazakhstan. Most of the economies in the region had already concluded BITs and DTTs with principal home countries in previous years, with the number of such treaties peaking in 1996 and 1997.

More countries are cooperating and promoting FDI jointly within regional or bilateral arrangements in Asia and the Pacific.[21] More regional FTAs or economic arrangements with investment components were concluded or launched (annex table A.II.1), with ASEAN leading in both regional and bilateral FTAs.

c. Services FDI on the rise

As in the world as a whole, the sectoral composition of FDI is changing in Asia as well. The share of the primary sector remained stable (at 5%) with oil and gas, in particular, attracting FDI. The share of manufacturing fell (from 57% in 2002 to 53% in 2003);[22] weak corporate earnings and demand for semiconductors persisted until mid-2003 and deterred investment in electronics and telecom equipment. While manufacturing attracted the bulk of FDI in some countries (e.g. China) in 2003, the share of services rose in FDI inflows into many other economies, a major proportion going to the newly industrializing economies[23] and to ASEAN as a region.

As a result, the share of services in Asia's total FDI stock increased from 43% in 1995 to 50% in 2002 (table II.5). For instance, the share of services in total FDI flows in ASEAN increased from 30% in 2002 to 48% in 2003 and in the Republic of Korea from 65% in 2002 to 72% in 2003. These economies are becoming increasingly service-oriented and are creating an efficient infrastructure for such services as finance, telecoms and commerce.[24] FDI in services has also grown in lower income countries (e.g. Bangladesh and Pakistan) because of higher investment in infrastructure and utilities. In India and the Philippines, it has grown in particular in IT-related services (chapter IV).

Within services, more than half of FDI goes to finance, transport, telecommunications and business services. Tourism is also an important industry in countries such as Cambodia (Chenda 2004), Thailand (Tantraporn 2004) and the Pacific islands. Competition for FDI in high-value-added services (e.g. regional headquarters, R&D) is becoming more intense among economies in North-East Asia (e.g. Hong Kong (China), the Republic of Korea) and South-East Asia (e.g. Malaysia, Singapore, Thailand).[25]

Cross-border M&A sales in services increased by half, up from $9.5 billion in 2002 to $14.3 billion in 2003, adding to the rise in services FDI in Asia. The lion's share of the increase was in North-East and South-East Asia, where M&A sales in finance grew by 1.4 times

Box II.6. Asia and the Pacific: examples of efforts to improve the investment climate, 2003-2004

- Cambodia shortened the processing time for investment proposals from 45 working days to 28 working days. It also amended the Law on Investment to increase transparency, predictability and the attractiveness of the country for FDI. It published an investment guide in 2003 to make investment opportunities and conditions better known (box II.7).
- China opened its finance and travel industries to foreign investment, and the country's Guizhou province opened 13 industries to FDI. It allowed, for the first time, the establishment of educational institutions jointly operated by foreign and domestic investors or institutions. It also cancelled a first batch of investment approval requirements for 789 items (box II.10). A Closer Economic Partnership Arrangement agreement was signed with Hong Kong (China) in 2003, which provides certain privileges to Hong Kong (China) firms investing in the mainland (box II.8). A similar agreement was also signed with Macao (China).
- Indonesia signed double taxation agreements with several countries and allowed FDI in more industries.
- Kazakhstan enacted a new law on investment on 8 January 2003. The law regulates FDI in the country and contains provisions for the protection of investment, as well as incentives and State support for investment.
- Malaysia further liberalized equity ownership and expatriate employment policies in manufacturing.[a]
- An IPR of Nepal was undertaken (UNCTAD 2003b), and an investment guide to promote the country's investment opportunities and conditions was published (box II.7).
- The Republic of Korea established a free economic zone (FEZ) Committee to coordinate policies relating to the design, development and operation of FEZs in the country. It also announced a strategy to attract TNCs' regional headquarters and a seven-year tax exemption to foreign businesses involved in high-tech services. It opened non-domestic legal services to foreigners.
- Pakistan introduced additional tax incentives for foreign investors and established the Pakistan Intellectual Property Rights Organization.
- Saudi Arabia opened up more industries to FDI, including electricity, gas transmission and distribution, education and pipeline services. Restrictions on FDI in some telecom industries such as Internet and e-mail service provision, and data and message transmission services, were removed.
- An IPR of Sri Lanka was undertaken with a view to improving its investment climate (UNCTAD 2004f).
- Viet Nam established a Foreign Investment Bureau to attract FDI. The Bureau, located in the Ministry of Planning and Investment, supervises foreign investment activities and reviews and improves the country's foreign investment policy. Viet Nam also revised the Law on Corporate Income Tax in July 2003, to create a fair and equal playing field for domestic and foreign enterprises.

Source: UNCTAD.

[a] Foreign equity holdings up to 100% are allowed for all new projects as well as investments in expansion/diversification projects by existing companies, irrespective of the level of exports, with the exception of industries contained in the Sensitive List. In addition, expatriate posts will be granted automatic approval.

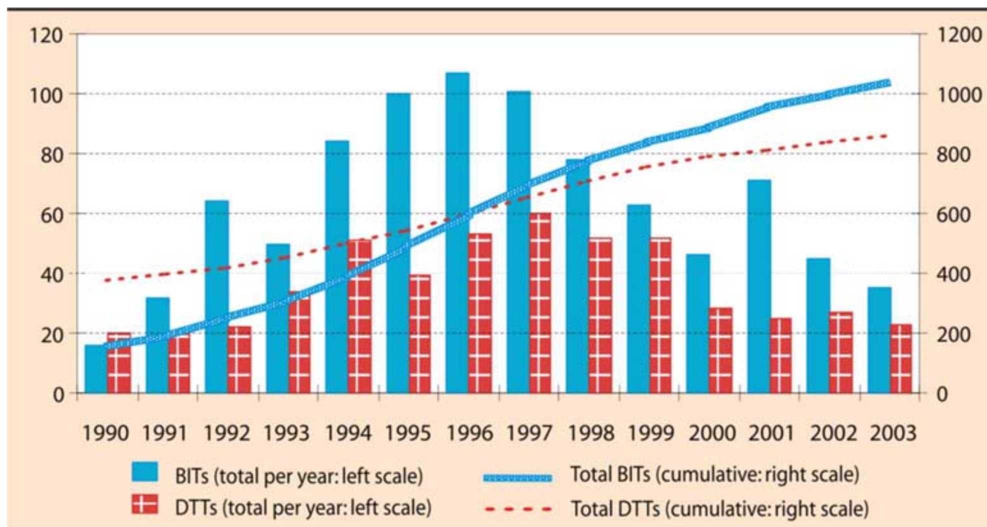
Box II.7. Cambodia and Nepal: investment guides highlight opportunities

Cambodia is perhaps the most open economy among the world's 50 LDCs, and a good deal more open than most of its neighbours. *An Investment Guide to Cambodia,* published in October 2003 by UNCTAD and ICC, includes a description of a number of steps the country has taken to improve its investment environment. These include revisions of its laws on investment and taxation, and legal reform more generally. Cambodia has been quite successful in attracting FDI in the garments industry (which dominates the country's exports) and the tourism industry (which benefits from the attraction of Angkor Wat). Other opportunities can be found in infrastructure development, hydropower and agro-processing.

Nepal is another country that has been moving towards creating a more hospitable environment for foreign investors. It has renewed its trade treaty with India, guaranteeing most Nepali manufactures duty-free access to the Indian market, and put in place a relatively liberal FDI regime by South Asian standards. The investment potential in a number of areas, as described in UNCTAD's *An Investment Guide to Nepal* (March 2003), is high. In hydropower, the generation of 44,000 MW is thought to be economically feasible, and in tourism the country has spectacular natural assets and attractive cultural ones. The range of climates from the sub-tropical to sub-arctic offers remarkable opportunities for niche agricultural products such as medicinal herbs.

Source: UNCTAD-ICC 2003a, 2003b.

Figure II.11. Asia and the Pacific: number of BITs and DTTs concluded, 1990-2003



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

Box II.8. The Closer Economic Partnership Arrangement between China and Hong Kong (China)

The Closer Economic Partnership Arrangement between China and Hong Kong (China) was signed on 29 June 2003. Under it, Hong Kong (China) firms benefit from zero tariffs on a wide range of products exported to the mainland, subject to meeting the Hong Kong (China) rules-of-origin requirements. Eighteen service industries are being opened to Hong Kong (China) firms, starting 1 January 2004, with value-added telecom services having been opened on 1 October 2003. The Arrangement involves the progressive elimination of tariff and non-tariff barriers to trade in goods, liberalization of trade in services and the promotion of trade and investment between the two economies.

In the area of services, foreign service suppliers residing in Hong Kong (China) will enjoy preferential treatment under the Arrangement, provided they have been engaged in substantive business operations in Hong Kong (China) for a specific period of time and satisfy the following conditions: (i) have been incorporated in Hong Kong (China) for three to five years (depending on the industry); (ii) are liable to pay a profits tax; (iii) own or rent premises in Hong Kong (China) to engage in substantive operations; and (iv) employ at least 50% of staff resident in Hong Kong (China). The service industries cover accounting, advertising,[a] audiovisual, banking, organizing of conventions and exhibitions, construction and real estate, distribution (excluding tobacco), freight forwarding agency, insurance, legal, logistics, management consultancy, medical and dental, securities, storage and warehousing, telecommunications, tourism and transport.

While it is too early to assess how the Arrangement will affect the extent of flows of FDI in services to mainland China, its liberalization commitments are expected to lead to higher services FDI. In particular, the Arrangement could create a “first-mover advantage” for eligible Hong Kong (China) investors in sensitive service industries.[b] It could also result in a “channelling effect”, whereby foreign firms may invest in the mainland via Hong Kong (China) in order to benefit from the privileges provided by the Arrangement. For instance, Standard Chartered bank plans to incorporate its business in Hong Kong (China), rather than operating a branch there, to qualify eventually for the benefits accorded by the Arrangement when it invests indirectly in the mainland.[c]

Source: UNCTAD.

[a] Star TV (controlled by Rupert Murdoch) was one of the first well-known TNCs to take advantage of this opportunity when it received permission in July 2004 to establish a wholly-owned affiliate in the mainland (*Financial Times*, 6 July 2004).

[b] The market liberalization commitments under the Agreement offer further benefits to Hong Kong (China) companies in terms of lower entry thresholds in a number of service industries such as management consulting, freight forwarding and banking.

[c] “Business Digest”, *Far Eastern Economic Review*, 29 January 2004, p. 23.

Table II.5. Asia and the Pacific: distribution of FDI stock, by industry, selected Asian economies, 1995, 2002
(Per cent)

	1995				2002			
Economy	Primary	Manufacturing	Services	Unspecified	Primary	Manufacturing	Services	Unspecified
Armenia[a]	..	..	..	..	6.9	17.7	70.8	4.6
Bangladesh	9.1	69.9	5.3	15.7	..	..	..	..
China[b]	1.6[c]	58.5[c]	36.1[c]	3.8[c]	1.9	63.3	31.4	3.4
Hong Kong, China	-	8.3	91.7	-	-	2.8	93.0	4.3
India	7.9	83.4	8.7	-	..	..	..	..
Indonesia	18.2	64.5	17.2	-	..	..	..	..
Kazakhstan	62.9	20.9	3.3	12.9	68.1	7.4	24.5	-
Macao, China[d]	..	..	..	..	..	12.6	87.4	-
Malaysia[e]	4.5	52.7	33.5	9.3	24.0	38.0	38.0	-
Mongolia[f]	18.0	30.4	51.3	0.3	28.2	22.0	41.3	8.5
Pakistan[g]	2.1	24.5	73.4	-	6.1	22.2	71.7	-
Philippines	17.0	55.0	28.0	-	10.9	39.3	43.9	5.9
Republic of Korea	0.2	62.2	35.2	2.4	0.5	57.4	42.0	0.1
Singapore[h]	-	38.2	61.7	-	..	36.1	63.8	-
Sri Lanka[i]	-	56.8	43.2	-	..	41.0	59.0	-
Thailand	6.0	36.6	57.4	-0.9	2.4	37.7	56.8	3.1
Total above	**3.0**	**51.0**	**43.0**	**3.0**	**3.0**	**44.0**	**50.0**	**3.0**

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

[a] Based on cumulative flows from 1998.
[b] Based on cumulative approved FDI flows since 1979.
[c] Based on cumulative approved FDI flows during 1979-1997.
[d] Based on stock of 2001.
[e] Based on application of the proportion of gross FDI stock by sector for the period 1998-2002 to 2002.
[f] Based on cumulative value of foreign investment projects registered with the Foreign Investment and Foreign Trade Agency (FIFTA) since 1990.
[g] 2001 data are 1995 stock values plus cumulative flows during 1996-2001.
[h] Data for 1995 comprise equity investment (i.e. paid-up shares and reserves) only. Data for 2001 and 2002 incorporate net lending from foreign investors to their affiliates in Singapore. Data for 2002 are preliminary.
[i] Data refer to estimated foreign investments in projects approved by the BOI since 1978.

and those in business services, including ICT activities, by 3.7 times as compared to 2002.

Countries in the region are trying to attract FDI in services through integration or cooperation agreements. The ASEAN Framework Agreement on Services is an example (box II.9). In the context of the ASEAN Economic Community, the subregion has identified 11 priority industries for integration, of which 4 are in services (e-ASEAN, health care, air travel, tourism). This will involve the elimination of tariffs (for goods) and improvements in the modes of supply, including the immediate removal of non-tariff barriers. China, under its Protocol of Accession to the World Trade Organization (WTO), is committed to liberalizing its service industries in such areas as banking and finance, telecom, logistics and distribution, transportation, and retail and wholesale businesses; and it will undertake additional liberalization of services over the next few years (box II.10).

Box II.9. Liberalization of services in the ASEAN subregion: implications for FDI flows

The ASEAN countries agreed to work towards further liberalization of trade in services under the ASEAN Framework Agreement on Services, signed on 15 December 1995. The aim was substantially to eliminate restrictions on trade in services in the region and improve the efficiency and competitiveness of ASEAN service suppliers. The Agreement progressively improves market access and grants national treatment for service suppliers among ASEAN countries on a GATS-plus basis. Liberalization is carried out in three-year negotiation cycles, with each round resulting in commitments from member countries in agreed economic sectors/subsectors and modes of supply. ASEAN has concluded three packages of service commitments since 1 January 1996, covering air transport, business services, construction, financial services, maritime transport, telecommunications and tourism. The liberalization of FDI in services in ASEAN may further enhance the share of services FDI in the region.

Source: UNCTAD.

d. Promising prospects

FDI inflows to the Asia-Pacific region are set to rise. This optimism is largely based on bullish economic prospects for the region, as reflected, for example, in recent reports on the world economy (IMF 2004, World Bank 2004, Institute of International Finance 2004). The real GDP growth rate is estimated at 7.4% in 2004 (IMF 2004). Asian firms are confident about their performance in 2004,[26] which should have a positive effect on investment spending. Similarly, the improved profitability of Asian firms[27] as well as firms headquartered in major home countries such as Japan,[28] Europe and the United States should also stimulate more FDI to the region.[29]

China is set to remain the top recipient of FDI in manufacturing. The continued relocation of investment from high-cost economies, the opening up of its services sector and the expected increase in cross-border M&As in China could well push FDI inflows to yet another record high. Flows in 2004 to the Republic of Korea are also likely to increase, propelled by large cross-border M&As such as the $2.7 billion acquisition of Koram Bank by Citigroup (United States)[30] and the privatization of the Government's stakes in such assets as Hana Bank. As a result, the strong growth in FDI to North-East Asia as a whole is likely to continue and dominate flows to Asia. FDI flows to the ASEAN subregion are expected to maintain an upward trend, with more countries receiving

Box II.10. Liberalization of services in China: implications for FDI flows

China is opening its service industries to FDI in accordance with its schedule of commitments to the liberalization of services under its WTO accession agreement (box table II.10.1). It is removing restrictions on FDI in such industries as banking and finance, telecoms, logistics and distribution, transportation, and retail and wholesale trade. Thus, by 2008, service industries in China will be largely open to FDI. Aside from relaxing ownership control, China has also eased geographical restrictions and the scope of business operations.

So far, the lion's share of FDI flows to China has been in manufacturing, growing from 63% in 2002 to 74% in 2003. But with the opening up of service industries, their share is likely to rise.

Box table II.10.1. China: selected schedules for the liberalization of services and ownership control[a]
(Per cent)

Item	2001	2002	2003	2004	2005	2006	2007
Telecoms (value added services)	30	49	50[b]	c	c	c	c
Telecoms (voice and data services)	25	35	35	49	c	c	c
Telecoms (domestic and international)	-	-	-	25	25	35	49
Courier	49	Majority	Majority	Majority	100	..	..
Advertising	49	49	Majority	Majority[d]	100	..	..
Rental and leasing	-	Majority	Majority	100	..	..	..
Transportation of goods (railroad)	49	49	49	Majority	Majority	Majority	100
Freight forwarding agency	50	Majority	Majority	Majority[d]	100	..	..
Insurance (non-life)	-	51	100	..	..	..	..
Insurance brokerage for selected services	50	50	50	51	51	100	..
Domestic securities investment fund management	33	33	33	49	c	c	c
Storage and warehousing	49	Majority	Majority	100[d]	..	..	..
Testing and inspection	-	-	Majority	Majority	100	..	..
Wholesale and retail[b]	Minority	Minority	Majority	100[d]	..	..	..
Packaging services	-	Majority	Majority	100	..	..	..

Source: UNCTAD, based on China, Ministry of Commerce 2001.

a Per cent relate to maximum foreign equity ownership allowed on or before 11 December of the year shown.
b For Hong Kong (China) companies under CEPA, maximum ownership is allowed as from 1 October 2003.
c No further commitments were made to further relax foreign ownership for these years at the time of accession.
d For Hong Kong (China) companies under CEPA, 100% ownership is allowed as of 1 January 2004.

Source: UNCTAD.

greater flows than in 2003. The smooth elections of new Governments in a number of ASEAN countries in 2004, the regional integration process and strong economic growth should further encourage FDI.

Flows to South Asia are also set to increase, especially to India. The Government has announced the objective to raise FDI flows by two-to-three times.[31] The agreement among the South Asian countries to establish the South Asia Free Trade Area and the improved geo-political situation should strengthen the investment environment. Resource-seeking FDI will continue to increase in Central Asia**,** dominated by Azerbaijan and Kazakhstan. FDI flows to the Pacific islands can also be expected to rise thanks to an improved economic situation in that subregion and in Australia, Japan and New Zealand – the major investors in the Pacific island economies. Some of the Pacific island economies are introducing new measures to attract FDI.[32]

For West Asia, FDI prospects are modest, given the uncertainty affecting some countries there. However, some have the potential to attract significant FDI flows (e.g. box II.11 on FDI prospects in Turkey). Progress in rebuilding Iraq should have a direct impact on FDI flows. Overall, oil investment will continue to dominate the scene, with Saudi Arabia receiving a significant share of such investment.

By sector, FDI in manufacturing should increase in 2004 in response to a rise in world demand and growth of industrial activities (chapter I). In particular, an improvement in global demand for electronics,[33] automotive products and telecom equipment in some Asian countries, together with higher corporate profitability, should encourage TNCs to increase their capital spending. The services sector will most likely continue to account for the largest share of FDI inflows in the more developed Asian economies. FDI in tourism may be adversely affected if there is another outbreak of avian influenze (or "bird flu") and SARS, but in R&D, ICT and corporate services (such as business processing operations and call centres) it should grow in countries such as India, Malaysia, the Philippines and Singapore. The increase in cross-investment in regional budget airlines signals a resumption of FDI in tourism in 2005.[34] With

Box II.11. Promising FDI prospects for Turkey

Although Turkey has not attracted FDI commensurate with its potential (see annex table A.I.8), prospects are promising. The present Government has taken a number of measures to improve the FDI environment (Erdilek 2003). A new FDI law (Law 4875) was enacted in June 2003 to replace the old one (Law 6224), dating back to 1954. The new law replaces the old FDI approval and screening system with a notification and registration system, bans nationalization without fair compensation, guarantees national treatment to foreign investors, eases restrictions on FDI, eliminates the minimum capital limit, grants foreign investors full convertibility in their transfers of capital and earnings, allows them to own property without any restrictions and recognizes foreign investors' right to international arbitration. The creation of the Investment Advisory Council in March 2004, aimed at increasing Turkey's attractiveness for FDI, is another example of the importance accorded to foreign investment; the Prime Minister and several of his cabinet members participated in the meeting, in addition to representatives of 20 leading TNCs.

The Government has also instituted inflation accounting[a] (one of the long-standing demands of foreign affiliates in Turkey), simplified the commercial code, liberalized the law on work permits for expatriates and drafted a bill to establish an investment promotion agency. The Government's accelerated privatization programme, which is expected to culminate in the privatization of Türk Telekom in 2004, is also aimed at spurring inward FDI. Turkey's economic performance during the past two years, coinciding with the Government's pro-FDI policies, has been impressive. As the economic growth rate has risen,[b] inflation has fallen sharply, to its lowest level in a generation, along with nominal and real interest rates.

Source: Erdilek 2003.

[a] Inflation accounting has been in effect in Turkey since early 2004. It enables companies to restate their financial statements in terms of constant purchasing power units. This has been an important issue for foreign investors in Turkey, and will enable them to lower their taxes.

[b] According to IMF 2004, real GDP growth rates grew to 7.9% in 2002 and 5.8% in 2003 as compared with -7.5% in 2001.

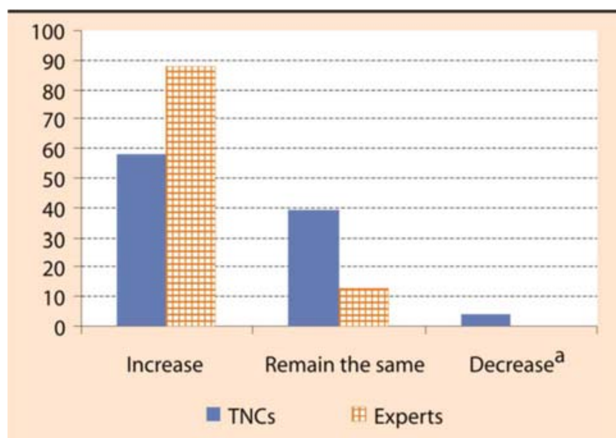
further liberalization, privatization and more M&As, FDI in intermediate services such as telecoms, finance and power generation should also increase.

These expectations are supported by the findings of UNCTAD's 2004 surveys of top TNCs and international location experts: almost 60% of the TNCs (UNCTAD 2004c) and nearly 90% of the experts (UNCTAD 2004a) expect an improvement in FDI prospects over 2004-2005, with the worst-case scenario being unchanged prospects (figure II.12).[35] For West Asia, however, the outlook is less optimistic compared to the rest of the region, with 13% of the responding TNCs expecting a deterioration. Both TNCs and location experts ranked China top position as an FDI destination, followed by India and Thailand. In manufacturing, improved prospects are anticipated in motor vehicles, machinery and equipment and chemicals, according to experts (UNCTAD 2004a). In services, banking and insurance, business services and tourism are expected to take the lead in attracting FDI over the next two years. In terms of corporate functions, the relocation of production and logistical and support services is expected to be strong for Asia and the Pacific (UNCTAD 2004a).

IPAs will do their part to attract more FDI. In fact, competition for FDI will become more intense, including through a greater use of incentives and ongoing liberalization, as well as the use of targeting. UNCTAD's 2004 survey of IPAs reveals that some 83% of the respondents expect to intensify their investment promotion efforts by using targeting strategies, while 54% are ready to resort to additional incentives and 67% consider liberalizing their national investment regimes to attract FDI (figure II.13) (UNCTAD 2004b). Investor targeting and liberalization were more frequently cited instruments for attracting FDI than in any other region. IPAs regard China and India as leading regional sources of FDI for 2004-2005, complementing the established investors (France, Germany, Japan, United Kingdom, United States).

Figure II.12. Asia and the Pacific: prospects for FDI inflows, 2004-2005, as reported by TNCs and location experts

(Per cent of respondents)

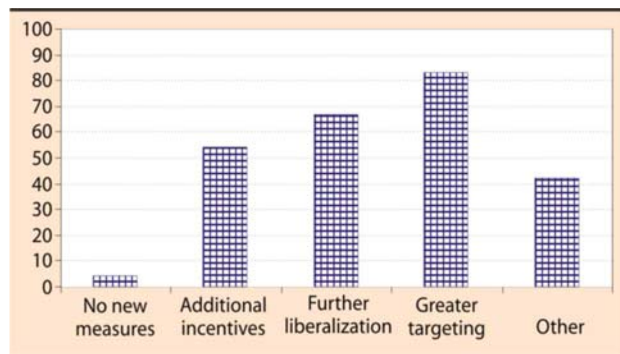


Source: UNCTAD, www.unctad.org/fdiprospects.

[a] Locational experts do not expect decreases in FDI inflows.

Figure II.13. Asia and the Pacific: expected policy measures to attract FDI, 2004-2005, as reported by IPAs

(Per cent of respondents)



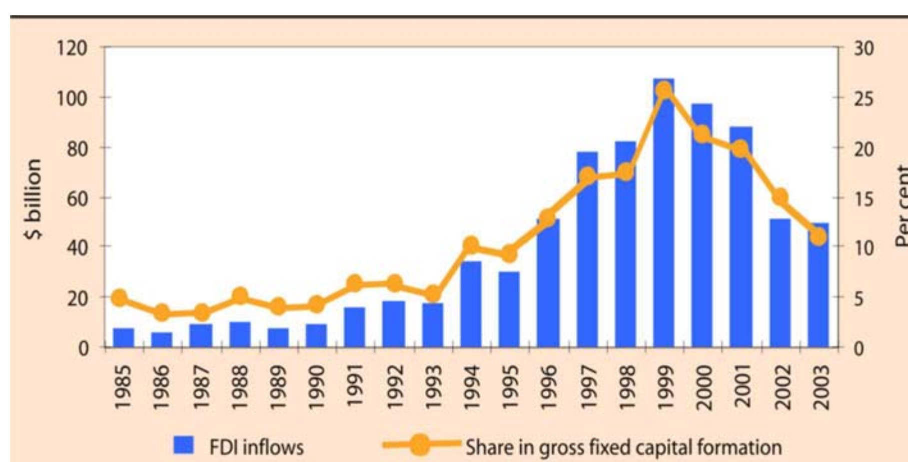
Source: UNCTAD, www.unctad.org/fdiprospects.

3. Latin America and the Caribbean: another disappointing year

a. A continuous decline

FDI flows to Latin America and the Caribbean (LAC) fell by 3% in 2003, to $50 billion – the lowest level since 1996.[36] This was the fourth consecutive year of decline, following a 53% drop over the period 1999-2003 (figure II.14; annex table B.1). Of the region's 40 countries, 19 saw declining inflows. FDI as a percentage of gross fixed capital formation dropped to 11%, from a high of 26% in 1999 (figure II.14). While there were wide variations among countries,[37] the three large economies Argentina, Brazil and Mexico saw the highest declines. The frequency distribution according to the range of FDI inflows between 1999 and 2003 has remained almost unchanged, with 9 countries receiving more than $1 billion and 31

Figure II.14. LAC: FDI inflows and their share in gross fixed capital formation, 1985-2003



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

countries less than $1 billion in 2003 (table II.6). Despite declines, Brazil and Mexico remained the most important recipients (table II.7). Total outward FDI rose significantly in 2003, but mainly from tax havens such as Cayman Islands and the British Virgin Islands.

Table II.6. LAC: frequency distribution of host economies, by range of FDI inflows, 1999-2003
(Number)

Range	1999	2000	2001	2002	2003
More than $30 billion	-	1	-	-	-
$20-29 billion	2	-	2	-	-
$10-19 billion	1	3	1	2	2
$5-9 billion	3	1	-	-	1
$1-4 billion	6	3	8	7	6
Less than $1 billion	28	32	29	31	31
Total	40	40	40	40	40

Source: UNCTAD, based on annex table B.1.

On the inward side, there was considerable variation within the region. Mexico and Brazil, where services are the most important sector, experienced the sharpest decline in inflows (figure II.15). Mexico, in particular, is faced with a competitive challenge from China, notably in manufacturing (box II.12). Apart from small island economies (e.g. two offshore centres – Bermuda, the Cayman Islands), other relatively small countries (e.g. Ecuador, Honduras, Nicaragua, Panama, Uruguay) stand out in recording an increase in FDI inflows. Chile and Venezuela recovered a large part of the declines experienced in 2002.

On the home country side, six countries accounted for 65% of the region's FDI inflows during the period 1995-2002 (figure II.16). The United States alone contributed one third, followed by Spain (16%), while the Netherlands, the United Kingdom, France and Canada accounted for most of the rest. During the privatization process, Spain was the major investor from the EU, but in 2001 and 2002, FDI from Spain fell drastically (figure II.16).

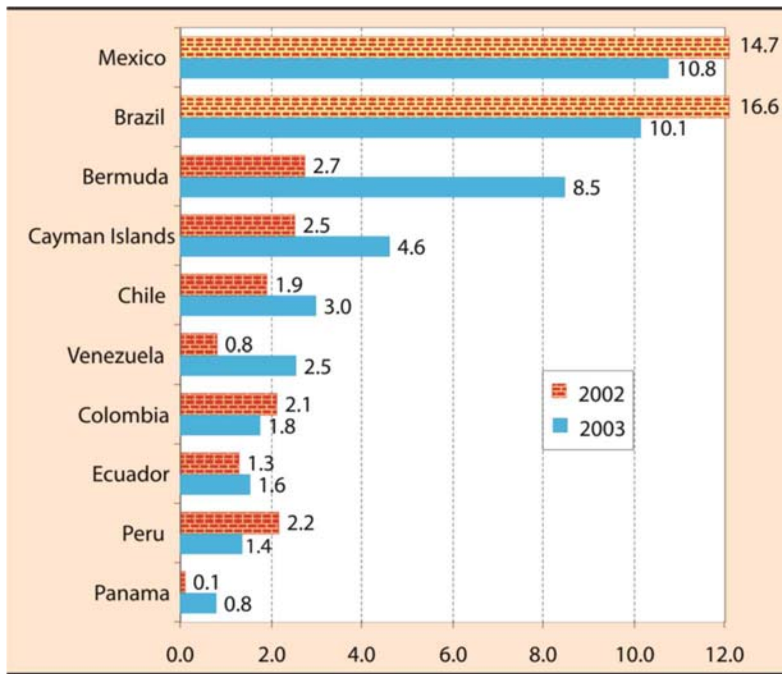
Various factors contributed to the continuing downturn, some of which were beyond the control of the host countries. TNCs from major home countries invested less because of deteriorating economic conditions there. The EU

Table II.7. LAC: economy distribution of FDI inflows, by range, 2003

Range	Economy
More than $10 billion	Brazil and Mexico
$5-9 billion	Bermuda
$1-4 billion	Cayman Islands, Chile, Colombia, Ecuador, Peru and Venezuela
Less than $1 billion	Anguilla, Antigua and Barbuda, Argentina, Aruba, Bahamas, Barbados, Belize, Bolivia, Costa Rica, Cuba, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Nicaragua, Panama, Paraguay, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, Uruguay and Virgin Islands (British)

Source: UNCTAD, based on annex table B.1.

Figure II.15. LAC: top 10 recipients of FDI inflows, 2002, 2003 [a]
(Billions of dollars)



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

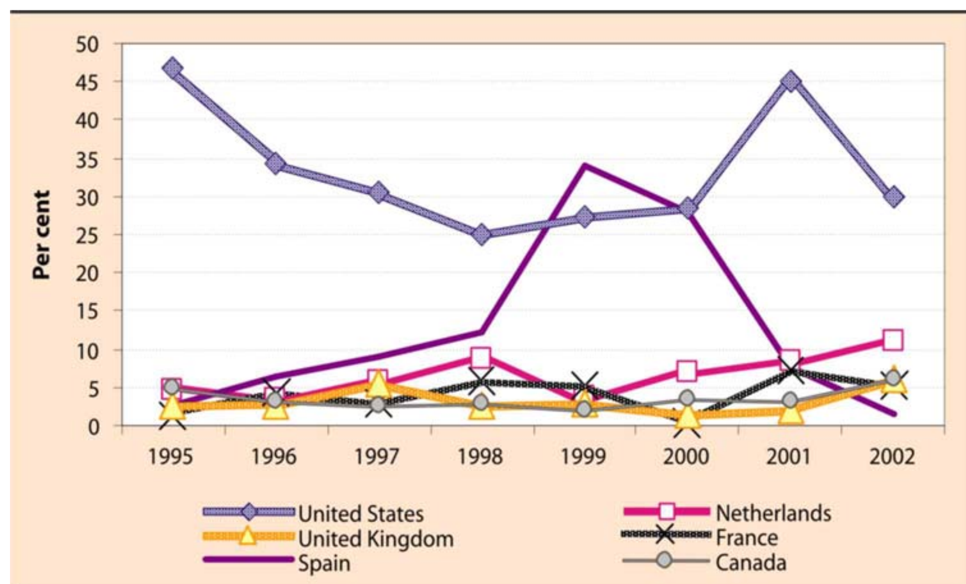
[a] Ranked on the basis of the magnitude of 2003 FDI inflows.

experienced disappointing economic growth rates during the period 2001-2003 (IMF 2004). Another factor was a steep drop in cross-border M&As in the region, both in number (from 581 in 2000 to 281 in 2003) and value, from a high of $64 billion in 1998 to $12 billion in 2003. Particularly affected was investment by big public utility TNCs. However, this alone does not explain why the region attracted less FDI than others, its share shrinking to only 29% of total FDI to all developing economies, from 46% in 1999 (UNCTAD 2004g).

The steep decline in FDI flows can also be attributed to some extent to "normalization" – a return to conditions preceding the privatization drive and the M&A-led FDI boom of the late 1990s. The steepest declines have taken place mainly in those countries that experienced by far the largest increases, such as Brazil and Mexico. The region's share of FDI flows to all developing economies had risen from an annual average of 30% in 1991-1996 to 43% in 1997-1999, largely because TNCs acquired State-owned enterprises through privatization programmes implemented in the region. With privatizations running out of steam – either because the programmes were nearing completion or because further privatizations met with public resistance – the region lost one of its major driving forces behind FDI (box II.13).

Yet the return to normality, too, offers at best a partial explanation. The weak growth performance of the region – an important determinant of FDI flows – also played a role. Growth in real GDP was below its long-term trend, the average annual GDP growth rate being only 0.7% for the period 2001-2003 (IMF 2004), compared with 6.6% for developing

Figure II.16. LAC: FDI inflows from major home countries as a percentage of world total, 1995-2002



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

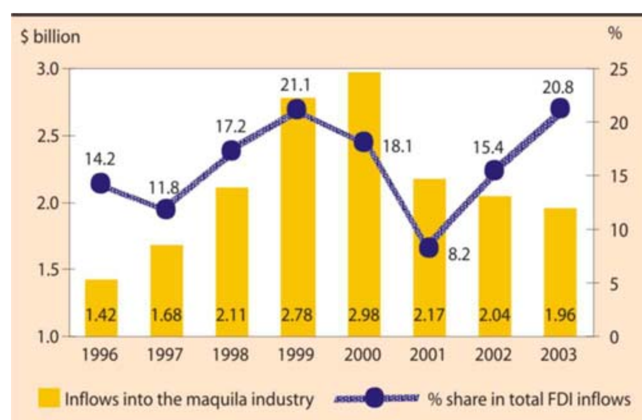
Note: Percentages are based on FDI inflows in LAC countries that account for some 86% of total inflows to the region in 2002.

Box II.12. Is the FDI relocation from Mexico's *maquila* industries ending?

Maquiladoras have traditionally accounted for a large share (47%) of Mexico's merchandise exports. Developments in the recent past have raised concerns about their international competitiveness.

Between December 2000 and April 2004, the number of such enterprises dropped from 3,703 to 2,820, with 220,000 job lost as a result.[a] Meanwhile, annual inflows in *maquiladoras* dropped by about one third, from their peak of $3 billion in 2000 to $2 billion in 2003, falling to about the same level they had reached in 1998 (box figure II.12.1).

Box figure II.12.1. FDI inflows into Mexico's *maquila* industry, 1996-2003



Source: UNCTAD, based on data from the Ministry of Economy of Mexico, http://www.economia.gob.mx/pics/p/p1175/03-dic.xls.

The relocation of FDI from the *maquila* industries has mainly been caused by competition from Asia. One third of all enterprises that have left are reported to have moved to China (Carrillo 2003). Other Asian countries accounted for another 14% of relocations. But some companies have also shifted their activities to Central American and Caribbean locations (about 10%). This may be in anticipation of the planned FTA between the United States and Central America and the ensuing erosion of Mexico's trade preferences vis-à-vis Central America. More than 100 enterprises that left the *maquila* industries returned to the United States (35) or remained in Mexico but shifted into the PITEX scheme (*Programa de Importación Temporal para Producir Artículos de Exportación*). Thus, competition from lower cost locations was not the only reason.

Relocations have mainly affected two industries: textiles and clothing, and electric and electronic materials and accessories. They account for 88% of the total employment decline mentioned above. By contrast, activities such as the assembly of transport equipment appear to have remained largely unaffected as the number of persons employed remained almost unchanged between December 2000 and April 2004.

However, Mexico's geographic proximity with the United States remains an advantage for Mexico, for example for those exporting products too big to ship cheaply from Asia, or for those for which just-in-time management is an important factor

While the economic slowdown in the United States has been the trigger for the decline in the *maquila* industry, successful restructuring was also hampered by internal factors. The appreciation of the Mexican peso may have contributed to job losses as it inflated costs for TNCs operating in Mexico (ECLAC 2003b, p.19). This may have been exacerbated by lower exchange rates of Asian currencies, notably of China. Another factor giving rise to concern by many *maquiladoras* relates to cost increases resulting from taxes and red tape: almost half of all *maquiladoras* incurred higher costs recently, while another quarter did not succeed in reducing costs, which affected their ability to remain competitive (Carrillo 2003).

The Government of Mexico has taken steps to help overcome the cost problems[b] by announcing measures to simplify bureaucratic procedures and eliminate certain taxes. The payroll tax will be phased out in 2004, and most *maquila* operations will be exempted from income tax (*Impuesto Sobre la Renta*). Representatives of the *maquila* industries welcomed this move and committed themselves "to recover the 50,000 jobs lost because of the implementation of the ISCAS" [b] (payroll tax) in 2002. Non-tax incentives announced by the Government include the commitment to decide within 15 working days a company's request for establishing *maquila* operations. Furthermore, SME *maquiladoras* were offered a special government certification, so far restricted to

/...

Box II.12. Is the FDI relocation from Mexico's *maquila* industries ending?(concluded)

larger operations, which would expedite imports through customs checkpoints.

Since the beginning of 2004, the trend of decreasing exports seems to have ended, with two-digit growth in February and March and employment at its highest since the end of 2001. This has occurred mainly in the automobile and electric and electronic materials and components industries.[c]

Source: UNCTAD.

[a] Instituto Nacional de Estadística Geográfica e Informática (INEGI) (Mexico), http://www.inegi.gob.mx.

[b] *SourceMex*, 22 October 2003.

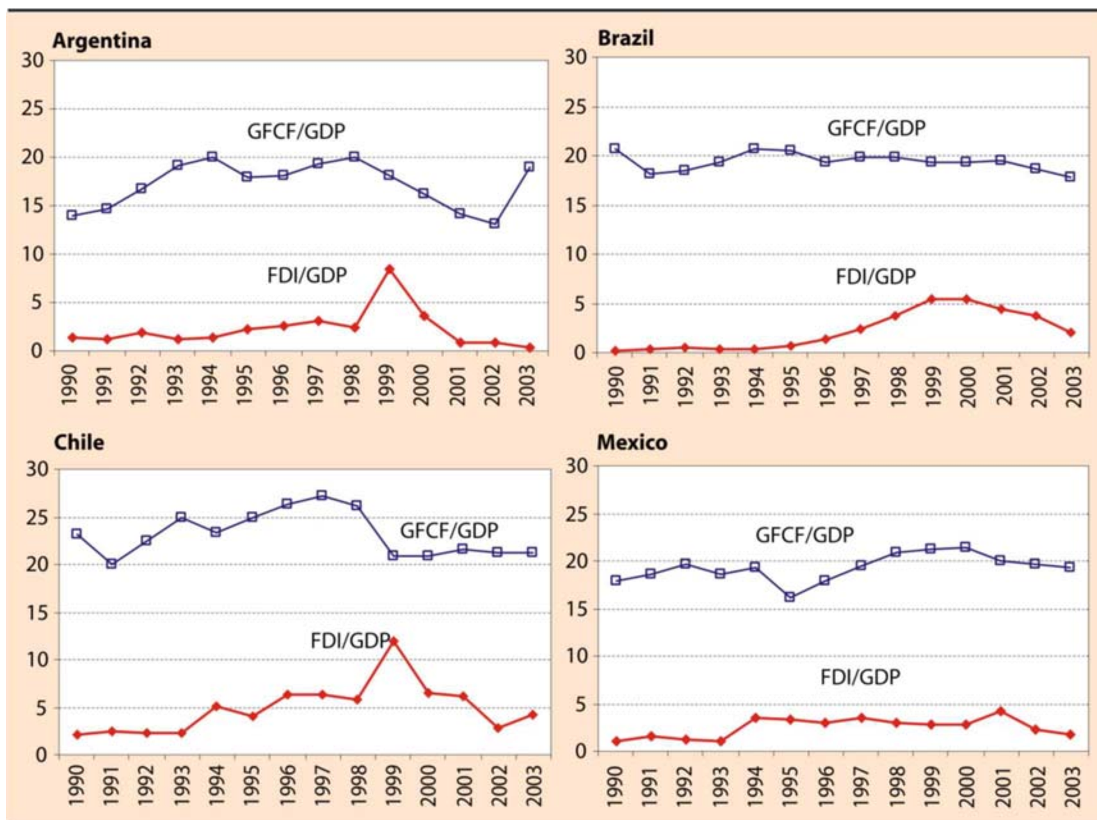
[c] Information obtained from INEGI.

Asia. This "lost half-decade"[38] was characterized by tight monetary and fiscal policies, which further contributed to the low economic and investment growth rates in Latin America. In contrast, Asian countries pursued macroeconomic policies that were supportive of growth. All this, in turn, was associated not only with declining FDI inflows, but also with lower domestic investment in various countries. Structural bottlenecks may have been one of the main reasons for both weak economic growth and low (foreign and domestic) investment.[39]

Foreign and local investors in the four largest Latin American economies (Argentina, Brazil, Chile, Mexico) reacted differently over time to economic indicators (figure II.17). In Argentina, both the economy and gross fixed capital formation began to contract already in the second half of 1998, but foreign investors had a delayed response to the rising economic tensions already perceived by local investors.[40] FDI inflows are now much below the level reached in the mid-1990s. In Chile, the fall in FDI in 2000 was more pronounced, caused partly by normalization after outstandingly high inflows in 1999. In Brazil and Mexico, foreign and local investments turned out to be relatively stable over the period 1990-2002.

Figure II.17. LAC: trends in FDI inflows and gross fixed capital formation in selected economies, 1990-2003

(Per cent of GDP)



Source: IMF 2003; UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

Box II.13. Why privatization is losing popularity in LAC

The recent backlash against privatization in some LAC countries seems to be due to two factors: governments were seen to have conceded too much to TNCs in the privatization of some enterprises; and the benefits of some privatization-related FDI in service industries fell short of expectations.

On the first point, several governments had granted favourable conditions to TNCs when they acquired State-owned assets in service industries (perhaps because they were still experimenting with regulatory issues or to send a political signal). In Argentina, for instance, privatized utilities were relieved of exchange-rate risk by having their charges denominated in dollars indexed to inflation in the United States. In Brazil, foreign investors in electricity generation received gas at subsidized prices under the Priority Programme of Thermoelectric Power of 2000; they later received gas for a guaranteed price from Bolivia, which removed exchange rate risks.

Following privatization of water supply in Bolivia's third largest city, Cochabamba, in early 2000, a consortium (Aguas del Tunari, in which Bechtel had a 27.5% stake) obtained a concession to manage it. User charges were increased to pay down debt and finance the investment required. The public protest that followed led to a reduction of the rate; eventually, the contract was cancelled. The consortium went to arbitration for $25 million in compensation.[a]

On the second point, there is a widespread perception that privatization has not yielded sufficient benefits for the community. In Argentina, for example, it is accepted that the privatization of telecoms has led to the expansion and better quality of services, but the charges paid by users were high, at least until the conversion from dollars to pesos of public utility tariffs and the price freeze decided in early 2002. In other services, however, benefits from privatization seem to be less clear. In gas and electricity, regulatory bodies alleged that private suppliers had failed to meet agreed standards.[b] Similarly, water concessions granted to Aguas Argentinas, a subsidiary of Suez (France), seemed to have worked well until the steep fall of the peso in early 2002. Suez then pulled out and went to arbitration after the authorities did not agree to higher charges to offset the devaluation. Negotiations continue.[c]

In 1999, the Government of the Dominican Republic decided to privatize electricity generators and distributors to remedy the chronic lack of reliable provision of electricity which increased business costs and hampered economic development. This resulted in considerable FDI inflows (starting with $0.6 billion in 1999). Unión Fenosa, a Spanish electricity company, purchased 50% of two electricity distributors, Edenorte and Edesur, of the State-owned Corporación Dominicana de Electricidad. However, the Government decided in September 2003 to repurchase these shares because of various difficulties.[d]

In April 2001, Jamaica succeeded in attracting FDI in the privatization of the electricity and energy firm Jamaica Public Service (JPS). The company was acquired by Mirant, an electricity company of the United States. It has not yet attained its ideal target according to survey results presented by the World Economic Forum (2003, p. 595), but consumers are now benefiting from investment in new generation capacity since 2001. Public consultations conducted by the Office of Utilities Regulation in early 2004 confirmed that reliability was no longer their major concern.[e]

Source: UNCTAD.

[a] The Cochabamba case continues to be debated between proponents and opponents of water privatization (see "Private passions", *The Economist*, 17 July 2003; and The Democracy Center 2003, "Bechtel vs. Bolivia", http://www.democracyctr.org/Bechtel).

[b] *Latin America Energy Report*, 11 July 2003.

[c] See, *The Economist*, 17 July 2003. An agreement was signed on 11 May 2004 to set the pace for further negotiations in exchange of $ 84 million investment in 2004-2005 (*Clarin*, 12 May 2004).

[d] According to survey results presented by the World Economic Forum (2003, p. 595), there were still incidences of electricity interruptions and voltage fluctuations. See also Economist Intelligence Unit, 22 September 2003; also Cámara Americana de Comercio del República Dominicana. "Ede-Norte, Ede-Sur, Antecadentes y Resultados de la Negociación", 20 October 2003.

[e] Office of Utilities Regulation, "Jamaica Public Service Company Limited tariff review for period 2004-2009", 25 June 2004.

b. Policy developments: continued liberalization

At the national level, the trend continued towards greater liberalization and investment facilitation. For example, Brazil simplified registration procedure by introducing an electronic registration system and initiated an Investment Policy Review (UNCTAD forthcoming e). Tax discounts for reinvested earnings were introduced in Mexico, and there are plans to reduce further corporate income taxes. In August 2003, Peru introduced a law seeking to promote decentralized investment to support regional development through cooperation between regional and local governments, private investors (domestic and foreign) and civil society.

At the bilateral level, LAC countries concluded 8 BITs and 8 DTTs in 2003, for a total of 421 BITs and 270 DTTs by the end of 2003 (figure II.18). The country with the largest number of BITs is Cuba (56), followed by Argentina (54) and Chile (49). Brazil and Mexico lead with the largest number of DTTs: 34 each.

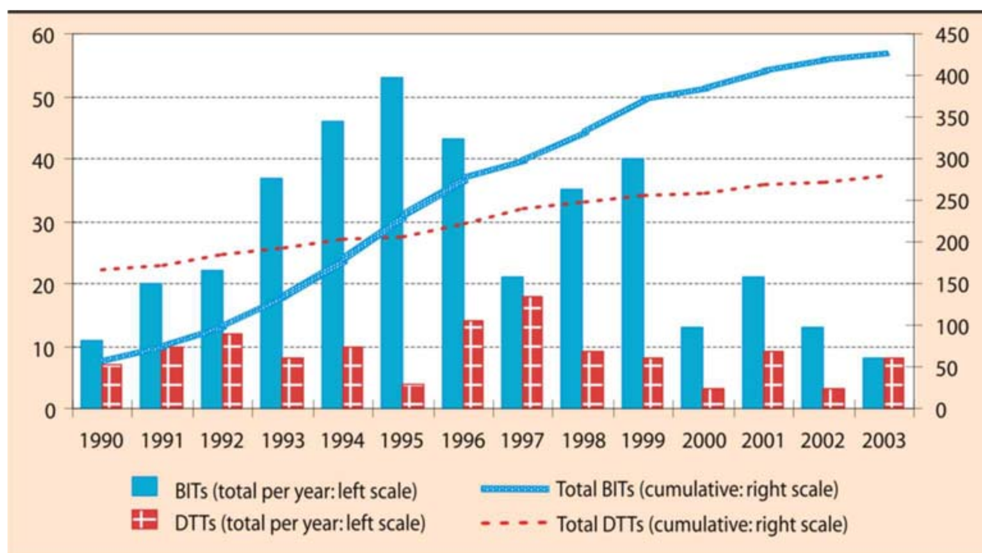
At both the bilateral and regional levels, FTAs now typically cover FDI issues, protecting investment and, increasingly, facilitating market access (annex table A.II.1). The EU and the United States are both engaged in FTA negotiations with various Latin American partners. Negotiations between the Southern Common Market (MERCOSUR) and the EU are also under way. Japan is a late-comer to FTAs; it gives priority to countries and regions with which it has important economic relationships, and where relatively high trade barriers pose obstacles to the expansion of Japanese firms. Japan has so far concluded an FTA with Mexico (April 2004), its largest trade partner in the region, but has not entered into formal negotiations with any other country in the region.

The region's efforts to attract and benefit from FDI are not limited to national, bilateral and regional arrangements; there is a growing interest in multilateral cooperation as well. An increasing number of countries are parties to various investment-related multilateral instruments. As of 1 July 2004, 30 countries had joined MIGA, while Antigua and Barbuda were in the process of fulfilling membership requirements. Also, 27 countries are now members of the International Centre for Settlement of Investment Disputes (ICSID), and 25 countries are parties to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

c. Sectoral patterns

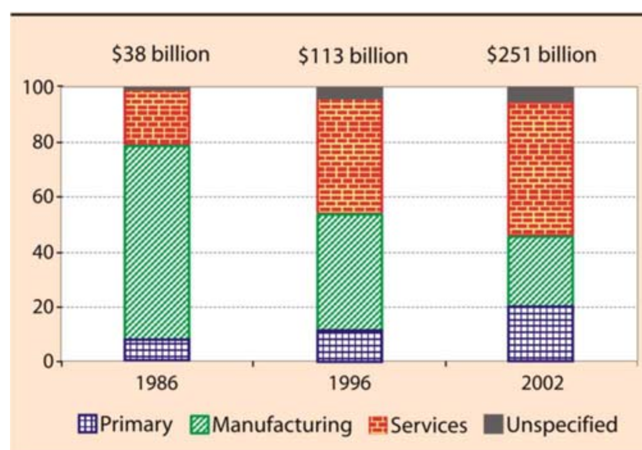
The region's sectoral distribution of FDI has shifted towards services at the expense of manufacturing (figure II.19). This is mainly the result of privatizations in the services sector. Resource-seeking FDI has traditionally played an important role in Andean Community countries

Figure II.18. LAC: number of BITs and DTTs concluded, 1990-2003



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

Figure II.19. LAC: sectoral distribution of inward FDI stock, selected countries, 1986, 1996, 2002[a]
(Per cent shares in total)



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

Notes: Totals for 1986 include data for five countries only (Argentina, Bolivia, Brazil, Peru and Venezuela), accounting for 43% of inward stock of LAC. Totals for 1996 are based on data for six countries only (Argentina, Brazil, Colombia, Paraguay, Peru and Venezuela), accounting for 45% of inward stock of LAC. Totals for 2002 are based on data for eight countries only (Argentina, Brazil, Chile, Colombia, El Salvador, Paraguay, Peru, Venezuela), accounting for 56% of inward stock of LAC.

[a] Or latest year available, i.e. Brazil (2000), Chile (2001), Paraguay (2001).

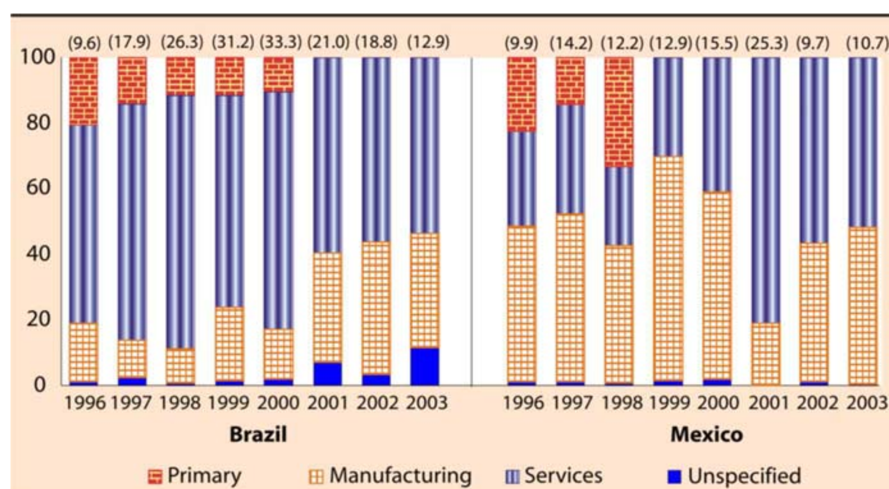
(Colombia, Ecuador, Venezuela).

In contrast, the primary sector in the two largest economies of Latin America, Brazil and Mexico, accounts for only a small share of total FDI inflows. Yet, the sectoral structure of FDI differs significantly between these two countries (figure II.20). Almost 70% of Brazil's total FDI inflows during 1996-2000 were absorbed by the services sector. The subsequent drop in FDI inflows in 2001-2003 was due to sharply reduced flows to telecommunications and finance. In Mexico, the manufacturing sector accounted for 54% of total FDI inflows during 1996-2000. However, unlike in Brazil, this sector's share fell in 2001, mainly because of exceptionally high FDI flows to financial services, but it recovered in 2002 and 2003.

The volatility and recent decline of FDI in the services sector of various LAC economies indicate that the normalization process applies to this sector as well. Particularly in South America, the privatization of service firms seems to have run its course. From 1990 to 1995, the country with the greatest participation of private capital in infrastructure projects was Argentina ($35 billion), ahead of Mexico ($26 billion). Between 1996 and 2003, Brazil dominated the region with $142 billion, ahead of Argentina ($38 billion), Mexico ($27 billion) and Chile ($19 billion).

Market-access-seeking FDI in services has been important in MERCOSUR and Chile, especially in telecom industries, with Telefonica (Spain) taking a lead and America Movil (Mexico) significantly expanding abroad (box II.14), and in electricity with the major involvement of Endesa (Spain) (box II.15). The two companies ranked among the largest TNCs, by consolidated sales, operating in Latin America in 2002.

Figure II.20. Brazil and Mexico: changes in the sectoral structure of FDI inflows,[a] 1996-2003
(Billion of dollars and per cent)



Source: UNCTAD, based on FDI/TNC database (www.unctad.org/fdistatistics) and Ministry of Economics of Mexico (www.economia.gob.mx).

[a] Total inflows in billions of dollars in brackets.

Box II.14. Two major players in the telecom industry

Recently, the telecom industry in LAC experienced growing competition between two major players: Telefónica of Spain and America Movil of Mexico. Both companies accelerated their acquisitions in the region, which was facilitated by a wave of divestments by United States telecom companies.

America Movil is the leading provider of wireless communication services in Mexico through its subsidiary Radiomovil Dipsa, which operates under the trademark "Telcel". Three-quarters of its revenues are generated in Mexico where the network covers approximately 31% of the country and 90% of the population. In 2002, America Movil acquired the shares of its foreign partners – Bell Canada International and SBC Communications – in the joint venture Telecom Americas Ltd., a company focusing since late 2000 on expanding in the South American wireless market. It has international telecom operations in Argentina, Brazil, Colombia, Ecuador, El Salvador, Guatemala, Mexico, Nicaragua, Venezuela and the United States. It is the main competitor of Telefónica in LAC and, more precisely, Telefónica Móviles, its wireless arm.

Telefónica Móviles is focusing on Latin America for its growth and, in recent years, has strengthened its position in the region. By July 2004, Telefónica Móviles was present in 7 LAC countries, providing service to more than 34 million mobile customers. Once the acquisition of the Bell South operations in LAC is completed, the company will be present in 13 LAC countries with more that 40 million lines. Following this recent acquisition (for $5.9 billion) of the ten Bell South operators, Telefónica Móviles is now the leader in the mobile market in seven countries, and second in five countries (box table II.14.1). Telefónica is also present in Latin America in the wireline business, with operations in 14 countries, providing more than 21 million lines as of March 2004 (box figure II.14.1).

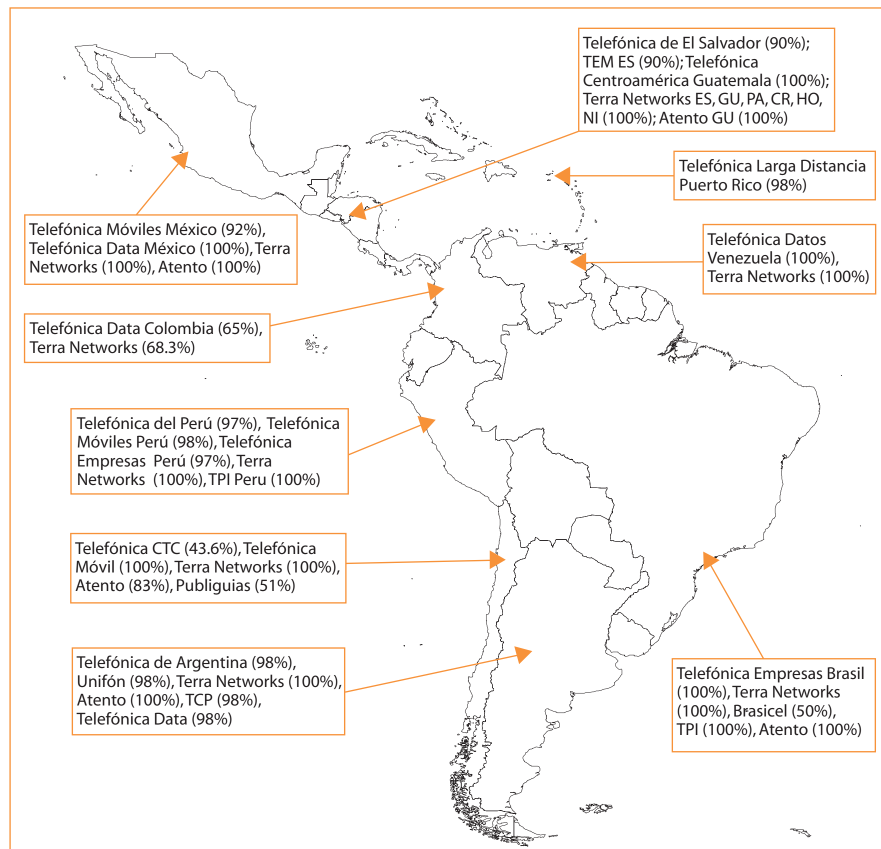
Box table II.14.1: Telefónica's market position for mobile phones, including acquisition of Bell South Mobile Assets[a]

Country	Rank	Market share (%)
Argentina	1	42
Brazil[a]	1	56
Chile	1	48
Colombia	2	32
Ecuador	2	35
El Salvador	2	25
Guatemala	3	22
Mexico	2	11
Nicaragua	1	69
Panama	1	53
Peru	1	72
Uruguay	2	30
Venezuela	1	45

Source: UNCTAD, based on Telefónica (www.telefonica.es/accionistaseinversores/).

[a] Acquisition announced 8 March 2004; however, not executed as of 1 July 1 2004.

Box figure II.14.1. Geographical presence and expansion of foreign affiliates of Telefónica in LAC, 2004



Source: UNCTAD, based on Telefónica's *annual reports* and its website (May 2004).

Source: UNCTAD.

Box II.15. Privatization in the electric power market: the case of Endesa

Endesa (Spain) generates, transports and markets electrical energy. It is the leading electricity utility in six LAC countries (box table II.15.1). The energy distributed in 2003 climbed to 49,500 Gwh. Service is provided to 10.5 million customers (50% of its worldwide business).

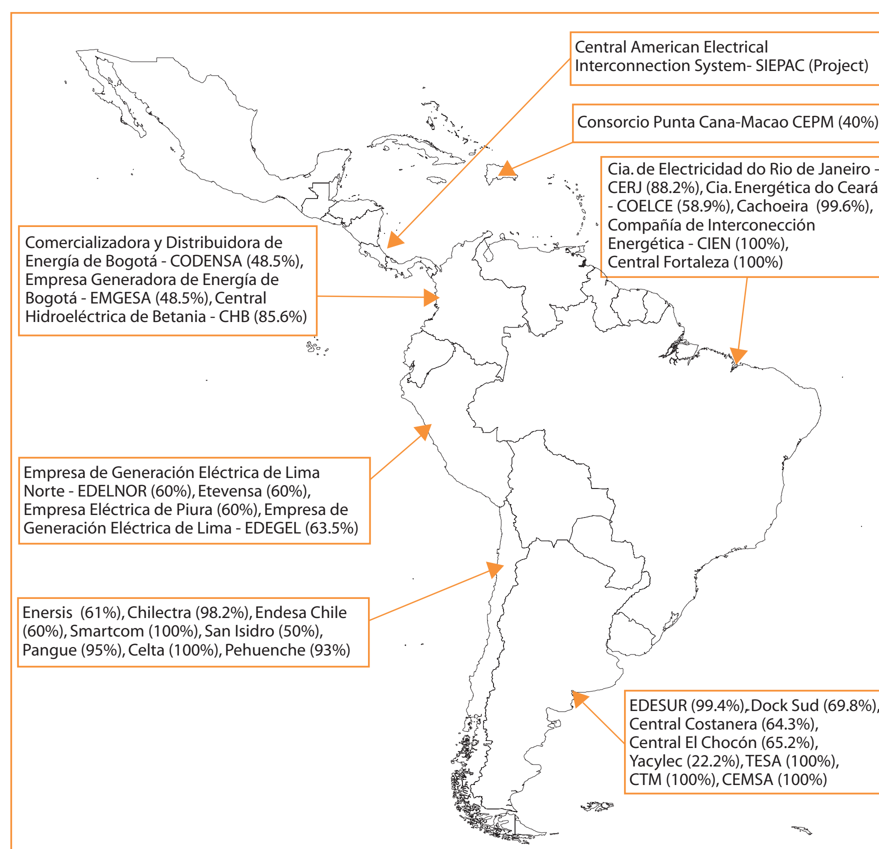
In the early 1990s, Endesa began expanding in Latin America in anticipation of the new competitive conditions in the European market. Business is conducted through its subsidiary Enersis, in which it holds a 60.6% interest. It is the largest operator in Argentina, Chile, Colombia and Peru (box figure II.15.1).

Box table II.15.1. Endesa's presence in LAC, 2004
(Per cent)

Country	Distribution of assets
Argentina	6
Brazil	19
Chile	40
Colombia	21
Dominican Republic	4
Peru	10

Source: UNCTAD, based on Endesa (www.endesa.com, May 2004).

Box figure II.15.1. Geographical presence and expansion of foreign affiliates of Endesa in LAC, 2004



Source: UNCTAD, based on Endesa's *Annual Report 2003* and its website, www.endesa.com (May 2004).

Source: UNCTAD.

d. Better prospects ahead

Prospects for FDI flows to LAC depend on a number of factors. FDI flows are forecast to rise, thus reversing the recent downward trend. FDI in the largest economies (Argentina, Brazil, Mexico) is expected to recover in 2004.

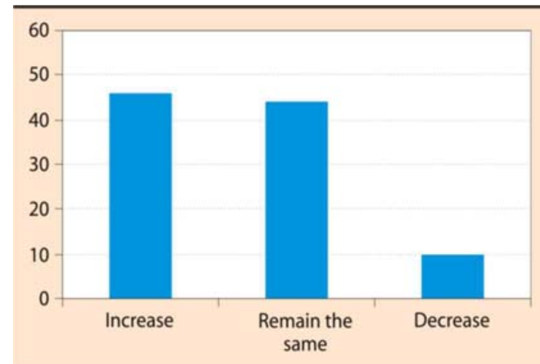
In the *short term*, prospects for FDI growth depend on the strength of the economic recovery; forecasts for LAC have improved significantly, approaching 4% in 2004 (IMF 2004). This should improve the profitability of foreign affiliates, ease liquidity constraints and offer more options for financing FDI. The *longer*

term FDI growth prospects, however, are uncertain. Structural problems that seem to have contributed to the region's diminishing attractiveness to investment remain. Furthermore, the normalization of FDI flows means that the region's share in overall flows to developing countries is unlikely to rise unless competitive weaknesses are overcome.

With privatization-related inflows likely to remain low (although such FDI could still be significant for some economies, e.g. Costa Rica, Ecuador), the region would need to attract new types of FDI. Moreover, governments will find it difficult to use the remaining potential for privatization as a stimulus to FDI. There is increasing scepticism towards privatization, especially after the financial crisis in Argentina. In addition, the region's ability to attract flows in relatively labour-intensive and technologically less demanding manufacturing industries has deteriorated due to the emergence of lower cost competitors, mainly in Asia. The "China challenge" is set to persist, even if the most affected countries respond by lowering taxes and easing bureaucratic procedures.

Policy makers can take heart, however, from the expectations of corporate executives. According to UNCTAD's survey of the largest TNCs, 46% of the respondents predict an increase in FDI inflows to the region for 2004-2005 (figure II.21). According to them, Brazil, Mexico, Argentina, Chile and Venezuela, in that order, will benefit most (UNCTAD 2004c).

Figure II.21. LAC: prospects for FDI inflows, 2004-2005, as reported by TNCs
(Per cent of respondents)

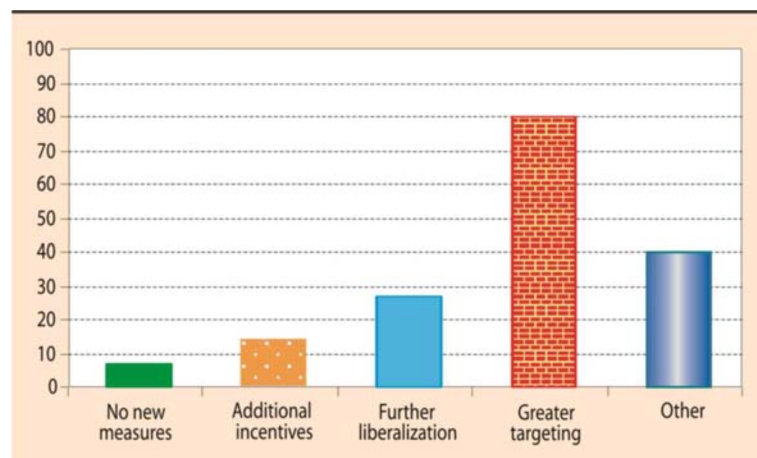


Source: UNCTAD, www.unctad.org/fdiprospects.

The leading sources of FDI remain the United States and Spain ahead of Canada, Germany and the Netherlands, in that order, according to IPAs (UNCTAD 2004b). To attract more FDI, IPAs have been concentrating on investor targeting and other measures (figure II.22). LAC is the least likely of all regions to introduce more incentives or further liberalize national FDI regimes over the short term. In fact, just over one-tenth of the IPAs surveyed reported that they were planning to use additional incentives for FDI, a significantly lower figure than in other regions.

In the *longer term*, the region's prospects for inducing more and newer types of FDI depend on whether host countries succeed in tackling their structural weaknesses. But even then, the chances of attracting FDI differ across the region. Measured by UNCTAD's Inward FDI Potential Index, prospects look best for Chile (ranked 48th among 140 countries during 2000-2002), followed by Mexico (ranked 50th). Apart from Brazil, which moved up from 72nd to 68th place, all other LAC countries dropped in the rankings, with Panama, the Dominican Republic, Costa Rica, Venezuela, Argentina, Jamaica and Peru placed between 58 and 81. For Argentina, the recovery of FDI from its seriously depressed level is contingent not only on tackling structural factors, but also on resolving its debt problem.

Figure II.22. LAC: expected policy measures to attract FDI, 2004-2005, as reported by IPAs
(Per cent of respondents)

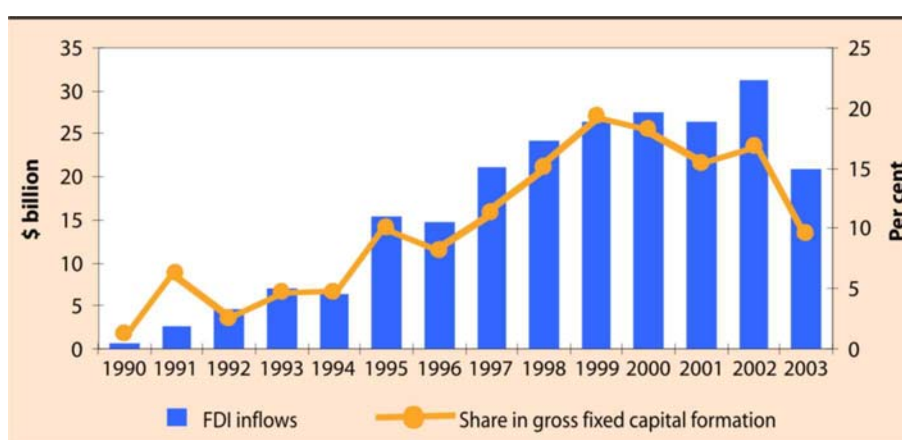


Source: UNCTAD, www.unctad.org/fdiprospects.

B. Central and Eastern Europe: awaiting the boom

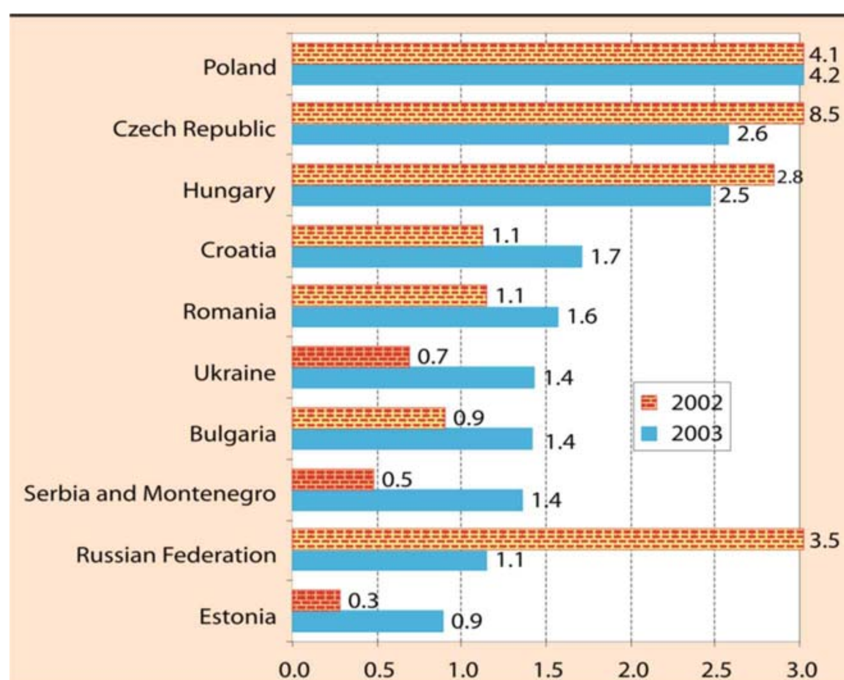
In contrast to earlier forecasts, FDI inflows into CEE declined from a record $31 billion in 2002 to a low of $21 billion in 2003 (figure II.23). This was almost entirely due to the end of privatization in the Czech Republic and Slovakia. Inward FDI in the rest of the region declined only marginally, from $19 billion to $18 billion. Overall, FDI inflows rose in ten countries and fell in nine, with Poland replacing the Czech Republic as the top recipient (figure II.24). In spite of the downturn, all but two countries remained in the same inflow-size range (table II.8). The share of inward FDI in gross fixed capital formation fell from 17% in 2002 to 10% in 2003 (figure II.23). No large-scale diversion of FDI from the older EU members to CEE countries occurred during 2003. In contrast, at $7 billion, FDI outflows from CEE reached a new record in 2003, up from $5 billion in 2002. Despite the decline in 2003, the medium-term prospects for growth of FDI in CEE are good.

Figure II.23. CEE: FDI inflows and their share in gross fixed capital formation, 1990-2003



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

Figure II.24. CEE: top 10 recipients of FDI inflows, 2002, 2003 [a]
(Billions of dollars)



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

[a] Ranked on the basis of the magnitude of 2003 FDI inflows.

Table II.8. CEE: frequency distribution of host countries, by range of FDI inflows, 1999-2003
(Number)

Range	1999	2000	2001	2002	2003
More than $5 billion	2	1	2	1	-
$1-4 billion	4	7	5	7	9
Less than $1 billion	13	11	12	11	10
Total	19	19	19	19	19

Source: UNCTAD, based on annex table B.1.

1. Inward FDI sharply down, outward FDI sharply up

a. Inward FDI: new EU members performed less well than other CEE countries

The decline in FDI inflows into CEE in 2003 was largely due to a fall in flows to the Czech Republic and Slovakia, two countries that had led the FDI surge in 2002 with large privatizations. The winding up of these privatizations contributed to the decline in FDI. Greenfield projects, spread over a longer period and generally smaller in size, could not immediately compensate for the fall in privatization-related FDI. This was despite the fact that both countries had been selected as locations for new automobile plants by TNCs (Toyota-PSA in the Czech Republic – *WIR02*, p. 69; PSA and Hyundai in Slovakia – box II.16). However, these projects will be fully operational only in 2005 or 2006, and a considerable proportion of the FDI associated with them is likely to materialize only at that time.

Outside the Czech Republic and Slovakia, the decline in FDI inflows was small, leading to the re-establishment of Poland, the Czech Republic and Hungary as the three top locations for inward FDI in the region (table II.9 and figure II.24).

The group of eight CEE countries that joined the EU in May 2004 – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, Slovakia – saw its FDI inflows shrink from $23 billion in 2002 to $11 billion in 2003. However, if the cycle of privatizations is set aside, FDI prospects for the new EU members from CEE are likely to improve rapidly in the near future (box II.17).

In the other 11 countries of the region – including Bulgaria and Romania (currently negotiating their entry into the EU) – FDI inflows rose from $8.6 billion in 2002 to $9.5 billion in 2003, representing an increase in their share of total FDI inflows from 28% in 2002 to 45% in 2003. In the South-Eastern European part of this group, a proportion of the high FDI can be explained by privatization deals, although these do not yet match the size of previous privatization deals in countries such as the Czech Republic, Hungary and Poland.

During the period 2001-2003, the Republic of Moldova, the former Yugoslav Republic of Macedonia and Serbia and Montenegro were the region's leaders in terms of the ratio of FDI to gross fixed capital formation (figure II.25). Most of these high ratios reflect small national economies. During 2002-2003, FDI inflows into the Russian Federation declined from $3 billion to $1 billion. But this should be temporary, as foreign investors can be expected to renew their interest in the natural resources of the Russian Federation.

Box II.16. Slovakia: a new hub for European automobile production

Thanks to FDI in large assembly projects, Slovakia is on its way to becoming a major European hub for automobile production. By 2006, when all factories currently under construction are scheduled to be operational, this country of 5 million people will have a capacity to produce 850,000 cars per year (Landler 2004). In a decade and a half, Slovakia will have been transformed from a country with no assembly capacity before 1991 into a key international player.

The backbone of the Slovak automobile industry today consists of three large assembly plants set up by TNCs that followed different strategies to enter the country. Germany's Volkswagen opted for a gradual entry. It took over a local plant – at that time mainly producing parts for Skoda Automobilová in the Czech Republic – in the capital city of Bratislava in 1991 and transformed it into a large assembly plant over time. Since 1998, Volkswagen Slovakia has been by far the largest firm and the largest exporter in the country. Its turnover was close to $5 billion in 2003 (Anderson 2004) and its exports

/...

Box II.16. Slovakia: a new hub for European automobile production (concluded)

exceeded $4.4 billion – 23% of the national total (AIA SR 2004). Currently, the labour-intensively manufactured off-road Touareg is its main product line.

French car-maker PSA Peugeot-Citroen and Hyundai of the Republic of Korea entered Slovakia through greenfield investments in small car production. PSA decided at the beginning of 2003 to build a factory in a town less than 100 kilometres from Volkswagen's Bratislava site. It is expected to start production in 2006. In early 2004, Hyundai chose Zilina, another town in western Slovakia, close to the other two plants, for another plant operation; this will reach full capacity in 2008. Slovakia's success in attracting automotive production is linked to five factors:

- The three main sites located in western Slovakia are close to Western Europe and in the middle of an emerging cross-border cluster of 13 car plants, 10 power train factories and hundreds of suppliers in a 500-km circle that encompasses the Czech Republic, Hungary, Poland, Slovakia and Slovenia (Wright 2004).
- Slovakia benefits, within that cluster, from good transportation links (a highway link to Western Europe is almost complete) and free movement of goods within the enlarged EU, which facilitates the cross-border supply of components.
- The country offers a combination of labour skills and competitive labour costs. The latter are particularly competitive due to the latecomer status of the country in attracting FDI. This has kept wages lower than in CEE countries that have been the traditional magnets for FDI (the Czech Republic, Hungary, Poland) and that, as a result, have seen their wages rising.
- Thanks mostly to Volkswagen's efforts – such as the construction of two industrial parks for suppliers – the supplier capacity of Slovakia is improving, making production more cost efficient. In 1997, the production value by Slovak automotive suppliers amounted to around $450 million. By 2003, it had increased by more than five times, to about $2.5 billion, more than 60% of which was sold to Volkswagen Slovakia in 2003 (AIA SR 2004).
- In the cases of PSA and Hyundai, the Government of Slovakia provided assistance within the limits of EU rules on State aid (up to 15% of the value of the projects): free land for the plants, construction financing, subsidies to train the labour force and tax breaks (Landler 2004). Direct payments to Hyundai were estimated to be around $170 million, while estimated public expenses related to the project amounted to $50 million (BBC Monitoring European 2004). PSA was expected to receive $114 million in government assistance (de Saint Seine 2003).

In addition to its contribution to export competitiveness, FDI in Slovakia's automobile industry is a major source of new investment and jobs. Over its 13-year presence in Slovakia, Volkswagen has invested around $1.3 billion in its Bratislava factory (Anderson 2004). PSA's and Hyundai's total investments, once fully operational, are expected to amount to $830 million and $1.5 billion, respectively (Wright 2004). In Bratislava, Volkswagen employs about 11,000 people, while its first-tier suppliers employ a workforce of more than 9,000 (Anderson 2004). Each of these TNCs plans to employ 3,000 persons, and thousands of additional jobs are likely to be created among suppliers.

To benefit fully from the opportunities presented by this emerging automobile industry, Slovak authorities have to deal with some of the challenges arising from its quick rise. One relates to labour skills and costs. To serve the assembly plants and their suppliers, training of many people with appropriate vocational skills is required. Also, as the three key plants are close to each other, general labour shortages may occur and wages rise. Authorities may also need to help firms that aim to become suppliers to the new plants, because the country's supplier industry is generally considered less developed than that of the Czech Republic or Poland (Mackintosh 2004). Even under an optimistic scenario of fast-increasing local supplies, Slovakia may need increasingly to import spare parts from neighbouring countries. Finally, the authorities of Slovakia will need to pay particular attention to completing the missing parts of the highway system linking the three plants to the Western European transportation networks.

Source: UNCTAD.

Table II.9. CEE: country distribution of FDI inflows, by range, 2003

Range	Economy
More than $1 billion	Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russian Federation, Serbia and Montenegro and Ukraine
Less than $1 billion	Albania, Belarus, Bosnia and Herzegovina, Estonia, Latvia, Lithuania, Republic of Moldova, Slovakia, Slovenia and The former Yugoslav Republic of Macedonia

Source: UNCTAD, based on annex table B.1.

b. FDI outflows: robust increase

FDI outflows from CEE rose by 42% in 2003, from $5 to $7 billion. The Russian Federation remained the leading source, alone accounting for the bulk (59%) of the region's outflows. The traditional dominance of Russian firms is reflected in the list of the top 25 TNCs of CEE (annex table A.II.2), in which they remain much larger than TNCs from other CEE countries (box II.18). Non-Russian outward FDI rose faster than that from the Russian Federation: Hungary's outward FDI surged from $0.3 billion in 2002 to $1.6 billion in 2003.

The surge of outflows is reflected in the ratio of FDI outflows to FDI inflows. On average, the ratio more than doubled, from 16% in 2002 to 33% in 2003. In 2002, the Russian Federation was already a net capital exporting country, a position that became more pronounced in 2003. Slovenia became a net capital exporter in 2003, while the ratio reached 62% for Hungary in the same year.

The Russian Federation, with an outward FDI stock of $52 billion in 2003, was the world's 21st largest outward investor (annex table B.4). In terms of the number of new FDI projects started in 2003, the Russian Federation moved up to 17th place, ahead of such countries as Finland, Turkey and Denmark.[41] The other CEE

Box II.17. EU enlargement has not led to large-scale FDI diversion

The eight CEE countries that joined the EU on 1 May 2004 have so far not diverted significant FDI flows away from the 15 older members or, more generally, have not improved their FDI position significantly relative to the older members. Over most of the late 1990s and early 2000s, the combined inflows of the eight remained considerably below the inflows for older EU members such as France and Germany and, more recently, Ireland and Spain (box table II.17.1). Since mid-1995, FDI flows into the eight accounted for a fraction of the inflows of the EU – a mere 4% in 2003, declining from a high of 11% in 1995.

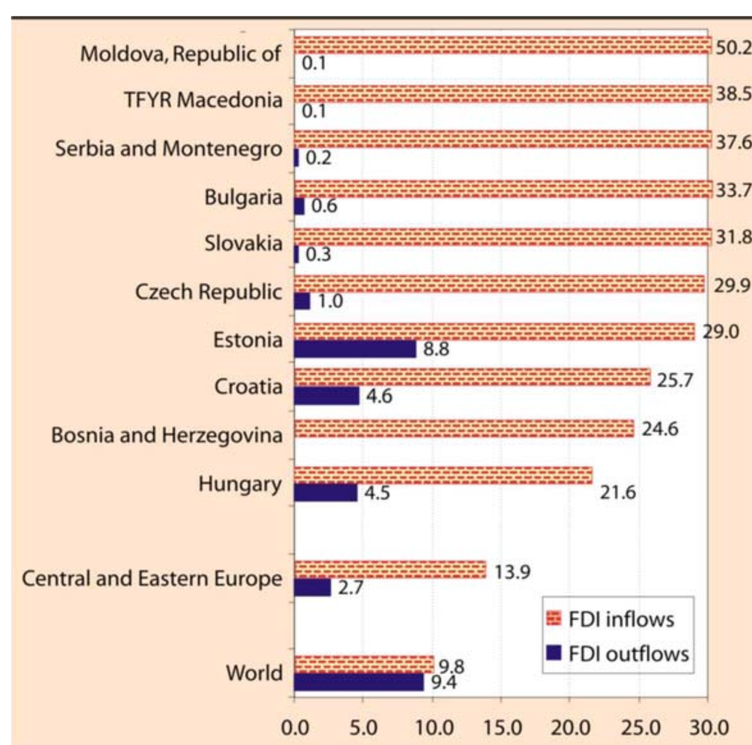
Box table II.17.1. FDI inflows into CEE countries acceding to the EU in 2004, compared with the EU-15, 1995-2003
(Billions of dollars)

Country/region	1995	1998	1999	2000	2001	2002	2003
CEE countries acceding to the EU	12.2	16.7	18.6	20.3	18.4	22.6	11.5
Of which:							
Czech Republic	2.6	3.7	6.3	5.0	5.6	8.5	2.6
Hungary	5.1	3.8	3.3	2.8	3.9	2.8	2.5
Poland	3.7	6.4	7.3	9.3	5.7	4.1	4.2
Slovakia	0.3	0.7	0.4	1.9	1.6	4.1	0.6
Memorandum:							
World	335.7	690.9	1 086.8	1 388.0	817.6	678.8	559.6
EU-15	114.6	249.9	479.4	671.4	357.4	374.0	295.2
Of which:							
France	23.7	31.0	46.5	43.3	50.5	48.9	47.0
Germany	12.0	24.6	56.1	198.3	21.1	36.0	12.9
Ireland	1.4	8.6	18.2	25.8	9.7	24.5	25.5
Spain	6.3	11.8	15.8	37.5	28.0	35.9	25.6
Share of FDI into CEE countries acceding to the EU in total inward FDI of EU-15 (%)	10.6	6.7	3.9	3.0	5.1	6.0	3.9

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

Source: UNCTAD.

Figure II.25. CEE: FDI flows as a percentage of gross fixed capital formation, top 10 countries, 2001-2003 [a]
(Per cent)



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

[a] Ranked on the basis of the magnitude of 2001-2003 FDI inflows as a percentage of gross fixed capital formation.

Box II.18. The 25 largest TNCs of CEE

In 2002, the 25 largest non-financial TNCs from CEE (annex table A.II.2) continued to expand both at home and abroad in terms of assets, sales and employment (box table II.18.1). The resilience of these top 25 firms contrasts with that of the firms on the top 100 list: the latter saw a marginal decline as a result of a global economic slowdown that year. Part of the explanation lies in the anticipation of EU enlargement by CEE TNCs, especially Russian and Croatian ones, as they aspired to gain a foothold in the 25-member EU. Another reason lies in the composition of the list, which is dominated by natural-resource-based firms (five on the list) and transportation companies (five).

The industry and country composition of the top 25 list in 2002 remained fairly stable compared to 2001. Three firms entered the list in 2002: Norilsk Nickel (Russian Federation), Finvest (Croatia) and Policolor (Romania). Latvian Shipping (Latvia), Lek (Slovenia) and Tiszai Vegyi Kombinát (Hungary) departed. Those departures increased the importance of natural-resource-based and Russian firms.

Russian TNCs continue to be larger and more transnationalized than the others – more than ten times in terms of foreign assets and foreign sales. And the transnationality index of the Russian firms is almost one and a half times higher than that of the other firms.

Box table II.18.1. Snapshot of the top 25 non-financial TNCs from CEE, 2001, 2002
(Billions of dollars, number of employees and per cent)

Variable	2001	2002	Change in 2002 from 2001[a]
Assets			
Foreign	9.3	9.8	5.4
Total	33.8	51.3	52.1
Sales			
Foreign	13.1	17.0	29.4
Total	30.2	33.6	11.1
Employment			
Foreign	30 053	31 643	5.3
Total	335 236	451 258	34.6
Average TNI	30.3	31.5	1.2

Source: UNCTAD, based on annex table A.II.2.

[a] The change between 2001 and 2002 is expressed in percentage points.

Source: UNCTAD.

countries were much smaller outward investors (in value terms, Hungary is 45th, Slovenia 53rd).

Outward FDI by Russian firms is motivated partly by a desire to gain a foothold in the enlarged EU, partly by a desire to control their value chains globally (e.g. Norilsk Nickel's investment into South Africa's Gold Fields, box II.19). As part of the latter's strategy, Russian companies continue to focus a large part of their outward FDI in other member countries of the Commonwealth of Independent States (CIS). In 2002-2003, four of the ten top destinations of outward FDI projects from the Russian Federation were other CIS member countries (table II.10).

In 2002-2003, the majority (Alrosa, Gazprom, Group Alliance, Itera Group, LUKoil, RusAl, UES, YUKOS) of the leading Russian outward investing firms (8 of the 15) – in terms of new projects set up abroad – were engaged in natural-resource-based activities. In the energy industry, in particular, Russian companies started to diversify their production base and access foreign markets by acquiring companies and establishing foreign affiliates. Gazprom began a large long-term pipeline joint venture linking the Russian Federation with Germany; and LUKoil initiated a $3 billion greenfield project in gas exploration in Kazakhstan.[42] Compared with these greenfield projects, the cross-border acquisitions of Russian firms tended to be smaller – in the order of $200-$300 million. For example, Norilsk Nickel signed the largest deal (box II.19), followed by LUKoil's acquisition of Beopetrol Beograd (of Serbia and Montenegro) and a partial acquisition of the Ukrainian Mobile Communications Enterprise by Mobile Telesystem. In 2004, the size of M&As by Russian firms rose.

Table II.10. The top 10 destinations of FDI projects from the Russian Federation, 2002-2003
(Per cent)

Country	Share
Ukraine (CIS)	13.9
Belarus (CIS)	4.8
China	4.3
Germany	4.3
Uzbekistan (CIS)	4.3
Kazakhstan (CIS)	3.9
Latvia	3.5
Romania	3.5
Egypt	3.0
Viet Nam	3.0
Top 10 destinations	48.5

Source: UNCTAD, FDI/TNC database (www.unctad.org/ fdistatistics) and OCO Consulting, LOCO*monitor* (for greenfield projects).

Box II.19. Norilsk Nickel: the fourth largest Russian TNC

After Gazprom, LUKoil and RusAl (aluminium), Norilsk Nickel is the fourth largest Russian TNC. Its assets abroad were estimated at around $2 billion at the end of 2002 (Liuhto and Vahtra forthcoming). It is a world leader in the production of several strategic metals: palladium, platinum, nickel, cobalt and copper (*idem*). It also deals with the sales and marketing of platinum-group metals (iridium, osmium, palladium, platinum, rhodium, ruthenium), cobalt and gold. Norilsk has been expanding abroad through a series of investments into trading and mining companies such as a 51% stake in the United States-based Stillwater Mining in 2003, a 20% stake in Gold Fields Ltd. of South Africa, and the acquisition of the London-based metal trading company Norimet Ltd. in 2000. Norilsk Nickel is particularly active in Belgium, South Africa, Switzerland, the United Kingdom and the United States. As a result, the firm is today the fifth largest producer of platinum-group metals and the fourth largest gold mining company in the world.

Source: UNCTAD, based on Liuhto and Vahtra forthcoming.

Besides natural-resource-based firms, the list of the top 15 Russian investors includes three automotive producers, one ICT company, one telecom operator, one insurance company and one food producer. The expansion of non-natural-resource-based companies abroad is a recent phenomenon. However, during the past few years, these companies have been active, opening production facilities, representative offices and sales units abroad to tap new markets and seize new business opportunities. For example, the ICT firm EPAM Systems aims to be a major competitor to the so-called "tier 1" offshore suppliers, especially companies in India that are traditionally strong in software development.

Slovenian and Hungarian TNCs, in contrast, seek to improve their intra-regional competitiveness by focusing their investment mostly on the lower income CEE or some developing countries. In the case of Hungary, oil and gas (an industry in which MOL is the national leader) accounted for 63% of outward FDI in 2003, followed by financial intermediation (22%) in which OTP is the national champion. MOL completed the integration of Slovnaft

(Slovakia) into the group, expanded its petrol-station network in Romania and acquired INA (Croatia). OTP completed the consolidation with its Slovakian affiliate and purchased DSK Bank in Bulgaria. In Slovenia, Lek, a firm that Novartis had acquired in 2002, became the leading outward investing firm in 2003; it had started production of generic drugs in Poland and Romania. Automotive supplier Prevent opened its 7th foreign production facility in Morocco and is planning to set up a plant in Shanghai, China. The value of outward FDI by other Slovene firms (e.g. domestic appliance producer Gorenje, retailer Mercator and engineering company Kolektor) is small.

In the future, other new EU members – such as the Czech Republic and Estonia – can be expected to report similar surges in FDI outflows.

2. Implications of EU membership for national policy

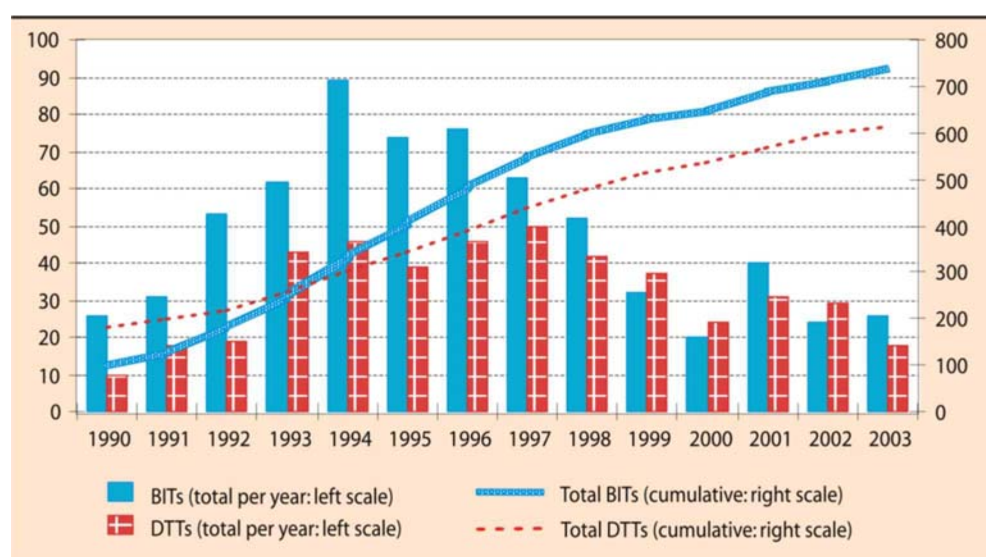
For the eight CEE countries that joined the EU in May 2004, full membership in the Union means that they needed to adopt the full body of EU law (the *acquis communautaire*). On the one hand, the *acquis communautaire* improves the business environment and the attractiveness of the accession countries. On the other hand, its application (e.g. concerning environmental protection or labour standards) may increase the cost of doing business.

In 2003, a number of CEE countries introduced policy measures aimed at liberalizing, promoting and protecting FDI. In the group of new EU member countries, for instance, the Czech Republic further liberalized its energy market and telecom industry, while Hungary adopted laws on the privatization of healthcare and on the gradual liberalization of the natural gas market in accordance with EU regulations (Natural Gas Act 2003). Other CEE countries, such as Serbia and Montenegro adopted various reform measures aimed at catching up with the rest of the region. For example, it permitted the free transfer of financial and other resources related to foreign investment, lifted previous limitations on the establishment of wholly owned foreign affiliates in the telecom and public information industries and lifted approval requirements for establishing foreign affiliates or for the acquisition of domestic companies (Foreign Direct Investment Law of 2003).

At the bilateral level, 26 BITs and 18 DTTs were signed in 2003. In the early 1990s, the number of DTTs in force was much higher than that of BITs. With the transition process picking up and various CEE countries gaining independence, the number of BITs and DTTs increased rapidly during the first half of the 1990s, with BITs growing faster than DTTs. The latter development reflected the growing importance attributed to inward FDI. With the transition process maturing, the number of new BITs and DTTs signed diminished (figure II.26). EU membership, however, made it necessary for old BITs to conform to EU regulations (box II.20).

A special policy issue arises out of the combination of relatively low wages, low corporate taxes and the use of subsidies – not so much for the new member countries as for the old EU members, especially those fearing a

Figure II.26. CEE: number of BITs and DTTs concluded, 1990-2003



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

Box II.20. BITs between the United States and the new EU member States and candidate countries

A number of provisions of the BITs between some of the new EU member States and candidate countries[a] and the United States were amended to facilitate these countries' meeting their obligations, whether existing or future, and to take steps to address potential incompatibilities between their existing international agreements and their obligations of EU membership.

BITs between these countries and the United States contained commitments on protection and market access for the FDI of investors of the contracting parties. In particular, they contained the principles of national treatment and most-favoured-nation treatment (MFN) at the pre- and post-establishment phases. With respect to some specific matters and industries (e.g. subsidies, agriculture and audio-visual), the Commission believed that these obligations would be inconsistent with specific obligations deriving from the EC Treaty and EU regulation. In addition, concerns with respect to national and MFN treatment, the obligations on performance requirements in some industries (i.e. audio visual and agriculture) were believed to raise issues of compatibility with EU rules as well.

To address the issue of compatibility between EU legislation and these BITs, the new EU members and candidate countries to the EU, the European Commission and the United States signed a Memorandum of Understanding (MoU) in September 2003 (box table II.20.1). This MoU served as a guide for amending and clarifying provisions in the individual BITs.

The amendments excluded from the scope of these BITs national and MFN treatment obligations measures with respect to agriculture, audiovisual, transport, financial services, fisheries and energy, to the extent such measures are necessary to meet EU obligations. The Understanding also addressed the EU concern that its authority, in accordance with article 60 of the EC Treaty, to adopt measures limiting capital movements and payments to and from third countries, and its authority under article 59 of the EC Treaty, to enact safeguard measures to preserve the functioning of the economic and monetary union, not be infringed.

Among the various issues dealt with under the amendments are obligations related to national and MFN treatment. For example, the Additional Protocol between the United States and Poland states that, in certain industries, the EU member country may take a reservation against national and MFN treatment obligations of the BIT, provided that such reservation is necessary to meet the country's obligations under EU law, and subject to the exception that, notwithstanding any such new reservation, existing United States investments in the country shall remain protected under the national or MFN treatment obligations of the BIT for at least 10 years from the date of the relevant EU law which made the reservation necessary. The Additional Protocol also provides that the United States reserves the right to make or maintain limited exceptions to national treatment obligations to fisheries and subsidies, and to the MFN treatment obligation in fisheries.[b]

Box table II.20.1. Specific BITs of new EU members and candidate countries with the United States

Country	Date of signature [a]	Date of entry into force	Date of expiry [a]
Bulgaria	23 September 1992	2 June 1994	1 June 2004
Czech Republic	22 October 1991	19 December 1992	18 December 2002
Estonia	19 April 1994	16 February 1997	15 February 2007
Latvia	13 January 1995	26 December 1996	25 December 2006
Lithuania	14 January 1998	22 November 2001	21 November 2011
Poland	21 March 1990	6 August 1994	5 August 2004
Romania	28 May 1992	15 January 1994	14 January 2004
Slovakia	22 October 1991	19 December 1992	18 December 2002

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

[a] BITs are tacitly renewed on the expiry date, but can be renounced at any time, with a one-year advanced notification after an initial period of ten years. As the BITs stood in their original version, before amendment, the acquired rights of established foreign investors remained valid for an unlimited period after the renunciation of the agreement. Following the amendments, the protection of acquired rights of established investors is limited in time, from ten to twenty years.

Source: UNCTAD.

[a] The countries concerned are Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania and Slovakia. The candidate countries are Bulgaria and Romania.

[b] The American Society of International Law, *International Law in Brief*, 7 April 2004 (http://www.asil.org/ilib/ilib0706.htm).

relocation of production facilities to the new EU members. As far as wages and related policies are concerned (table II.11), there have been long-standing differences between the more developed, higher wage, and the less developed, lower wage EU members. With the accession of ten new countries, discrepancies have further widened. In 2001, the average for the EU-15 was more than three times higher than that for the ten new member countries (table II.11). Even adjusted for labour productivity, new EU member countries offer major labour cost advantages.

As far as the fiscal regime is concerned, a wave of tax reductions at the beginning of 2004 was made by the majority of new EU member countries (table II.12). Not one of the eight CEE accession countries is in the top 11 in terms of corporate tax rates, while six are in the bottom eleven. A simple comparison of tax rates is of course not sufficient for assessing the relative tax burdens imposed on comparison. The profits to which the tax rates are applied ("the tax base") also needs to be taken into account.

Finally, under the EU Structural Funds, the eight new CEE members can expect (in the framework of the objectives defined by the EU regional policy) total transfers amounting to €21.5 billion over a three-year period (2004-2006) from the common budget of the EU.[43] These funds are intended mainly for such purposes as building basic infrastructure (including transportation), human resource development, competitiveness and enterprise development, rural development and improving environment. If used for the above purposes, they can enhance FDI attractiveness and improve the investment climate of CEE countries.[44]

This combination of factors – further combined with a favourable business climate, a highly skilled workforce and free access to the rest of the EU market – makes the eight accession countries attractive locations for FDI, both from other EU countries and from non-EU members. That applies especially to efficiency-seeking FDI. No wonder, then, that there are some concerns in the old EU members as regards a possible

Table II.11. Gross monthly average salary, selected economies, adjusted to productivity, 1998-2002
(Euros and per cent)

Country	Gross monthly average salary					Productivity[a]	Productivity/salary (EU-15=100%)
	1998	1999	2000	2001	2002	2000	2000
Average for the EU-15[b]	1 845	1 923	2 127	2 191	..	42.5	100
Of which:							
Greece	1 101	1 160	1 227	1 286	1 357	19.4	79
Portugal	..	..	1 052	1 112	..	10	48
Spain	..	1 297	1 326	1 372	1 425	26.1	98
New EU members from CEE	..	381	410	460	..	11.7	117
Of which:							
Czech Republic	..	343	379	430	510	10.9	144
Estonia	..	282	303	328	..	8.3	137
Hungary	307	314	348	408	489	11.1	160
Latvia	..	257	277	280	..	..	..
Lithuania	233	251	270	300	..	..	..
Poland	346	442	471	626	598	9.3	99
Slovakia	274	260	299	320	382	9.2	154
Slovenia	..	895	935	988	1 041	21.3	114
EU candidates	..	115	132	146	153	..	..
Of which:							
Bulgaria	101	111	120	127	132	..	..
Romania	..	120	144	165	174	..	..

Source: UNCTAD, based on http://europa.eu.int/comm/eurostat/; www.dree.org/elargissement (data in *italics*); and Stephan 2003, p. 10 (for productivity data).

[a] Value added per € 1,000 labour costs, national average.
[b] EUROSTAT estimate. Data for Austria, Ireland and Italy are not available.
[c] Average productivity is based on data for the Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia only.

Table II.12. Corporate tax rates in selected economies, 2003 and 2004: the highest and the lowest
(Per cent)

Rank	Economy	1 January 2003	1 January 2004
	Eleven highest		
1	Japan	42	42
2	United States	40	40
3	Germany	39.6	38.3
4	Italy	38.3	37.3
5	Canada	36.6	36.1
6	Israel	36	36
7	India	36.8	35.9
8	Malta	35	35
8	Pakistan	35	35
8	Spain	35	35
8	Sri Lanka	35	35
	Eleven lowest		
1	Cyprus	10/15	10/15
2	Ireland	12.5	12.5
3	Estonia	0/26	0/26 [a]
4	Lithuania	15	15 [a]
5	Latvia	19	15 [a]
6	Hungary	18	16
7	Chile	16.5	17
8	Hong Kong (China)	16	17.5
9	Iceland	18	18
10	Slovakia	25	19
10	Poland	27	19

Source: UNCTAD, based on *KPMG's Corporate Tax Rates Survey - 2004* (http://www.kpmg.co.uk/pubs/taxrates_04.pdf).

Note: On 1 January 2004, the Czech Republic applied a corporate tax of 28%, and Slovenia 25%.

[a] Information collected directly by UNCTAD.

relocation of manufacturing and services activities to the new members[45] – and the expectation of an FDI boom in the new members (section II.B.4).

3. A shift towards services brings about structural change

Service-related FDI inflows into CEE have followed the trend of growth in services (in GDP, employment, FDI) worldwide and in the region itself. In the CEE region, services had been largely neglected under the centrally planned economic system. With EU enlargement, the adoption of the *acquis communautaire* and the integration of the market for services, pressures have increased to upgrade services to the level of the old EU members and to attract FDI into higher value-added services, including export-oriented services.

In the largest host countries of the region (the Czech Republic, Hungary, Poland, the Russian Federation), the industry composition of inward FDI is gradually shifting from manufacturing towards services, and within services, from network industries privatized in earlier years towards business services. In the Czech Republic, Hungary and Poland, services had already become dominant in FDI in the late 1990s. In the Russian Federation, the structural change is slower, with both the primary and secondary sectors retaining a higher share of FDI. These variations reflect the increasing differences in income levels between the first three countries on the one hand and the Russian Federation on the other.

In general, the countries of CEE outside the CIS are characterized by substantial FDI penetration in infrastructure services (e.g. banking, telecommunications, water, electricity). In all non-CIS countries except Slovenia, foreign banks control the majority of banking assets (table II.13). Quite uniquely, foreign banks have penetrated not only the business segment, but also retail markets (Kraft 2004). In telecommunications, both the dominant operators and their competitors are mostly foreign affiliates.

In business services and R&D, however, FDI plays a relatively limited role. In terms of the number of FDI projects in services in 2002 and 2003, the Russian Federation leads, followed by Hungary, Romania, Poland and Bulgaria (table II.14). In terms of the largest projects, the Czech Republic, Hungary and Poland are the most frequently mentioned locations (Mikerova 2004).

Table II.13. CEE: foreign affiliates dominate banking assets, 2001
(Per cent)

Country	Share	Country	Share
Estonia	99	Latvia	65
Czech Republic	90	Macedonia	51
Croatia	89	Romania	47
Hungary	89	Albania	46
Slovakia	86	Moldova	37
Lithuania	78	Belarus	26
Bulgaria	75	Slovenia	21
Bosnia and Herzegovina	73	Ukraine	11
Poland	69	Russian Federation	9

Source: UNCTAD, based on annex table A.III.4.

Table II.14. Largest CEE recipients of services FDI projects, 2002-2003
(Number of projects and per cent)

Country	Number of projects			Share
	Total	Greenfield FDI[a]	Cross-border M&As	(Per cent)
Russian Federation	126	81	45	15
Hungary	121	72	49	14
Poland	116	37	79	14
Czech Republic	95	31	64	11
Romania	77	57	20	9
Bulgaria	53	31	22	6
Slovakia	43	18	25	5
Serbia and Montenegro	31	21	10	4
Total	852	439	413	100

Source: UNCTAD, based on information provided by OCO Consulting and UNCTAD, cross-border M&A database.

[a] Based on projects monitored in five key services areas: financial services, telecommunications services, headquarters and distribution centres, R&D and shared services/call centres.

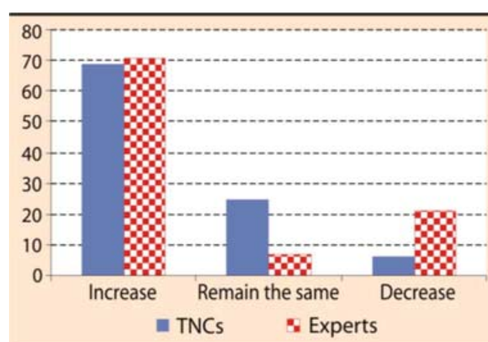
4. Prospects: again sunny

Robust growth is expected for FDI inflows into CEE, both in the new members of the EU and the rest of the region. Growth in CEE is predicted to remain robust, at 4.5% in 2004 (IMF 2004). Flows to EU accession countries are likely to experience a "second wind" of FDI from traditional investors seeking to reap the benefits from these countries' redefined location advantages. In the new members, this expectation is based on the wide range of new or expansion projects approved or committed over the past few years, which should lead to large FDI inflows in the near future. One illustration of this is the announced investment by Hyundai Motors in Slovakia (box II.16). Prospects for inward FDI will also depend on the success of these countries in positioning themselves as production and service platforms for TNCs originating outside Europe (the United States, Japan, the Republic of Korea, and, to a lesser extent, China and India).

Privatization in CEE is likely to pick up again in 2004, as new EU member countries seek to reduce further their public sector debts in line with EU requirements, which also augurs well for FDI. Over the longer term, many EU accession countries are well positioned to receive not only FDI, but also upgrade into higher value-added TNC activities. Better quality FDI should follow.

In UNCTAD's surveys of large TNCs and location experts (UNCTAD 2004a, 2004c), the CEE region attained the highest score, with more than two-thirds of the respondents of both TNCs and experts expecting FDI to increase during 2004-2005, fuelled by accession prospects (figure II.27). Poland and the Czech Republic were identified as the top FDI destinations. Romania, the Russian Federation and Hungary were also ranked high. Germany and the United States are expected to be the principal investors in the region. Location experts predict FDI inflows will rise in food and beverages and motor vehicles, while in services, prospects appear to be brightest in construction and real estate, retail and wholesale trade and transport (UNCTAD 2004a). Cross-border M&As and greenfield projects were viewed as equally important modes of entry by TNCs. Production still stands out as the corporate function most likely to be attracted to CEE, followed, at some distance, by logistics and supply services (UNCTAD 2004c).

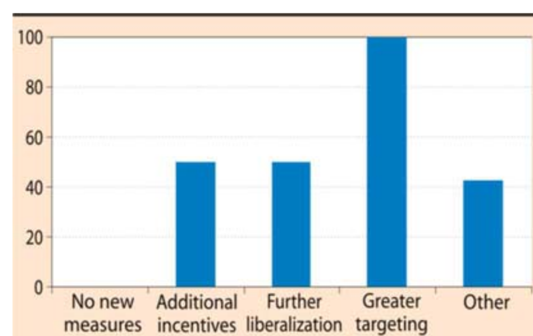
Figure II.27. CEE: prospects for FDI inflows, 2004-2005, as reported by TNCs and location experts
(Per cent of respondents)



Source: UNCTAD, www.unctad.org/fdiprospects.

As in the case of other regions, refined investor targeting, further FDI liberalization and additional incentives were mentioned as the principal instruments to attract FDI over the next year in UNCTAD's IPA survey (figure II.28). In fact, virtually all IPAs surveyed said they would use investor targeting to attract FDI into the region over the coming years, the highest proportion of all regions (UNCTAD 2004b). No IPA expected to remain passive by not introducing any new measures.

Figure II.28. CEE: expected policy measures to attract FDI, 2004-2005, as reported by IPAs
(Per cent of respondents)



Source: UNCTAD, www.unctad.org/fdiprospects.

C. Developed countries: the decline continues, but prospects are good

Mainly because of developments in the United States, FDI inflows into developed countries fell, but outflows increased in 2003. Policy measures at all levels improved the FDI climate, and a rebound in flows is expected in the short term.

1. Uneven trends

Developed-country FDI inflows declined by a quarter, to $367 billion – the lowest level in six years – whilst outflows increased by 4%, to $570 billion in 2003 (annex table B.1). Slow economic recovery, sluggishness in M&As and outflows of intra-company debt were mainly responsible for the continued decline. Outflows to developing countries increased, particularly in Asia, as TNCs sought locations with lower factor costs and high economic growth. FDI inflows were higher for 10 countries in the region and lower for 16. As a result of transshipped FDI, Luxembourg[46] was once again the largest FDI recipient worldwide, followed by China, France and the United States (figure II.29). The United States resumed its position as the top home country (figure II.29). FDI flows into the EU and Japan declined by 21% and 32%, respectively. In 2003, only two developed countries were ranked in the top ten in UNCTAD's Inward FDI Performance Index (down from three in 2002): Belgium-Luxembourg and Ireland, ranked first and fourth respectively (table I.5; annex table A.I.5).

Despite stronger performance in the world's stock market in 2003, cross-border M&A purchases and sales among developed countries were down in number and value for the third year in a row, to pre-1998 levels (annex tables B.7-B.8). At the regional level, North American and EU cross-border M&A sales declined by 16% and 37%, respectively. With regard to purchases, North American cross-border M&As grew by 8% while EU cross-border M&As fell by 44%. There were some large deals, including HSBC Holdings PLC (United Kingdom) acquiring Household International Inc. (United States), valued at $15 billion, the German company RWE AG acquiring American Water Works Co Inc. ($8 billion) and BP PLC-Russian Assets (Russian Federation/ United Kingdom parent) acquiring Alfa Renova-Russian Asset (Russian Federation) ($8 billion). Nevertheless, there were fewer cross-border M&A purchases and sales worth over $1 billion concluded by developed countries: purchases were down to 48 from 76 in 2002, and sales were down to 45 from 69 the previous year.

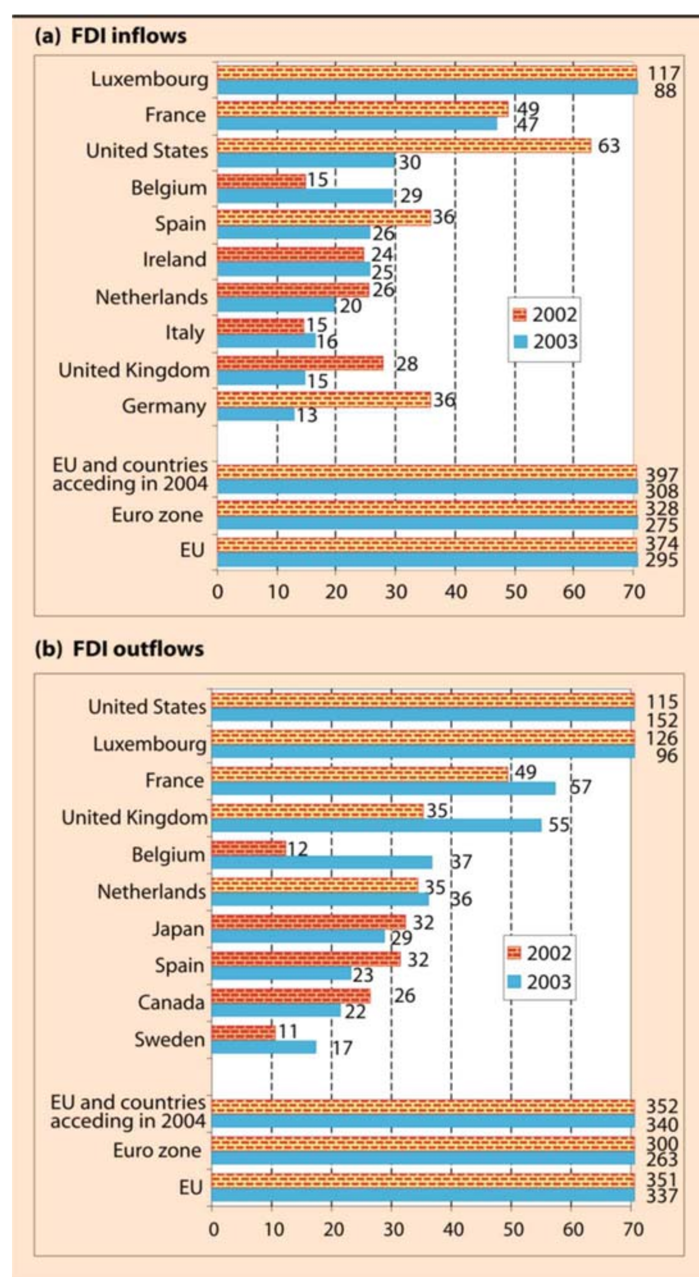
Inward investment into *North America* was down by 57%, largely on account of dropping inflows into the United States. FDI inflows into the United States declined (by 53%) for the third year in a row, to a low of $30 billion – its lowest value since 1992. There were large repayments of intra-company debt ($34 billion), as foreign affiliates in the United States reduced the debt they had accumulated with their parent firms abroad during the M&A boom of 1998-2001. With M&A activity running at much lower levels in 2003, new borrowing did not match repayments, resulting in substantial net outflows. Equity flows also declined (to $62 billion). Reinvested earnings rose because of improved profitability, but their level was low ($2 billion). FDI flows to Canada were at their lowest level since 1993, due primarily to divestments.

In recent years, the United States has increased its outward FDI while receiving much less inward FDI. This has meant that the balance-of-payments contribution of FDI has turned sharply negative. Thus, net FDI flows turned from a surplus of $171 billion in 2000 to a deficit of $122 billion in 2003 (figure II.30). The swing differs from previous such episodes in the past two decades in that it is the first time that both the FDI balance and the trade balance have moved negatively together. As a result, the combined impact of trade and FDI on the balance of payments in 2000-2003 went from minus $208 billion to minus $617 billion. The primary external financing for this growing deficit came from portfolio capital inflows, which surged (on a net basis) from $63 billion in 1999 to $437 billion in 2003. Most of these inflows were net foreign purchases of government debt securities.

FDI flows to the *EU* shrunk by over 21% in 2003, due primarily to sluggish economic growth, a fall in equity investment in general (and M&As in particular) and in intra-company loans. When the 16% depreciation of the dollar vis-à-vis the euro is factored in, the downward trend is even more pronounced. As noted above, Luxembourg's position as the top recipient (figure II.29) was due to transshipped investment (*WIR03,* p. 69). Only four EU countries registered

higher FDI inflows: Austria, Belgium, Italy and Ireland. Inflows into Austria rebounded strongly, in contrast to 2002 when they were low due to large divestments in the telecom industry. M&As and reinvested earnings were the main sources of the surge in FDI inflows. Belgium's FDI inflows doubled in 2003, with equity capital being the main source. FDI flows to Italy rose by 13% as a result of an increase in M&A activity, while in Ireland, they grew by 4% due to high equity inflows and reinvested earnings. However, in the case of both Italy and Ireland, these increases were more than offset by the depreciation of the dollar vis-à-vis the euro.

Figure II.29. Developed countries: FDI flows, top 10 countries, 2002, 2003 [a]
(Billions of dollars)



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

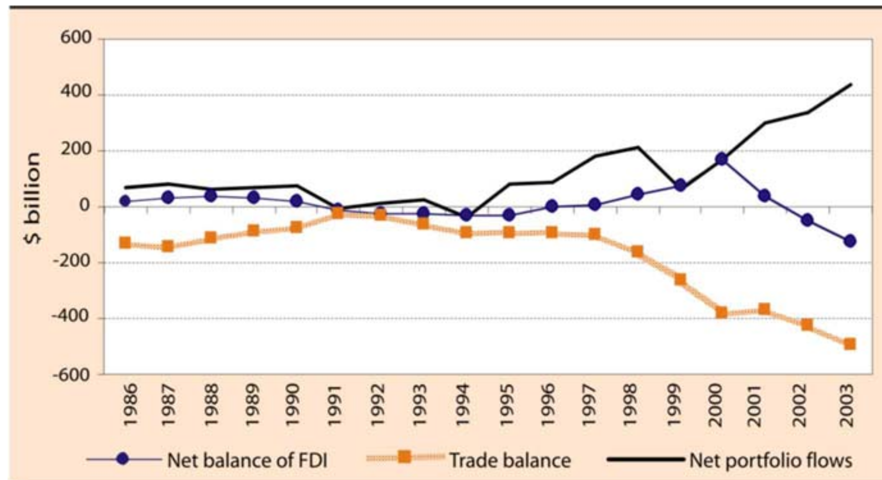
[a] Ranked on the basis of the magnitude of 2003 FDI flows.

Eleven EU countries registered lower inward FDI. In Sweden, inflows were at their lowest level since 1990, notably due to a major downturn in equity investment and intra-company loans. Group reorganizations (especially of the financial services Nordea Group) also had an impact. FDI flows to the United Kingdom were down by nearly half, mainly as a result of the continued downturn in cross-border M&As and a net repayment of loans to foreign parent companies. As a result, since 2000, FDI inflows to the United Kingdom have plummeted by $104 billion. In Germany, where inflows plunged by two-thirds, equity capital inflows remained stable, but were offset by large amounts of intra-company debt transactions. These were prompted by amendments to the German corporation tax act, which removed tax privileges on corporate borrowing by German shareholders. As a result, foreign parent companies reduced intra-company loans in favour of new equity investments. The decline since the peak year, 2000, amounts to $185 billion.

Inflows into "other Western Europe" rose by 140% in 2003. Switzerland's more than doubled, with both M&As and reinvested earnings rebounding strongly. In Japan, FDI inflows fell by one-third (having grown by half in 2002), with its share of global inflows remaining low, at only 1%. In recent years, inward investment has risen due to deregulation in the finance, telecom, retail and pharmaceutical industries, and to M&As in the auto and retail industries. But weak economic growth has held back significant improvements. Nevertheless, the country could achieve its target of doubling inward FDI stock by 2006 (box II.21).

For the first time since 1999, no developed country received more than $100 billion of FDI, with Luxembourg the only country to attract more than $50 billion (table II.15). For most of them, inflows were between $1 billion and $50 billion. Japan remained in the $1-$9 billion cohort (table II.16). In the 2001-2003 period, FDI inflows as a percentage of gross fixed capital formation continued the downward trend

Figure II.30. United States: balance of trade and net flows of FDI and portfolio investment, 1986-2003



Source: UNCTAD, based on IMF and OECD data.

Box II.21. Can Japan double its inward FDI stock by the end of 2006?

Prime Minister Junichiro Koizumi of Japan stated in January 2003 that Japan would seek to double the cumulative amount of inward FDI in five years.[a] To that end, concrete measures were proposed. The five priorities of this package (encompassing 74 specific measures) were: to disseminate information on FDI within Japan and abroad; to improve the business environment; to review administrative procedures; to improve the living standards and environment for TNC expatriates; and to develop local and national structures and systems (*WIR03*). Progress has been made with the successful implementation of the M&A code reform — of particular importance for improving the business environment, given that M&As are the main source of global FDI.

Despite the new measures, however, FDI inflows in 2003, on a balance-of-payments basis, amounted to $6.3 billion, down from $9.2 billion in 2002. This raises the question as to whether Prime Minister Koizumi's goal is achievable.

According to FDI stock data for the past five years, Japan was one of the top performers among developed countries. Between 1999 and 2003, a number of developed countries doubled their stock of inward investment: Ireland (168%), Austria (156%), Finland (153%), Portugal (122%), Switzerland (102%) and Japan (95%). However, growth in FDI stock started from a small base, and inflows for 2003 were lower than 2002. The stated goal of doubling inward FDI stock from $50 billion in 2001 to $100 billion in 2006 requires that Japan receive a minimum of $10 billion a year.[b] This represents a considerable challenge.

As the second largest economy in the world, Japan has a large potential market for FDI. It ranked 12th in UNCTAD's FDI Potential Index, but 127th in the FDI Performance Index for the 2001-2003 period (annex table A.I.5). High costs relating to personnel, land construction and company operations are some of the factors that have inhibited inward FDI. Furthermore, practices of various kinds – many informal – operate against inward FDI. In 2003, Japan's FDI inflows as a percentage of GDP at current prices were 0.1%, compared with 2.8% for the EU and 0.8% for the United States.

The main locational advantages of Japan for FDI are market size and advanced technological capabilities associated with created assets. The economy is rebounding from the economic stagnation of the 1990s, and growth prospects are relatively strong for the medium term. Japan is potentially a large market for efficiency-seeking and market-seeking FDI. The manufacturing sector is very efficient and globally competitive, as highlighted by the example of Nissan, and there is an emerging consensus that foreign firms can help revitalize poorly performing companies. Services FDI is growing, accounting for two-thirds of inward flows. Cross-border M&As have increased in this sector, including in traditionally protected industries such as retail trade[c] and financial services.[d] FDI in this sector now spans

/...

that began in 2001, falling to less than 10% (figure II.31). Excluding Luxembourg, Ireland ranked first place in this measure (figure II.32).

Unlike inflows, FDI outflows from developed countries rose by 4% in 2003 (annex table B.2). While outward investment from North America was up by 22%, from the EU it was down by 4%. Overall, outflows from 10 of 25 developed countries increased. The United States regained its position as the main investor country, followed by Luxembourg, France and the United Kingdom. United States outward flows rose by 32% on the 2002 figure, and its global share shot up to 25%, from 19% the previous year. They were mainly financed from reinvested earnings (from $75 billion to $119 billion), derived from

Box II.21. Can Japan double its inward FDI stock by the end of 2006? (concluded)

a wide range of industries – from telecoms to hotels and golf courses.[e]

Economic growth has increased, thus restoring prospects for market-seeking FDI. However, transaction costs are still high, and the exchange rate is volatile. A further potential limiting factor is the relative competitiveness of Japanese companies vis-à-vis foreign investing companies. Deregulation in retail, for instance, provides as many opportunities for Japanese companies as for foreign investors. In retail, neither Wal-Mart nor Carrefour are finding the Japanese market easy to exploit. Jusco, a local supermarket chain, is not only emulating Wal-Mart's market strategy, but improving on it.[f]

The wave of inward FDI in recent years was due to deregulation in the non-manufacturing sector, a rise in corporate failures, a decline in stock valuations, reductions in cross-shareholdings and the global M&A boom. In many ways, this represents the first wave of inward FDI into Japan. Given the importance of M&A activity in developed countries, reforms to facilitate such transactions are of particular relevance. Whilst reform of the M&A law is under way, the specific issue of tax deferral for stock swaps for foreign companies is only being evaluated and has not yet been revised. Since stock swaps account for a large share of global M&As, if this issue is not resolved, M&As with foreign companies will prove difficult. On a more positive note, local mayors and prefectural governors see FDI as a source of local economic regeneration and employment. The former perception of M&As (the main FDI entry mode into Japan) as job cutters has given way to one of job retention, as has been the case in Ripplewood's acquisition of Seagaia.[g]

In the final analysis, large-scale deregulation may still be necessary. Japan's FDI environment and attitude towards FDI has been improving. Whilst the concrete measures for the promotion of FDI in Japan should help, their full implementation will be necessary to achieve the goal of doubling the country's inward stock.

Source: UNCTAD.

[a] General Policy Speech by Prime Minister Junichiro Koizumi to the 156th Session of the Diet, 31 January 2003 (http://www.kantei.go.jp/foreign/koizumispeech/2003/01/31sisei_e.html). Reiterated in the General Policy Speech by the Prime Minister to the 159th Session of the Diet, 19 January 2004 (http://www.kantei.go.jp/foreign/koizumispeech/2004/01/19sisei_e.html).

[b] In Japanese yen, this represents 6.6 trillion in 2001 and 13.2 trillion in 2006.

[c] For example, Tesco (United Kingdom) acquired C Two Network in 2003. Costco (United States) and Carrefour (France) had already entered the Japanese market through greenfield investments, and Wal-Mart (United States) entered the market through a partnership with Seiyu.

[d] Goldman Sachs made a major investment of $1.27 billion in Sumitomo Mitsui Financial Group in 2003. Merrill Lynch & Co also took a major stake in a UFJ Holdings' affiliate to write off bad debt. However, it should be noted that Merril Lynch's foray into the Japanese market through a partial acquisition of Yamaichi Securities in 1998 led to massive losses.

[e] Distressed assets were acquired, for example, by Ripplewood Holdings and the Goldman Sachs Group. See, "Foreign acquisitions in Japan focus more on healthier firms", *Wall Street Journal* (Eastern Edition), 5 July 2002, p. A.8; and "A global journal report: Goldman plans $1.27 billion bet on Tokyo", *Wall Street Journal* (Eastern Edition), 16 January 2003, p. C.1.

[f] "A global journal report Pacific aisles: Wal-Mart's foray into Japan spurs a retail upheaval. As giant confronts barriers, local competitors rush to emulate its methods. Balking at the '10 foot' rule", *Wall Street Journal* (Eastern edition), 19 September 2003, p. A.1.

[g] In some cases, M&As have conserved jobs in target companies that would have gone bankrupt without M&As, for example, Ripplewood's acquisition of the troubled Seagaia resort in Miyazaki prefecture. "American investors put Japan's resorts in play ", *New York Times,* 6 Jan 2004, p. W.1.

Table II.15. Developed countries: frequency distribution of host countries, by range of FDI inflows, 1999-2003
(Number)

Range	1999	2000	2001	2002	2003
More than $300 billion	-	1	-	-	-
$100-299 billion	2	2	1	1	-
$50-99 billion	3	3	4	1	1
$10-49 billion	8	8	6	11	10
$1-9 billion	8	8	11	6	10
Less than $0 billion	4	3	3	7	5
Total [a]	25	25	25	26	26

Source: UNCTAD, based on annex table B.1.
[a] After 2002, Belgium and Luxembourg are reported separately.

Table II.16. Developed countries: country distribution of FDI inflows, by range, 2003

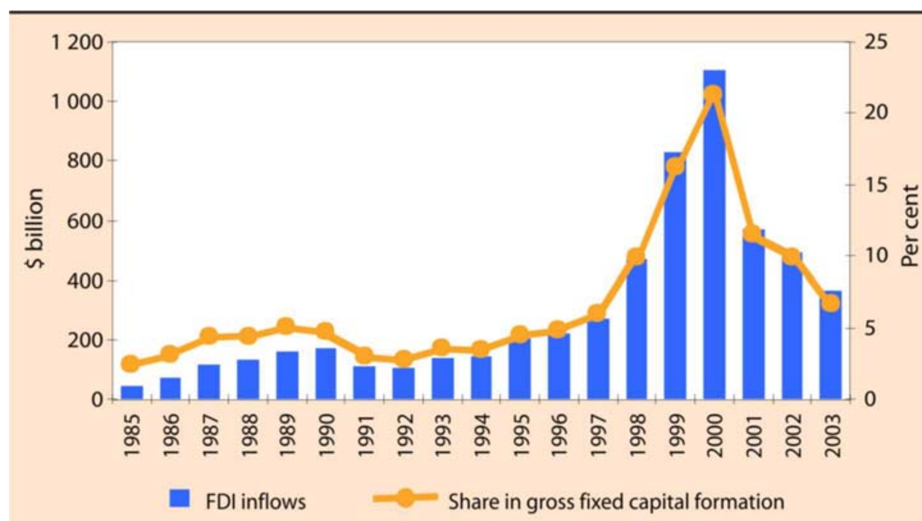
Range	Economy
More than $50 billion	Luxembourg
$10-49 billion	Belgium, France, Germany, Ireland, Italy, Netherlands, Spain, Switzerland, the United Kingdom and the United States
$1-9 billion	Australia, Austria, Canada, Denmark, Finland, Israel, Japan, New Zealand, Norway and Sweden
Less than $1 billion	Gibraltar, Greece, Iceland, Malta and Portugal

Source: UNCTAD, based on annex table B.1.

overall improvements in corporate profitability in foreign markets. Canadian outflows declined by 18%, despite more cross-border M&A purchases (annex table B.8). Overall, outflows from France and the United Kingdom rose by 16% and 57%, respectively. In these countries, this was largely due to increases in intra-company loans. Luxembourg's outward FDI flows fell by 24% paralleling a similar fall in inflows due to transshipped investment (*WIR03*, p. 69). Outflows from Germany slumped by 70%, due to reduced parent company loans as well as the weak performance of German enterprises. Denmark, Finland and Norway registered notable declines associated with large divestments, as the Nordea group, a financial services company whose shares are owned by these three countries and Sweden, came under the direct ownership of its Swedish parent firm.

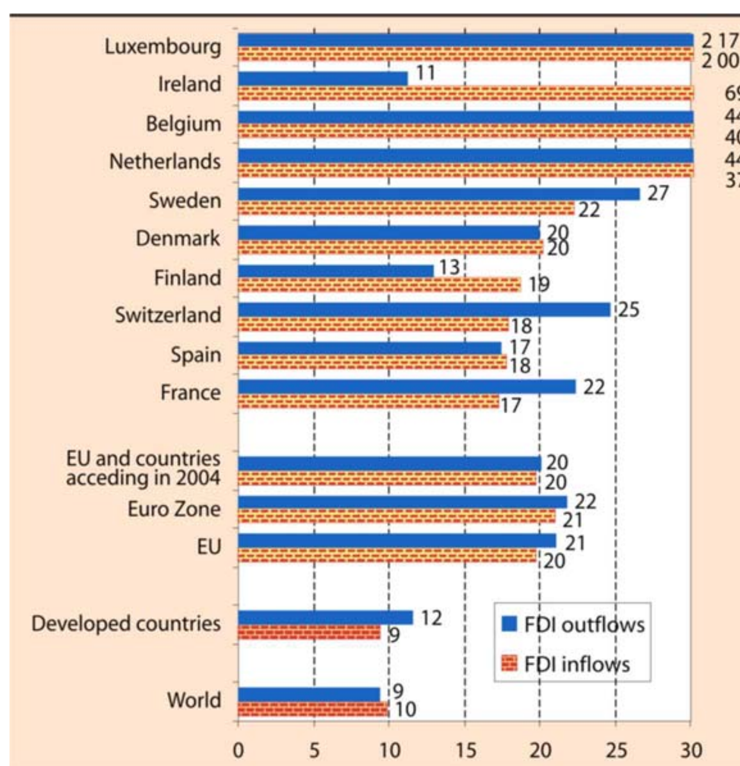
The importance of the EU and the United States diminished as the preferred destinations for developed-country FDI, as developing countries became the main poles of attraction. There was a tendency to look for lower cost locations in the face of intensifying competition and pressures to cut operating costs. While FDI from the EU into the CEE accession countries fell sharply in 2003, there were some notable investments. For instance, Volkswagen substantially increased its production in Slovakia (see CEE section).

Figure II.31. Developed countries: FDI inflows and their share in gross fixed capital formation, 1985-2003



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

Figure II.32. Developed countries: FDI flows as a percentage of gross fixed capital formation, top 10 countries, 2001-2003 [a]
(Per cent)



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

[a] Ranked on the basis of the magnitude of 2001-2003 FDI inflows as a percentage of gross fixed capital formation.

Japan's outflows continued to fall (by 11%), having also dropped in 2002. They were mainly in the tertiary sector, with Europe being the main destination. However, the trend is towards increased investment in manufacturing in Asia and the United States. Notable examples included the $8.7 billion investment by Nissan in the United States, and the $1.1 billion Toshiba-Matsushita joint-venture investment in a LCD plant in Singapore (JETRO 2003). This contrasts with FDI outflows from the United States and Europe, which increasingly involve services.

2. Policy responses

At the national level, a number of countries adopted policies aimed at attracting and facilitating FDI (table II.17). The FDI process was streamlined and simplified in France, Japan, Germany and Portugal. In response to declining FDI inflows, France set up a strategic council to recommend measures that would make it more attractive to investors (box II.22). Japan, as mentioned above, has launched an initiative at the highest level of government to double inward FDI by 2006 (box II.21).

Countries also continued to conclude BITs and DTTs – albeit at a reduced rate – reaching 1,211 and 1,691, respectively (figure II.33). This reflects the fact that developed countries have already entered into many such treaties – particularly BITs – with their key investment partners. There is also a trend towards signing up to multiple FTAs covering also investment issues. For example, the United States has concluded and initiated a number of FTAs with countries or groups of countries (e.g. in Central America and Southern Africa) (annex table A.II.1). In ongoing, but slow negotiations for a Free Trade Area of the Americas (FTAA), it has been agreed that the differences in the levels of development and the size of the economies will be taken into account (box II.23). The EU is developing economic partnership agreements (EPAs) with members of the African, Caribbean and Pacific (ACP) group of countries which, like FTAs and regional trade agreements (RTAs), will also cover investment issues.

Table II.17. Examples of policy changes in developed countries, 2003-2004

Country	Law / regulation/ policy	Policy changes
Austria	Privatization programme	Privatization of the State holding company, Österreichische Industrieholding (ÖIAG), the steel group, Böhler-Uddeholm (25%), Voest Alpine steelworks (34.7%), Telekom Austria (47.2%), and the engineering and services group, VA Technologie (24% State-owned). The government strategy is for a core of Austrian shareholders (through syndicates of industrial partners, banks, insurance firms and pension funds) to hold a majority stake in the privatized companies, to guarantee that their headquarters remain in Austria.
Canada	Legislation to reform the financial services industry	Allows foreign banks or interests to own up to 20% of an individual bank double the previous limit).
	Foreign ownership rules in telecommunications	Permitted ownership share in media companies raised from 20% to 33% by 2004.
France	Foreign investment policy	National Strategic Council for Attractiveness set up to enhance the appeal of France for investment and expertise.
	Regulation on financial relationships with foreign firms	Eliminates prior declarations and authorizations, except for investments in sensitive industries such as national defence and health. Non-EU investment is now subject only to the administration declaration, regardless of the investment amount.
Germany	Foreign investment Modernization Act	Eliminates tax disadvantages faced by foreign investment funds distributed in Germany.
	Tax Allowance Reduction Act	Avoids double taxation. Allows income tax paid abroad to be credited against German taxes due.
	Foreign investment policy	The Invest in Germany corporation replaced the separate offices of the commissioner for FDI in Germany and the Industrial Investment Council as the one-stop shop for investors.
Ireland	2003 budget	Non-trading investment income (such as interest, royalties and rental income) is now taxed at 25%, to discourage brass-plate companies.
Japan	Foreign investment policy	The Japan External Trade Organization (JETRO) opened the Invest Japan Business Support Center, a one-stop office that will provide foreign companies with complete information on conditions and procedures, and related consultation, regarding investment in Japan.
	Foreign investment policy	Concrete measures put in place to increase inward FDI (box II.21).
	Trade Insurance Scheme	This scheme is run under the auspices of the Ministry of Economy, Trade and Industry. Japanese affiliates abroad (specifically Asia) can utilize government trade insurance from 2004.
Portugal	Contractual regime	Establishment of a single contractual regime for large-scale investment projects, regardless of the business sector involved or the nationality of the investor.
	Procedures relating to FDI	Simplified procedures relating to FDI.
	Regulations on shares of foreign capital in privatized companies	Certain regulations limiting the shares of foreign capital in privatized firms have been repealed.
Spain	Tax reform	The standard capital gains tax for companies has been cut from 18% to 15% for assets held for more than one year.
Sweden	Tax	Tax on capital gains on the sale of business-related shares on or after 1 July 2003 (the same should apply to Swedish economic cooperation, certain foundations and non-profit organizations) have been abolished.
Switzerland	New telecoms law	Aims to complete opening to investors of the last-mile telecoms network, which is fully owned by Swisscom.
United Kingdom	The Finance Act, 2003 The change took force for accounting periods starting on or after 1 January 2003.	Changes the basis of taxation for non-resident companies operating in the United Kingdom.
United States	The Safeguards Rule	On 23 May 2003, non-bank financial institutions must be in compliance with the Federal Trade Commission ("FTC") rule implementing the information security requirements of the Gramm Leach Bliley Act ("GLBA").
	Ratification of the Madrid Protocol with the World Intellectual Property Organization (WIPO) in Geneva on the 2 August 2003.	Provides trademark owners with the option to use the International Registration system to protect their trademarks in all of the 59 Madrid Protocol member countries with only one application, in one language and with one set of fees in a single currency.

Source: UNCTAD.

Box II.22. France adopts new measures to attract FDI and skills

In 2003, Prime Minister Jean-Pierre Raffarin outlined a number of new measures to attract FDI to France. Forty measures were drawn up with the relevant government departments.[a] The overall objective was to identify and analyze both the strengths and weaknesses of France as a host country for FDI compared with its competitors. This new policy is to be guided by the recommendations of a national Strategic Council for Attractiveness (Conseil stratégique pour l'attractivité de la France). Members include also chief executives from leading TNCs.

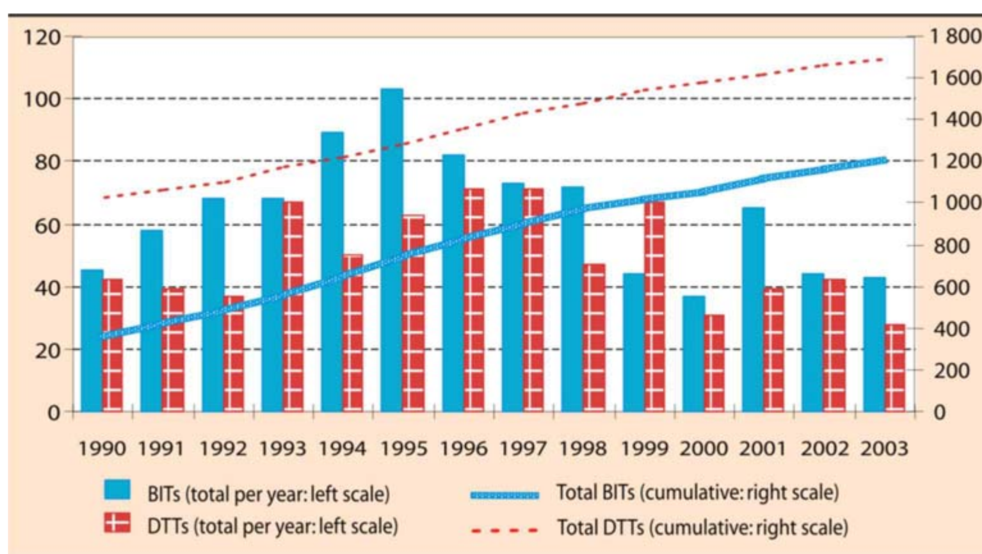
The measures seek to attract both skills and investment.[b] A programme is being launched in 2004 to attract the world's leading experts to growth sectors in France and to build teams centred around them. A number of measures aim to improve radically the conditions of entry and residence for expatriate managers and their families. With respect to attracting FDI, objectives include targeted improvements in the tax competitiveness of France, in particular relating to R&D and innovation. More effective support for the setting up of businesses will be provided, legal security for investors enhanced and laws simplified and modernized. Additional measures include initiatives to attract headquarters and decision-making functions of TNCs to France and to enhance its competitiveness as a European financial centre. This can be seen as an example of a developed country seeking to leverage the offshoring of services. Furthermore, a drive to promote France's image to investors internationally is to be launched in September 2004. This will involve an advertising campaign based on successful investments in France, and meetings with potential investors, specifically targeting the United States, the United Kingdom, Japan, Germany and China.

Source: UNCTAD.

a "France adopts new measures to enhance appeal", *AFII (Invest in France Agency) Press Release*, http://www.afii.fr/UK/Newsroom/PressReleases/?p=press_release_2003-12-11&l=en.

b "France adopts new measures to enhance appeal", *AFII Press Release*, 11 December 2003, http://www.afii.fr/France/Newsroom/PressReleases/press_release_2003-12-11_en.pdf.

Figure II.33. Developed countries: number of BITs and DTTs concluded, 1990-2003



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

Box II.23. Free Trade Area of the Americas[a]

At the seventh FTAA Ministerial Meeting held in Miami on 20 November 2003, participating countries agreed that the FTAA will include measures in each negotiating discipline, and horizontal measures, as appropriate, that take into account the differences in the levels of development and the size of the economies, and that are capable of implementation. Special attention will be given to the needs, economic conditions (including transition costs and possible internal dislocations) and opportunities of smaller economies, to ensure their full participation in the FTAA process.

Ministers instructed the Trade Negotiations Committee to develop a common and balanced set of rights and obligations applicable to all countries. They agreed that the negotiations on the common set of rights and obligations will include, among other things, provisions on services and investment. The results of the negotiations must be WTO compliant.

During the first week of February 2004, the Trade Negotiations Committee met in Puebla, Mexico, to develop guidelines for the FTAA negotiating groups for developing a common and balanced set of rights and obligations to be applicable to all countries and to develop procedures for plurilateral negotiations among FTAA countries that wish to undertake additional liberalization and disciplines within the FTAA. The co-chairs have agreed that further progress is necessary before resumption of the next meeting of the Trade Negotiations Committee.

Source: UNCTAD.

[a] The third draft of the Agreement and additional information is available at http://www.ftaa-alca.org.

Negotiations for these EPAs are taking place under the overall umbrella of the Cotonou Agreement. Japan has developed an FTA strategy aimed at strengthening alliances in areas not covered by the WTO; achieving liberalization over and above levels attainable in the WTO; facilitating the development and expansion of markets on a bilateral or regional level; and increasing Japan's bargaining power in WTO negotiations.[47]

3. Services dominate

Services dominated the changing pattern of FDI in developed countries as a group, accounting for more than two-thirds of both inflows and outflows in the 2000-2002 period. FDI in the primary sector was still of importance (albeit declining) in countries such as Australia (18% in 2001), the Netherlands (19% in 2001) and Norway (28% in 2001). Manufacturing still accounted for a large share of total FDI stock in some countries, notably Canada (52% in 2002), Iceland (54% in 2002), Italy (40% in 2001) and Sweden (68% in 2001), with chemicals, automobiles and machinery being the largest industries.

Developed countries are the prime source as well as destination of FDI in services. Between 1996 and 2002, inward and outward stocks in services rose in 10 and 13 developed countries, respectively.[48] In absolute and relative terms, the United States accounted for the highest outward and inward FDI stocks in services (amounting to $1,050 billion and $826 billion, respectively, at the end of 2002, or 69% and 61% of the totals, respectively – annex tables A.I.20-A.I.23), led by finance, trade, business activities and transportation, storage and telecoms. Other countries with a large share of services in their inward stock are Denmark, Switzerland, Luxembourg and France (above 80%, annex table A.I.22); countries with the largest outward share in services are Denmark, France, Austria and the United States (ranging from 69% to 78%, annex table A.I.23).

While finance has remained the top service industry, its share in total FDI stock has declined. Trade has also declined in relative importance. In contrast, FDI stock in business services and the transport, storage and telecom industries has expanded. Further liberalization and ongoing privatization programmes in the services sector have shaped this pattern. Cross-border M&As are important market entry vehicles for FDI in services in developed countries, with more deals concluded in infrastructural industries than in business activities, partly reflecting privatization.

Finance has consistently been the main industry for M&A sales and purchases, apart from 2000, when telecoms held sway. Between 1996

and 2002, the share of finance in inward FDI stock decreased from 21% to 19% and in outward stock from 27% to 23%, affected largely by the decline in M&As. In 2003, however, cross-border M&A purchases and sales in finance grew strongly, by 38% and 18%, respectively, due largely to the resurgence of global stock markets and strong growth in the United States economy. There has been a relative decline in the share of finance in inward FDI stock for some countries, notably the United States, the United Kingdom, the Netherlands and France. By contrast, FDI stock in finance rose in several countries due to significant increases in inflows in that industry in 2002, accounting for 46% of total FDI flows. This is due to the success of the International Financial Services Centre in Dublin, set up in 1987 as a financial services cluster. Locational advantages (appropriate regulatory environment plus incentives) were the catalyst, and agglomeration economies have taken root. In Switzerland and Germany, the finance industry attracted more than 70% and 40% of FDI inflows in 2002, respectively. The largest finance industry deal in 2003 was HSBC Holdings PLC (United Kingdom) acquiring Household International Inc. of the United States (annex table A.I.1). In May 2004, the Royal Bank of Scotland Group, plc. acquired a United States bank, Charter One, for $10.5 billion.

Business activities increased their shares of total inward and outward FDI stocks in developed countries to 14% and 22%, respectively (annex tables A.I.18 and A.I.19). Many developed countries have experienced large increases in their FDI market share in this industry in recent years, notably Denmark, France and Germany, with over half of their inflows going to such activities in 2002. Denmark, Austria and the United States accounted for the major shares of outward investment flows in these activities, all above 40% in 2002. The share of this industry in total purchases and sales of cross-border M&As declined in 2003, to 3% and 8%, respectively. In contrast to the increasing share of FDI flows and stock in general, cross-border M&As are used as a mode of investment in capital-intensive service industries to a greater degree than in business activities. Thus their value is usually smaller. One of the largest M&As in this industry in 2003 was the acquisition of a German company, Viterra Energy Services, by a United Kingdom investor group for $996 million.

Inward and outward FDI stocks in the transport, storage and telecom industries grew strongly, and their shares rose to each 7% by 2002 (annex tables A.I.18 and A.I.19). Cross-border M&As were the driving force, particularly in capital-intensive telecoms as illustrated by the large deal that took place in 2000 when Vodafone acquired Mannesmann AG for $203 billion. In 2003, the share of transportation, storage and telecoms in cross-border M&A purchases was down to 7%, having peaked in 2001 with a 19% share, primarily due to the telecom boom: the telecoms share in cross-border M&As did not exceed 4%, compared to 18% in 2001.

Trade almost retained its share of inward and outward FDI stocks (11% and 7% respectively in 2002) (annex table A.I.18 and A.I.19). However, it continues to account for a sizeable share of inward FDI stock in some developed countries such as Iceland (17%), Austria (16%) and the United States (16%). M&A purchases and sales in trade fell in 2003. The retail industry has been characterized by a spurt of M&A activity by the main players. Some major deals in 2003 include the Canadian company Alimentation Couche-Tard Inc. acquiring the United States company Circle K Corp. ($812 million), and the United Kingdom company Tesco's acquisitions of C Two-Network Co. Ltd. of Japan ($264 million) and Kipa Kitle Pazarlama Ticaret of Turkey ($118 million).

TNCs are finding niche areas for FDI in services. For example, the Netherlands has become an important logistics centre in Europe for companies such as Coca-Cola, Fed-Ex, Texas Instruments. Switzerland (Dupont, Philip Morris, Hewlett-Packard) and the Netherlands (Nike, Unisys, Starbucks) took the lead in attracting regional headquarters. Sweden has become the leading European country for winter car-testing for a number of automobile firms, while the film industry in London (Nachum and Keeble 2000) has also proven an attractive niche area for services FDI.

4. Prospects: FDI will pick up again, but not everywhere

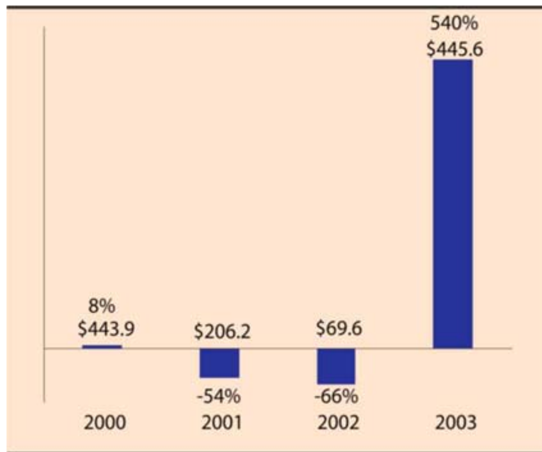
The outlook for FDI in 2004 is positive for both inward and outward FDI. But much will depend on the pace of the global economic recovery. FDI is expected to rebound in most developed countries as economic growth gains momentum. Prospects will be influenced by

developments in cross-border M&As, developments in the euro-dollar exchange rate, as well as the results of economic reform programmes under way in major economies.

Economic variables are favourable. Real GDP in 2004 (3.5%) is expected to be higher than in 2003 (2.1%), and its growth is predicted to be broad-based, including countries (France, Germany, the Netherlands, Switzerland) that experienced low or negative economic growth rates in 2003 (IMF 2004). The United States will lead economic growth. If the United States dollar should decline further, its impact on FDI flows is not certain. The profitability of firms in major countries continues to improve.[49] The United States' *Fortune* 500 firms experienced a dramatic turnaround (figure II.34). Stock markets, too, improved. Worldwide M&As, including cross-border ones, are picking up.

Figure II.34. Profits of the United States' *Fortune 500* firms, 2000-2003

(Values in billions of dollars and growth rates in per cent)

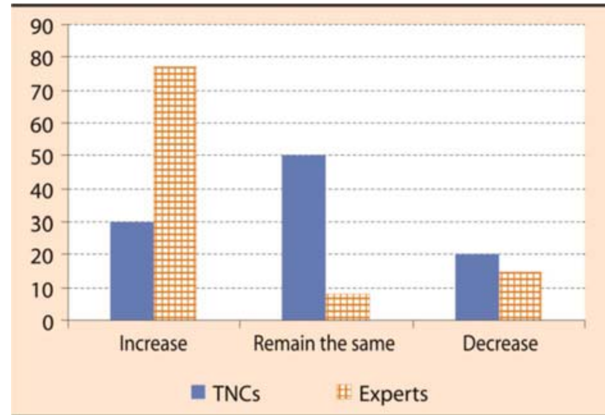


Source: *Fortune*, 5 April 2004, p. 97.

UNCTAD's survey of the top TNCs and international location experts yielded a mixed response as to FDI prospects in 2004-2005: almost 80% of experts but only 30% of TNCs predicted an increase (figure II.35). Greater optimism was expressed for North America and Japan than for Western Europe by TNCs. One-fifth of the TNCs surveyed predicted a deterioration in FDI in Western Europe (UNCTAD 2004c). Both TNCs and experts ranked the United States, followed by the United Kingdom and Canada, as the top FDI destinations among developed countries (UNCTAD 2004a, 2004c). Electrical and electronic products, motor vehicles, chemicals and machinery were viewed by experts as the most attractive industries in manufacturing. In services, transport and business services were seen to be the most attractive, followed by tourism, retail and wholesale trade and computer/ICT services.

Figure II.35. Developed countries: prospects for FDI inflows, 2004-2005, as reported by TNCs and location experts

(Per cent of respondents)



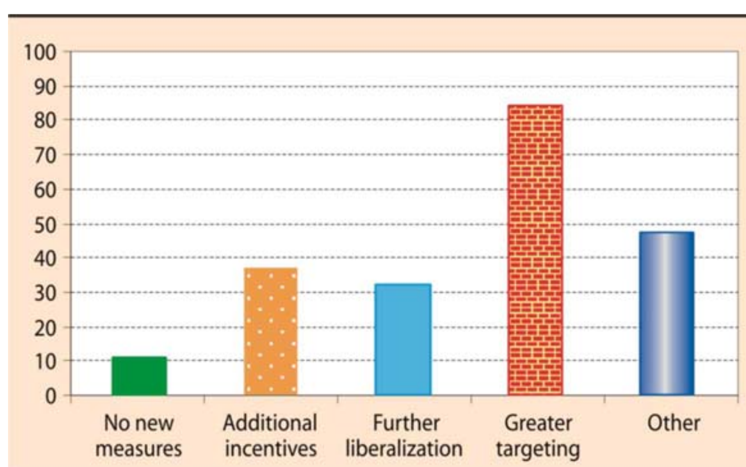
Source: UNCTAD, www.unctad.org/fdiprospects.

Location experts consider that the bulk of relocations will involve lower value-added corporate functions. Processing activities, followed by logistics and support functions, are the most frequently mentioned corporate functions likely to relocate abroad, in particular to developing countries. More respondents expected higher value-added functions such as R&D to relocate to developed countries than to developing countries (UNCTAD 2004a).

UNCTAD's IPA survey suggests that these institutions will make greater use of investor targeting – identified as the single most important measure to attract FDI in 2004. Further liberalization did not rank high. Some 10% of the responding IPAs – the highest share of all regions – did not envisage the introduction of any new measures (figure II.36). They view the United States, followed by Germany and the United Kingdom as being the top investors (UNCTAD 2004b).

Despite the overall positive prospects for economic growth in the region, FDI flows are likely to grow at a slow pace, unevenly across countries. Lower growth prospects for the Euro zone, compared with the United States and the United Kingdom, are likely to dampen FDI prospects there. For Japan, however, inflows are poised to increase, even if cross-border M&As continue to remain at a low level.

Figure II.36. Developed countries: expected policy measures to attract FDI, 2004-2005, as reported by IPAs
(Per cent of respondents)



Source: UNCTAD, www.unctad.org/fdiprospects.

Notes

1 Algeria, Angola, Benin, Botswana, Congo, Egypt, Ethiopia, Ghana, Mali, Morocco, Mozambique, Rwanda, Sierra Leone, South Africa, the Sudan, Tunisia, Uganda and the United Republic of Tanzania.

2 Niger and Zambia.

3 Burkina Faso, Cameroon, the Democratic Republic of the Congo, Côte d'Ivoire, Gabon, Gambia, Guinea, Kenya, the Libyan Arab Jamahiriya, Madagascar, Malawi, Namibia, Nigeria, Senegal, Togo and Zimbabwe.

4 AGOA encouraged the upgrading of automotive plants, with increased production and investment of over $20 million in South Africa. In Swaziland, investors from China and Taiwan Province of China invested over $30 million in denim fabric mills and other facilities. A new coffee-processing plant was built in Uganda to serve the United States market. A garments factory in Beira, Mozambique, attracted some FDI. In Mauritius, Chinese and Indian firms invested over $100 million in new spinning mills. The biggest winner was Lesotho, which became the largest African apparel exporter to the United States. Lesotho estimates that this has created 10,000 new jobs in the past year (*source:* www.agoa.info). Its exports to the United States grew from $129.5 million in 2001 to $267.7 million by the end of September 2003 (USITC, news.bbc.co.uk).

5 *Source*: http://allafrica.com/stories/200404010162.html.

6 *Source*: www.gov.bw/cgi-bin.

7 This is the first multilateral export credit and political risk agency in which its member countries directly assume financial liability for political risk-related foreign investment losses that could affect trade within their own countries.

8 Kitco Bullion Dealers (www.kitco.com).

9 Includes China, Hong Kong (China), Democratic People's Republic of Korea, the Republic of Korea, Macao (China), Mongolia and Taiwan Province of China.

10 FDI flows to China slowed down at the initial outbreak of SARS, but surged towards the end of the year, resulting in marginally higher flows than in the previous year.

11 Luxembourg received $88 billion of FDI flows in 2003, most of which was transshipped to other destinations.

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

13 Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam.

14 The initial outbreak of SARS deterred FDI to some countries. But in the second part of the year, flows recovered, averting an overall decline.

15 An increase in investment in the oil industry and construction services contributed to the rise in FDI flows to Brunei Darussalam.

16 Comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

17 Privatization proceeds of FDI increased from $5 million in 2002 to $30 million in 2003.

18 Comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

19 Comprises Bahrain, Cyprus, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, the occupied Palestinian territory, Qatar, Saudi Arabia, the Syrian Arab Republic, Turkey, the United Arab Emirates and Yemen.

20 Mainly China, Hong Kong (China), the Republic of Korea and Taiwan Province of China.

21 Such cooperation includes statistical harmonization. For instance, the ASEAN Working Group on Foreign Direct Investment Statistics was established to harmonize and improve the quality of data on FDI in the region so that progress in the ASEAN Investment Area arrangement can be effectively monitored and regional FDI measured.

22 Based on 12 economies (ASEAN countries (not including Cambodia), China, Hong Kong (China) and the Republic of Korea) for which data are available. These economies accounted for about 85% of the total FDI flows to Asia and the Pacific in 2002-2003.

23 Comprises Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China.

24 The services sector accounted for more than 60% of the GDP of the newly industrializing economies during 2000-2002, as compared to 39% for the other developing Asian countries.

25 Hong Kong (China), the Republic of Korea, Malaysia, Singapore (box IV.3) and Thailand have introduced policies for attracting regional headquarters and regional business hub activities.

26 "Asian companies raise a record amount of funds", *Financial Times*, 22 March 2004.

27 For example, profits of the top 1,000 companies in Asia for 2002/03 increased by 128% over the previous fiscal year (data obtained from the *Asian Week*). Profitability continues to improve in 2004: for 550 companies listed on the stock exchanges in the Republic of Korea during the first quarter of 2004 profits were twice as high as those in the corresponding period of 2003 (*Nihon Keizai Shimbun*, 19 May 2004). Improved profitability is also reflected in foreign affiliates operating in the region owned by 551 Japanese TNCs: profits rose by more than 40% in the two consecutive fiscal years 2002-2003 (*Nihon Keizai Shimbun*, 25 June 2004).

28 See "Surging demand revitalises electronics", *Financial Times,* 28 April 2004; "Strong sales of digital gear buoy Japanese electronic makers", *The Wall Street Journal Europe,* 28 April 2004.

29 See Thornton 2004; "America's largest corporations", *Fortune* 500, Vol. 149, No. 6, 5 April 2004; "Europe 500", *The Wall Street Journal Europe*, 24 June 2004.

30 "Citigroup lands $2.7 bn Koram deal", *Financial Times*, 24 February 2004.

31 "FDI push to continue, focus on core sector", *The Economic Times*, 29 May 2004 (http://economictimes.indiatimes.com/articleshow/706854.cms); "Economy can grow by over 8%: FM", *Outlook India.com*, 28 May 2004 (http://www.outlookindia.com/pti_news.asp?id=224767).

32 For instance, Vanuatu is promoting specific investment opportunities in tourism, agriculture and fisheries. It also plans to put in place an investment marketing strategy and product profiling for specific investment opportunities.

33 "Global semiconductor sales up 18.3% in 2003". Press release, Semiconductor Industry Association, February 2004 (http://www.sia-online.org/pre_release.cfm?ID=299).

34 "Thais become new budget jetsetters", *CNN.com*, 12 February 2004 (http://www.cnn.com/2004/TRAVEL/02/12/biz.trav.thai.nofrills.rent/); "Low-cost airlines catalyst for change", *Business Times*, 7 June 2004 (http://www.business-times.asia1.com.sg/story/0,4567,118936,00.html); "Singapore's no-frill Tiger Airways hits turbulence over name", *Channel News Asia*, 2 March 2004 (http://www.channelnewsasia.com/stories/corporatenews/view/73504/1/.html).

35 Other recent corporate surveys, too, indicate that companies are optimistic about increasing their investment in the region in the near future (Marugami et al. 2003; AT Kearney 2004).

36 Figures from ECLAC (2004) differ due to different country coverage; specifically, ECLAC data exclude financial centres such as Bermuda and the Cayman Islands.

37 For comprehensive data on FDI and activities of TNCs in individual LAC countries, see UNCTAD 2004g and www.unctad.org/fdistatistics.

38 Quoted from ECLAC in *The Economist*, 26 April 2003, p. 43.

39 Nunnenkamp (2003), comparing structural factors for 20 LAC countries and 8 Asian countries, found that Latin America lags significantly behind Asia in competitiveness. See also UNCTAD 2003e.

40 Owing to the acquisition of YPF by Repsol (Spain), 1999 was an exceptional year, and although there was a significant drop in 2000, the level of FDI was still higher than in 1998.

41 *Source:* OCO Consulting's LOCOMonitor database of greenfield FDI projects.

42 Zarubezhneft, a company not on the list of the top 15, started a $1.3 billion oil refinery project in Viet Nam.

43 The figure for the eight new CEE members is calculated on the basis of commitment appropriations under the Structural Funds for acceding countries, contained in the *Third Report on Economic and Social Cohesion* (European Commission 2004, p. 186).

44 The EU Structural Funds are not specifically directed to FDI, but may have an indirect effect. However, a simulation study showed that increasing and redirecting the Structural Funds would have only a small effect – 1% of total FDI (Breuss et al. 2001).

45 Concerns have been expressed in the press by various EU countries about relocation to new members. See, for example, Gunhild Lütge, "Ungarn lockt", *Die Zeit* (Hamburg), 22 April 2004 (http://www.zeit.de/2004/18/Siemens); "Im Sog des Ostens", *Tagesspiegel* (Berlin), 21 March 2004 (http://archiv.tagesspiegel.de/archiv/21.03.2004/1031764.asp); "Esso verlegt 200 Jobs nach Prag", *Hamburger Abendblatt* (Hamburg), 10 March 2004 (http://www.abendblatt.de/daten/2004/03/09/271295.html); "BASF kehrt im Herbst Wien den Rücken", *Der Standard* (Vienna), 1 April 2004 (http://derstandard.at/?id=1614047); "Avec l'élargissement, les délocalisations vers l'Est se multiplient", *Le Monde* (Paris), 28 March 2004 ; "Electrolux ferme une usine en Suède et relance le débat sur les délocalisations", *Le Monde*, 18 May 2004 (http://www.lemonde.fr/); and "Will bigger be better?", *Director* (London), 56(10) (May 2003), p. 49.

46 About four-fifths of FDI flows are transshipped FDI, i.e. investment that is invested in other countries. For an explanation, see *WIR03*.

47 "Japan's FTA strategy", Economic Affairs Bureau, Ministry of Foreign Affairs, Japan, October 2002, http://www.mofa.go.jp/policy/economy/fta/strategy0210.html.

48 Countries that experienced a fall in the share of services in inward FDI stock were Australia, Canada, Italy, Luxembourg, Portugal, Sweden and Switzerland, while countries that experienced a fall in outward FDI stocks were Australia, Italy, Luxembourg and Portugal.

49 For 551 Japanese firms whose profits are reported by region, domestic profits increased by 20% and foreign profits by 22% in fiscal year 2003 (*Nihon Keizai Shimbun*, 25 June 2004). Not surprisingly, Japanese FDI is expected to rise in 2004. Planned expenditures of FDI for 757 Japanese TNCs in 2004 are 12% higher than in 2003 (*Nihon Keizai Shimbun*, 17 May 2004). In particular, investment expenditures in China are expected to rise by more than 20%.