

United Nations Conference on Trade and Development

World Investment Report

2003 **FDI Policies for Development:
National and International
Perspectives**



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PART ONE

FDI FALLS AGAIN — UNEVENLY

CHAPTER I

FDI DOWN 21% GLOBALLY

Global foreign direct investment (FDI) inflows, down by 41% in 2001, fell by another fifth in 2002—to \$651 billion, or just half the peak in 2000 (table I.1). Driving the most significant downturn of the past three decades were weak economic growth, tumbling stock markets (which contributed to a plunge in cross-border mergers and acquisitions (M&As)) and institutional factors such as the winding down of privatization in several countries. The United States and the United Kingdom alone accounted for 54% of the fall in the countries with reduced inflows. In 2002,

- inflows in the developed world declined by 22%, with nine countries experiencing

increases and 16 countries decreases. The United States alone accounted for more than half of the fall in the latter countries;

- the decline in the developing world (23%), which faced even sharper declines in other private external capital flows, was steepest in Africa (41%), followed by Latin America and the Caribbean (33%). Flows to the world's most populous region, Asia and the Pacific, fell only a little, thanks to higher flows to China;
- Central and Eastern Europe (CEE) resisted the global decline, with its FDI inflows rising by 15%, although flows to 10 countries in the region fell; and

Table I.1. Selected indicators of FDI and international production, 1982-2002
(Billions of dollars and per cent)

Item	Value at current prices (Billion dollars)			Annual growth rate (Per cent)						
	1982	1990	2002	1986-1990	1991-1995	1996-2000	1999	2000	2001	2002
FDI inflows	59	209	651	23.1	21.1	40.2	57.3	29.1	-40.9	-21.0
FDI outflows	28	242	647	25.7	16.5	35.7	60.5	9.5	-40.8	-9.0
FDI inward stock	802	1 954	7 123	14.7	9.3	17.2	19.4	18.9	7.5	7.8
FDI outward stock	595	1 763	6 866	18.0	10.6	16.8	18.2	19.8	5.5	8.7
Cross-border M&As ^a	..	151	370	25.9 ^b	24.0	51.5	44.1	49.3	-48.1	-37.7
Sales of foreign affiliates	2 737	5 675	17 685 ^c	16.0	10.1	10.9	13.3	19.6	9.2 ^c	7.4 ^c
Gross product of foreign affiliates	640	1 458	3 437 ^d	17.3	6.7	7.9	12.8	16.2	14.7 ^d	6.7 ^d
Total assets of foreign affiliates	2 091	5 899	26 543 ^e	18.8	13.9	19.2	20.7	27.4	4.5 ^e	8.3 ^e
Export of foreign affiliates	722	1 197	2 613 ^f	13.5	7.6	9.6	3.3	11.4	-3.3 ^f	4.2 ^f
Employment of foreign affiliates (thousands)	19 375	24 262	53 094 ^g	5.5	2.9	14.2	15.4	16.5	-1.5 ^g	5.7 ^g
GDP (in current prices)	10 805	21 672	32 227 ^h	10.8	5.6	1.3	3.5	2.6	-0.5	3.4 ^h
Gross fixed capital formation	2 286	4 819	6 422 ⁱ	13.4	4.2	1.0	3.5	2.8	-3.9	1.3 ⁱ
Royalties and licences fees receipts	9	30	72 ^j	21.3	14.3	6.2	5.7	8.2	-3.1	..
Export of goods and non-factor services	2 053	4 300	7 838 ^k	15.6	5.4	3.4	3.3	11.4	-3.3	4.2 ^k

Source: UNCTAD, based on its FDI/TNC database and UNCTAD estimates.

^a Data are only available from 1987 onward.

^b 1987-1990 only.

^c Based on the following regression result of sales against FDI inward stock (in millions dollars) for the period 1980-2000: Sales=934.0435+2.351837*FDI inward stock.

^d Based on the following regression result of gross product against FDI inward stock (in millions dollars) for the period 1982-2000: Gross product=436.3332+0.421268*FDI inward stock.

^e Based on the following regression result of assets against FDI inward stock (in millions dollars) for the period 1980-2000: Assets=-1 443.239+3.929293*FDI inward stock.

^f For 1995-1998, based on the regression result of exports of foreign affiliates against FDI inward stock (in millions dollars) for the period 1982-1994: Exports=291.5394+0.453183*FDI inward stock. For 1999-2002, the share of exports of foreign affiliates in world export in 1998 (33.3 per cent) was applied to obtain the values.

^g Based on the following regression result of employment (in thousands) against FDI inward stock (in millions dollars) for the period 1982-1999: Employment=13 865.43+5.507718*FDI inward stock.

^h Based on data from the International Monetary Fund, *International Financial Statistics*, June 2003 and *World Economic Outlook*, April 2003.

ⁱ Data for 2002 was extrapolated using the share of countries and economies with available 2002 data in 2001 world gross fixed capital formation.

^j 2001.

^k Based on the International Monetary Fund, *World Economic Outlook*, April 2003.

Note: Not included in this table are the value of worldwide sales by foreign affiliates associated with their parent firms through non-equity relationships and the sales of the parent firms themselves. Worldwide sales, gross product, total assets, exports and employment of foreign affiliates are estimated by extrapolating the worldwide data of foreign affiliates of TNCs from Austria, Finland, France, Germany, Italy, Japan, Portugal, Sweden, Switzerland and the United States (for employment), those from Austria, Finland, France, Germany, Italy, Japan, Portugal and the United States (for sales), those from Japan and the United States (for exports), those from the United States (for gross product), and those from Austria, Germany and the United States (for assets) on the basis of the shares of those countries in the worldwide outward FDI stock.

- both manufacturing and services were hit hard, while FDI flows to the primary sector rose.

All this reduces the opportunities for developing countries to reap the benefits of FDI. The decline should however not obscure the fact that variations in flows do not change much the characteristics of the underlying FDI stock, which defines the structure of international production and which

remains dominated by the Triad (European Union (EU), Japan and the United States).

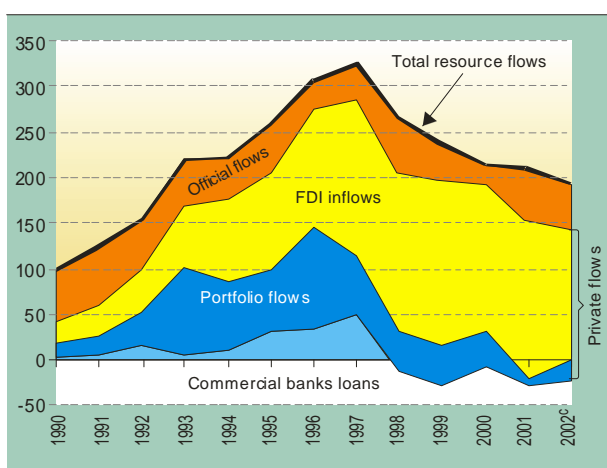
The prospects for a recovery in 2003: uncertain at best. Preliminary data do not suggest a rebound. Much will depend on the overall economic situation, especially in the main home countries.

A. The downturn continues

The decline in FDI flows in 2001–2002—after years of steady growth interrupted by a trough in the early 1990s and a sharp spurt in 1999–2000—was much steeper than that in GDP, exports and domestic investment (table I.1). FDI remains the biggest component of net resource flows to developing countries, fluctuating less than portfolio flows and commercial bank lending as measured by the relative variance of these variables (figure I.1).¹ And since 1990, it has been a growing part of total investment in developing countries (figure I.2).

The dramatic fall in FDI flows has slowed the expansion of international production. Sales, value added, assets, exports and employment of foreign affiliates all registered slower growth in 2002 (table I.1) than in 1996–2000 (but higher than

Figure I.1. Total resource flows^a to developing countries,^b by type of flow, 1990–2002
(Billions of dollars)



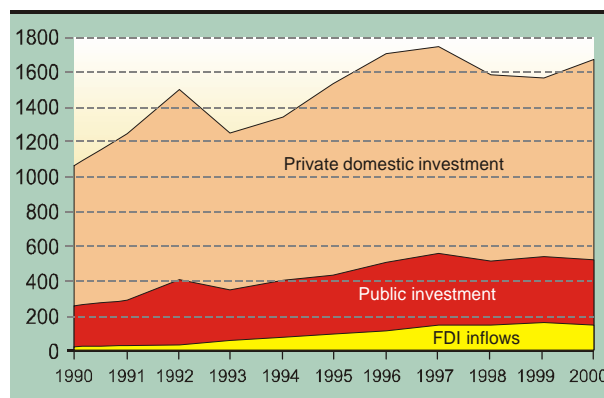
Source: UNCTAD, based on World Bank, 2003.

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

^b The World Bank's classification of developing countries is different from that of UNCTAD. Central and Eastern Europe is included in the former classification.

^c Preliminary.

Figure I.2. FDI inflows, private domestic investment and public investment in developing countries and Central and Eastern Europe,^a 1990–2000
(Billions of dollars)



Source: UNCTAD, FDI/TNC database; and Everhart and Sumlinski, 2001.

^a Data in this figure cover the following countries: Argentina, Azerbaijan, Bangladesh, Barbados, Belize, Benin, Bolivia, Brazil, Bulgaria, Cambodia, Chile, China, Colombia, Comoros, Costa Rica, Côte d'Ivoire, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Estonia, Grenada, Guatemala, Guinea-Bissau, Guyana, Haiti, India, Indonesia, Islamic Republic of Iran, Kazakhstan, Kenya, Republic of Korea, Lithuania, Madagascar, Malawi, Malaysia, Mauritania, Mauritius, Mexico, Morocco, Namibia, Nicaragua, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Poland, Romania, Seychelles, South Africa, Saint Lucia, Saint Vincent and the Grenadines, Serbia and Montenegro, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uruguay, Uzbekistan and Venezuela.

in 2001 for some indicators). For the largest transnational corporations (TNCs) most indicators of the size of foreign operations declined slightly in 2001, the beginning of the FDI downturn period (box I.1).

The slower growth of the foreign activities of TNCs in 2001–2002 could translate into lower ratios of the transnationalization of economic activities for host countries. In 2000, reflecting the FDI boom, the transnationality index continued to rise (figure I.3), with a noticeable increase over the previous year.²

Box I.1. The world's largest transnational corporations

After years of expansion, the foreign operations as measured by foreign assets, sales and employment of the top 100 TNCs worldwide, stagnated in 2001, the latest year with complete data (box table I.1.1). Despite the burst of the bubble in information and communication technology, there is no significant shift in the industrial composition of the top 100 (annex table A.I.1). Petroleum and automobile companies remain high on the list, still led by Vodafone, a telecom company.

The picture of the 50 largest TNCs from developing economies is more complex (annex table A.I.2). Due to the economic downturn, sales (both total and foreign) declined in 2001. Total assets and employment also fell. Like many of the largest 100 TNCs, they had to undergo a restructuring process in order to remain competitive in a difficult economic environment. However, these TNCs continued to expand their production capacities abroad as shown by increases in foreign assets and employment (box table I.1.1). The ranking remains fairly stable. Hutchison Whampoa consolidated its top position. And with Singtel ranked second, two companies with major interests in telecoms were in the top 10. Petroleum and electrical and electronic equipment also figure prominently. As in previous years, the majority of the companies on the top 50 list are headquartered in Asia. And except for five companies from South Africa, the remaining firms hail from Latin America.

The 25 largest non-financial TNCs based in CEE, many of them natural-resource based or in transportation, were only marginally affected by the global slump (annex table A.I.3). The geographic concentration of their activities also protected them. Russian TNCs continue to be larger and more globally spread than the others. With foreign assets of more than \$5 billion, Lukoil, the largest Russian TNC, compared with the top 10 in developing countries. Tiszai Vegyi Kombinát (Hungary) and KGHM Polska Miedz (Poland) rolled back their foreign presence in 2001. And Skoda Group Plzen (Czech Republic) went through bankruptcy, shrinking its assets at home and abroad. Replacing them were firms expanding rapidly abroad, such as the Hungary's pharmaceutical TNC Richter Gedeon.

Source: UNCTAD.

Box table I.1.1. Snapshot of the world's 100 top TNCs, top 50 from developing economies and top 25 from CEE, 2001

(Billions of dollars, number of employees and per cent)

(a) World's top 100 TNCs			
Variable	2001	2000	% change 2001 vs. 2000
Assets			
Foreign	2 934	3 113	-5.8
Total	5 914	6 184	-4.4
Sales			
Foreign	2 235	2 356	-5.2
Total	4 352	4 748	-8.3
Employment			
Foreign	6 890 178	6 791 647	1.5
Total	13 383 852	14 197 264	-5.7
Average TNI	59.4	55.7	3.7

Source: UNCTAD/Erasmus University database.

^a The change between 2000 and 2001 is expressed in percentage points.

(b) Top 50 TNCs from developing economies			
Variable	2001	2000	% change 2001 vs. 2000
Assets			
Foreign	183	155	17.6
Total	515	541	-4.9
Sales			
Foreign	143	186	-22.9
Total	355	393	-9.7
Employment			
Foreign	501 936	403 000	24.5
Total	1 159 476	1 321 449	-12.3
Average TNI	45.7	35.3	10.4

Source: UNCTAD, FDI/TNC database.

^a The change between 2000 and 2001 is expressed in percentage points.

(c) Top 25 from Central and Eastern Europe			
Variable	2001	2000	% change 2001 vs. 2000
Assets			
Foreign	9.3	8.1	15.2
Total	33.8	30.8	9.7
Sales			
Foreign	13.1	12.1	8.8
Total	30.2	29.8	1.6
Employment			
Foreign	30 053	32 203	-6.7
Total	335 236	353 983	-5.3
Average TNI	30.3	32.2	-1.9

Source: UNCTAD survey of the top TNCs in CEE.

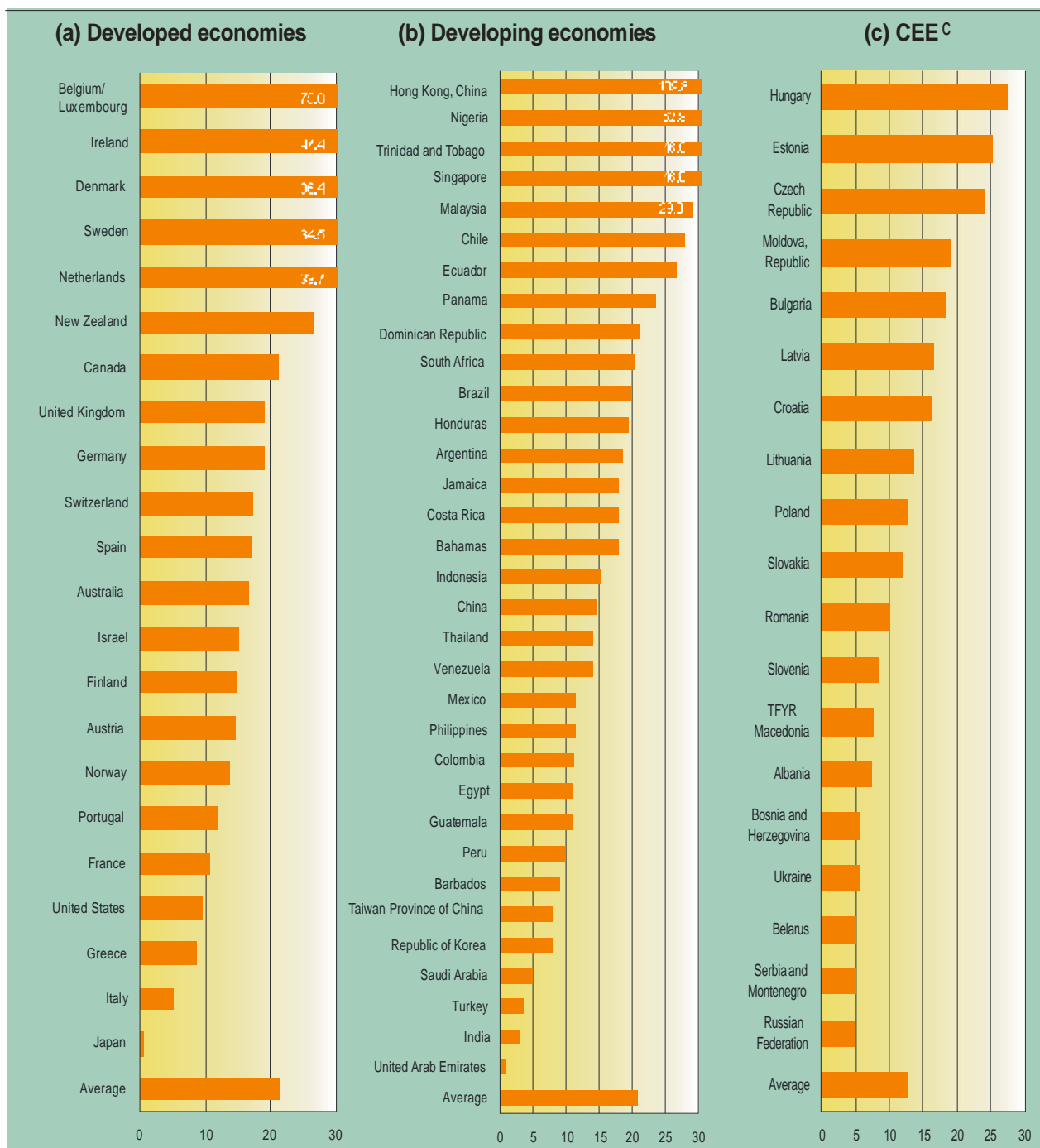
^a The change between 2000 and 2001 is expressed in percentage points.

B. The unevenness of the downturn

The decline in FDI inflows in 2001 and 2002 was uneven in four ways:

- *Geographically.* Regions fared differently, and a handful of countries accounted for the bulk of the decline worldwide.
- *Sectorally.* Flows to both manufacturing and services fell, but not those to the primary sector. Finance, transport, storage and communications
- were severely affected, while FDI in other industries remained virtually unchanged (health and social services) or even rose (mining, quarrying and petroleum).
- *Financially.* The decline in intra-company loans exceeded that in equity flows (in 2001 all the financial components of FDI declined about half).

Figure I.3. Transnationality index^a of host economies,^b 2000
(Per cent)



Source: UNCTAD estimates.

^a Average of the four shares : FDI inflows as a percentage of gross fixed capital formation for the past three years 1998-2000; FDI inward stocks as a percentage of GDP in 2000; value added of foreign affiliates as a percentage of GDP in 2000; and employment of foreign affiliates as a percentage of total employment in 2000.

^b Only the economies for which data for all of these four shares are available were selected. Data on value added are available only for Finland (1999), France (1998), Italy (1997), Japan (1999), Netherlands (1996), Norway (1998), Portugal, Sweden, United Kingdom (1997), United States, China (1997), India (1995), Malaysia (1995), Singapore and Taiwan Province of China (1994). For other economies, data were estimated by applying the ratio of value added of United States affiliates to United States outward FDI stock to total inward FDI stock of the country. Data on employment are available only for Austria, Denmark (1996), Finland (1999), France (1998), Germany, Ireland, Italy (1999), Japan (1999), Netherlands (1996), Norway (1996), Portugal, Sweden, United Kingdom (1997), United States, Hong Kong (China) (1997), Indonesia (1996) and Singapore (1999). For other countries, data were estimated by applying the ratio of employment of Finnish, German, Japanese, Swedish, Swiss and United States affiliates

^c For Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Lithuania, Romania, Serbia and Montenegro, Slovakia, TFYR Macedonia and Ukraine the employment impact of foreign-owned affiliates was estimated on the basis of their per capita inward FDI stocks. The corresponding ratios for employment refer to 1999. With the exception of Belarus, Czech Republic, Hungary, Poland and Slovenia, the value added of foreign-owned firms was estimated on the basis of the per capita inward FDI stocks. The corresponding ratios for value added refer to 1999.

- *Mode of entry.* Cross-border M&As fell more than greenfield FDI.

The decline in *outflows* was also uneven.

Geography

The United States alone accounted for nearly 90% of the decline in inflows to developed countries in 2002 (as it did in 2001) (table I.2; chapter II). Among developing regions the fall was steepest in Africa (41%), a return to normalcy after the exceptionally large inflows registered by two countries in 2001 (chapter II). Flows to Latin America and the Caribbean dropped for the third year in a row, this time by a third. The decline in flows to the Asia-Pacific region (which includes West Asia) was quite small (11%). And flows to CEE rose by 15%.

Despite the high concentration, the decline was widespread, with 108 of the total of 195 host economies receiving less in 2002 than

Table 1.2. FDI inflows to major economies, 2001 and 2002
(Billions of dollars)

Host region/economy	2001	2002
World	823.8	651.2
Developed countries	589.4	460.3
European Union	389.4	374.4
France	55.2	51.5
Germany	33.9	38.0
Luxembourg	..	125.6
United Kingdom	62.0	24.9
United States	144.0	30.0
Developing countries	209.4	162.1
Africa	18.8	11.0
Algeria	1.2	1.1
Angola	2.1	1.3
Nigeria	1.1	1.3
South Africa	6.8	0.8
Latin America and the Caribbean	83.7	56.0
Argentina	3.2	1.0
Brazil	22.5	16.6
Mexico	25.3	13.6
Asia and the Pacific	106.9	95.1
China	46.8	52.7
Hong Kong, China	23.8	13.7
India	3.4	3.4
Korea, Republic of	3.5	2.0
Malaysia	0.6	3.2
Philippines	1.0	1.1
Singapore	10.9	7.7
Taiwan Province of China	4.1	1.4
Thailand	3.8	1.1
Central and Eastern Europe	25.0	28.7
Czech Republic	5.6	9.3
Poland	5.7	4.1
Russian Federation	2.5	2.4

Source: UNCTAD, FDI/TNC database.

in 2001. With FDI inflows of \$53 billion, an average of \$144 million a day, China overtook the United States (\$30 billion) to become the world's second largest recipient (after Luxembourg), strengthening its position in world manufacturing exports (chapter II). India and Malaysia also attracted larger FDI flows (chapter II), while flows to the major host countries declined in Latin America (Argentina, Brazil, Chile, Mexico, Venezuela). In Africa, flows to Morocco and South Africa, the two largest recipients in 2001, fell considerably. In the CEE, the Czech Republic boosted its inflows to more than \$9 billion, thanks to the \$4 billion sale of Transgas to RWE of Germany.

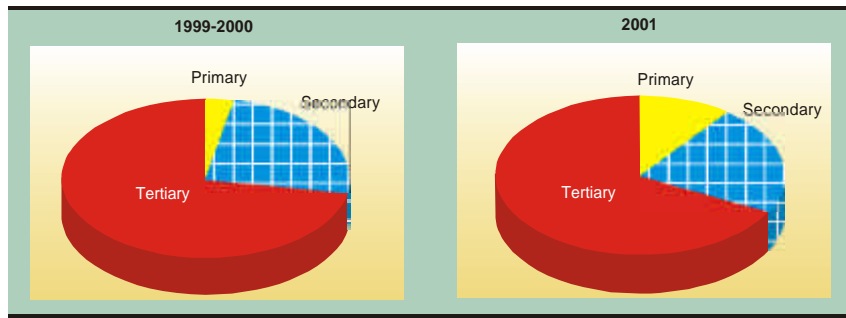
Sector

FDI inflows in 50 countries, which together accounted for roughly 90% of the total, declined by more than 45% in both manufacturing and services in 2001, compared with 1999–2000. But FDI in the primary sector rose by 70%, down in developing countries but up significantly in the developed countries (figure I.4; annex table A.I.4). Services are the single largest sector for FDI inflows. In the peak years 1999–2000, most large cross-border M&As were in services (particularly telecommunications), a pattern sustained in 2001–2002, though at a much lower level.

Financing

The role played by the three modes of FDI *financing* (equity investment, intra-company loans and reinvested earnings) in the decline in 2002 (as well as in the preceding year) was also uneven. The 2002 decline in intra-company loans (by 77%) was much larger than that in equity investments (by 12%) for the 30 countries (accounting for two thirds of total FDI flows) with data (figure I.5). The 79% fall in FDI flows to the United States in 2002 involved declines of \$50 billion in new equity investment and \$80 billion in intra-company loans—and a rise of \$30 billion in reinvested earnings. The fall in intra-company loans was due to large repayments of loans by foreign affiliates in the United States to their parent companies. Interest rates in the United States were lower than in other areas, especially the EU.³ And parent firms reduced loans to their foreign affiliates, particularly to EU affiliates in the United States, because of the reduced need to finance M&As in the United States (see chapter II).⁴

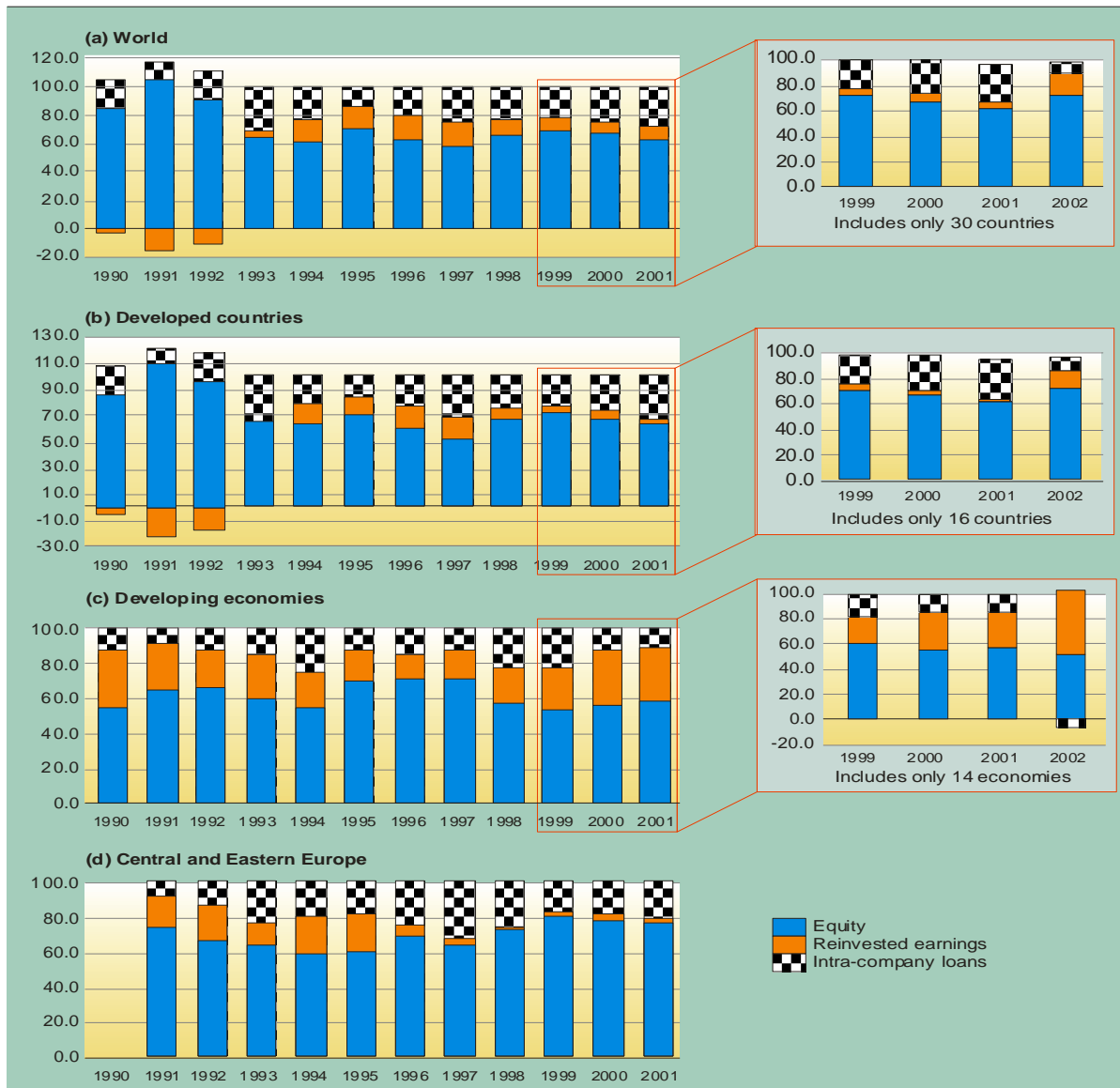
Figure I.4. Inward FDI flows, by sector, 1999-2000 and 2001 (Per cent)



Source: UNCTAD, FDI database and annex table A.I.4.

Notes: Data cover 50 countries for which data are available for 1999, 2000 and 2001. They account for 94 % and 89 % of world inward flows in 1999-2000 and 2001, respectively. In the absence of actual data, approval data were used in some countries.

Figure I.5. FDI inflows, by type of financing, 1990-2002 (Per cent)



Source: UNCTAD, based on IMF, Balance of Payments Statistics, April 2003 CD-ROM and UNCTAD FDI/TNC database.

Mode of entry

M&As declined relative to entry through greenfield projects. Cross-border M&As, down by 48% in 2001, fell another 38% in 2002. The share of cross-border M&A deals fell from at most 80% of total FDI flows in 2001 to at most 55% in 2002.⁵

Outflows

United States outflows (\$120 billion) rose by 15% in 2002 (chapter II). EU outflows (\$394 billion) decreased by 13% in 2002 and Japan's fell by 18%. In 2001 the decline in FDI flows from developed countries was concentrated primarily in other developed countries (table I.3). And in 2002, it is expected to be smaller. FDI from developing countries (\$43 billion) also declined, but its share in world outflows remained almost the same; 7% each in 1999–2000, 2001 and 2002 (annex table B.2). That from CEE (\$4 billion) rose, with the Russian Federation, the largest investor from the region, accounting for the bulk. Its share in world outflows also rose over the past years and reached 0.6% in 2002.

Table I.3. Outward FDI flows,^a by geographical destination, 1999-2001
(Billions of dollars and percentage distribution)

Region/economy	Value in billion dollars		Percentage distribution	
	Average 1999-2000	2001	Average 1999-2000	2001
Developed countries	924.2	470.1	83.7	74.6
Western Europe	640.9	259.7	58.0	41.2
European Union	589.4	236.6	53.4	37.5
Other Western Europe	50.9	24.1	4.6	3.8
Unspecified Western Europe	0.6	- 1.0	0.1	-0.2
North America	256.2	197.3	23.2	31.3
Other developed countries	25.0	9.1	2.3	1.4
Unspecified developed countries	2.2	3.9	0.2	0.6
Developing economies	129.2	115.2	11.7	18.3
Africa	6.8	8.5	0.6	1.3
North Africa	0.5	1.8	0.0	0.3
Other Africa	5.0	6.3	0.5	1.0
Unspecified Africa	1.3	0.4	0.1	0.1
Latin America and the Caribbean	84.7	69.1	7.7	11.0
South America	39.5	20.3	3.6	3.2
Other Latin America and Caribbean	36.4	38.0	3.3	6.0
Unspecified Latin America and Caribbean	8.8	10.9	0.8	1.7
Asia	33.9	36.5	3.1	5.8
West Asia	0.8	2.8	0.1	0.4
Central Asia	1.0	0.1	0.1	0.0
South, East and South-East Asia	31.0	32.8	2.8	5.2
Unspecified Asia	1.1	0.8	0.1	0.1
The Pacific	1.5	0.8	0.1	0.1
Unspecified developing countries	2.4	0.3	0.2	0.1
Central and Eastern Europe	18.0	18.6	1.6	3.0
Unspecified	32.7	26.3	3.0	4.2
Total world	1 104.1	630.3	100.0	100.0

Source: UNCTAD, FDI database.

^a Totals are based on data for the following countries: Australia, Austria, Belgium and Luxembourg, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and United States.

C. Performance Index captures the downturn's unevenness⁶

UNCTAD's third set of benchmarks for inward FDI performance and potential (following those in *WIR01* and *WIR02*) ranks countries by how they do in attracting inward direct investment and what their potential is in that respect. Not a full-blown analysis of the determinants of FDI location, the exercise is meant to provide data for policymakers on some variables that can be quantified for a large number of countries.

The Inward FDI *Performance* Index ranks countries by the FDI they receive relative to their economic size, calculated as the ratio of a country's share in global FDI inflows to its share in global GDP. A value greater than one indicates that the country receives more FDI than its relative economic size, a value below one that it receives less (a negative value means that foreign investors disinvest in that period). The index thus captures the influence on FDI of factors *other than market*

size, assuming that, other things being equal, size is the "base line" for attracting investment. These other factors are diverse, ranging from the business climate, economic and political stability, the presence of natural resources, infrastructure, skills and technologies, to opportunities for participating in privatization or the effectiveness of FDI promotion.

The ranks show large variations over time because the numerator (FDI shares) and the denominator (GDP shares) can shift significantly from one year to the next. The variations can be particularly large for economies with tiny global GDP shares, where a few large investments (say, for M&As, privatization or resource-extraction) can change the ranking significantly. It is thus important to bear in mind that in such cases strong inward FDI performance may be a temporary phenomenon. Given the nature of the variables

used, of course, such volatility is to be expected. If a different denominator, like population, were used, the ranks would be much more stable but this would not capture the attractiveness of an economy to FDI as well.

The Inward FDI *Potential* Index captures several factors (apart from market size) expected to affect an economy's attractiveness to foreign investors. Because the index relies on variables that can be quantified with the available data, it does not include the social, political, governance and institutional factors that may affect FDI but are impossible to compare meaningfully across countries. It also does not include some economic factors like tax incentives for FDI, quantity and quality of skills, availability and efficiency of local suppliers or cost of infrastructure services that are in principle measurable but for which data are not available.

Performance Index

The leader in the 1999–2001 Inward FDI Performance Index, Belgium and Luxembourg, retains the rank it attained in the earlier period (1998–2000).⁷ Of the top 20 performers, six are industrialized, two are mature East-Asian tiger economies, three are economies in transition and the remaining nine are developing economies, including three from sub-Saharan Africa (table I.4). The two lowest-ranked performers in 1999–2001 are Suriname and Gabon, followed by Indonesia, badly affected by the 1997 financial crisis. The laggards also include several oil-rich economies from the West Asia and North Africa region.

These index ranks are, of course, quite different from the ranks given by the values of FDI inflows. For instance, the largest FDI recipient in

Table I.4. Ranks in the UNCTAD inward FDI performance index, 1999–2001

Rank	Economy	Rank	Economy	Rank	Economy	Rank	Economy
1	Belgium and Luxembourg	36	Switzerland	71	Venezuela	106	Ethiopia
2	Angola	37	Brazil	72	Mexico	107	Kyrgyzstan
3	Hong Kong, China	38	Armenia	73	Costa Rica	108	Russian Federation
4	Ireland	39	Germany	74	Austria	109	Italy
5	Malta	40	United Republic of Tanzania	75	Romania	110	Egypt
6	Singapore	41	Spain	76	Tunisia	111	Sri Lanka
7	Sweden	42	Argentina	77	Ghana	112	Turkey
8	Netherlands	43	Papua New Guinea	78	Peru	113	Greece
9	Denmark	44	New Zealand	79	United States	114	Guinea
10	Brunei Darussalam	45	Togo	80	Colombia	115	Botswana
11	Czech Republic	46	Morocco	81	South Africa	116	Pakistan
12	Gambia	47	Poland	82	Benin	117	Sierra Leone
13	Nicaragua	48	Mongolia	83	Nigeria	118	Kenya
14	Bolivia	49	Finland	84	Uzbekistan	119	Burkina Faso
15	Kazakhstan	50	Viet Nam	85	Myanmar	120	India
16	Congo, Republic	51	Latvia	86	Côte d'Ivoire	121	Niger
17	Guyana	52	Portugal	87	Belarus	122	Cameroon
18	Moldova, Republic of	53	Hungary	88	Ukraine	123	Haiti
19	Chile	54	Jordan	89	Madagascar	124	Zimbabwe
20	Cyprus	55	Honduras	90	Philippines	125	Bangladesh
21	Estonia	56	Bahrain	91	Australia	126	Rwanda
22	Croatia	57	Sudan	92	Korea, Republic of	127	Congo, Democratic Republic
23	Jamaica	58	Uganda	93	Tajikistan	128	Japan
24	Mozambique	59	China	94	Senegal	129	Oman
25	Bulgaria	60	Lithuania	95	El Salvador	130	Nepal
26	Slovakia	61	Thailand	96	Lebanon	131	Iran, Islamic Republic
27	Trinidad and Tobago	62	France	97	Iceland	132	Kuwait
28	United Kingdom	63	Georgia	98	Qatar	133	Malawi
29	TFYR Macedonia	64	Zambia	99	Guatemala	134	Libyan Arab Jamahiriya
30	Canada	65	Israel	100	Uruguay	135	Saudi Arabia
31	Dominican Republic	66	Bahamas	101	Algeria	136	United Arab Emirates
32	Panama	67	Albania	102	Taiwan Province of China	137	Yemen
33	Azerbaijan	68	Mali	103	Syrian Arab Republic	138	Indonesia
34	Namibia	69	Norway	104	Paraguay	139	Gabon
35	Ecuador	70	Malaysia	105	Slovenia	140	Suriname

Source: UNCTAD.

the industrial world in 2001, the United States, ranks 79th in the Performance Index. The largest in the developing world, China, comes 59th. Similarly, strong performers, such as Angola receive relatively small absolute values of FDI.

The ranks in the 1999–2001 Inward FDI Performance Index are similar to those in 1998–2000 (the correlation coefficient between them is 0.95). The five leaders are the same as the previous period (annex table A.I.5). (The top 10 gainers and losers between the two periods are shown in figure I.6.) The largest jumps are for relatively small economies, but there are also significant changes for large economies like South Africa (gainer) and Malaysia (loser), reflecting fluctuations in M&A activity or the effects of macroeconomic crises.

How do different regions fare in the Performance Index? Western Europe does best in the industrial world, raising its index value in the last two periods (figure I.7; annex table A.I.6). North America just maintains its index value (but at below one) from the early 1990s. In the developing world, Latin America and the Caribbean remain the best performers in the decade of the 1990s, with a better performance in the final period. North Africa and other Africa improve their position, but their indices values remain below

unity; note, however, that other (i.e. sub-Saharan) Africa does better than West Asia and South Asia. East and South-East Asia maintains an index value of over one, but has not recovered its performance of before the financial crisis. Among the economies in transition, Central Asia does very well, with the highest regional index value in the last period. CEE lowers its index value from above unity to below.

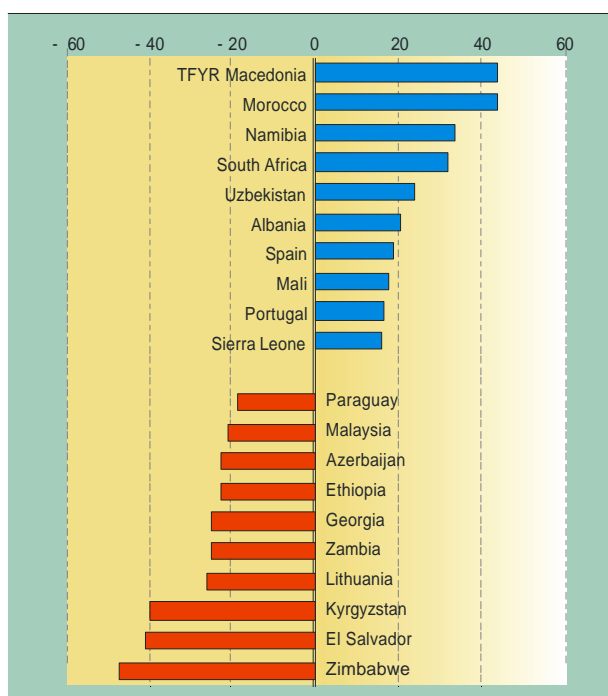
The preceding section has highlighted the unevenness of the recent decline in FDI. If Performance Index values are calculated for the years 2000 (the FDI peak year) and 2001 (the first year in the current FDI downturn period) separately, a similar unevenness appears. While one would expect two consecutive years to have fairly similar rankings, there is in fact a great deal of turbulence. The ranks shift more in these two years than in 1998–2000 to 1999–2001.⁸ There are 24 countries with rises in ranks of 20 or more places and 25 with falls of a similar magnitude. A big loser is Argentina, a result of its macroeconomic and political crisis. The list of countries with major losses in ranking also includes Bahrain, Jordan, Germany and Malaysia, with their inflows particularly affected by the economic slowdown.

Potential Index

The Inward FDI Potential Index, based mainly on structural variables (see annex table A.I.7 for raw data), is far more stable than the Performance Index. So the ranks for 1988–1990 are quite similar to those 12 years later in 1999–2001 (with a correlation coefficient of 0.92). Recent years show even higher correlation with the final year, reaching 0.99 for the preceding period 1998–2000. The ranks, as may be expected, correspond to incomes, with the United States leading in each three-year period (annex table A.I.8). But incomes do not fully reflect potential: Japan, Germany and Sweden, for instance, rank below Singapore and the United Kingdom in the Potential Index. At the bottom of the index are very poor countries, such as the Democratic Republic of Congo and Sierra Leone—but the country with the fourth lowest ranking, Zimbabwe, is richer than many countries that rank higher.

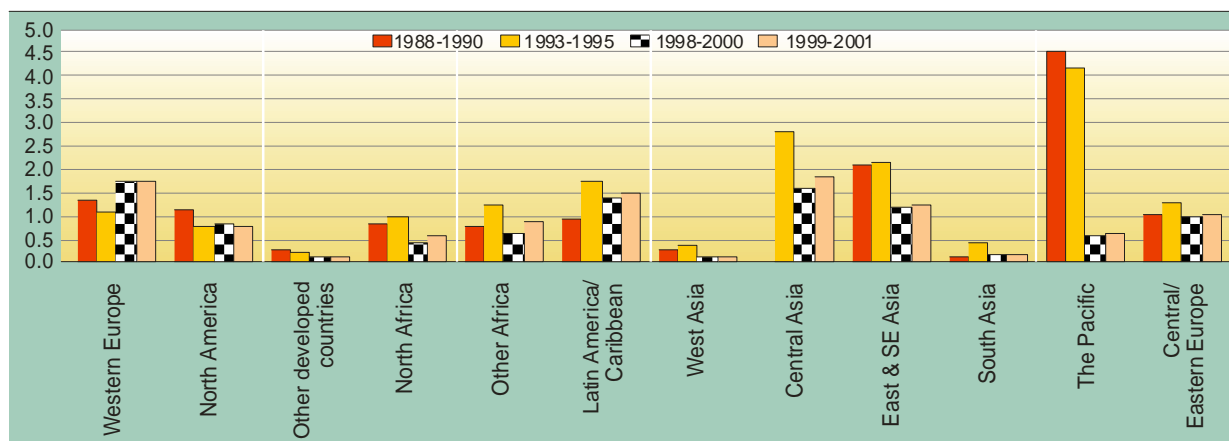
The leading 20 countries are all developed countries except for the four mature tiger economies of East Asia. The largest gains in the index over the 12 periods are by Guyana (39 places), Lebanon (27), El Salvador (26), Yemen (22) and Kuwait (18). Among developed countries, the main gainer is Ireland (13), and among the

Figure I.6. Main gainers and losers in Inward FDI Performance ranking, 1998–2000 to 1999–2001
(Change in rank)



Source: UNCTAD.

Figure I.7. Inward FDI Performance Index, by main region, 1988–1990, 1993–1995, 1998–2000 and 1999–2001



Source: UNCTAD.

newly industrializing countries the Philippines (10). The largest losers are Zimbabwe (down 55 places), Indonesia (50), Kenya (43), Pakistan (37) and Paraguay (37). Among developed countries the countries down most are Italy (8), France (7) and Australia (7).

It is not possible to compare ranks over time for most of the CEE countries because there are no data for the early years. However, the ranks are plausible and interesting. The leader is Slovenia, followed by the Russian Federation and the Czech Republic.

Comparing performance and potential

There is a surprising amount of broad overlap between the two indices. There are seven countries in common among the 20 leading countries by each index, and seven in the 20 lagging countries (table I.5). The exceptions are countries like Angola and Brunei Darussalam that have shot up in the performance ranks because of recent lumpy inflows of FDI for resource-based activities. Only one country, Japan, appears among the leaders in the Potential Index and the laggards in the Performance Index—again, the reason for this is well known.

There may be lessons from comparing the two indices, tracing the factors that lead to a discrepancy between the two ranks by drawing up a *four-fold matrix* of inward FDI performance and potential:

- *Front-runners*: countries with high FDI potential and performance.

- *Above potential*: countries with low FDI potential but strong FDI performance.
- *Below potential*: countries with high FDI potential but low FDI performance.
- *Under-performers*: countries with both low FDI potential and performance.⁹

The first and last groups do not raise any particular issues: the former includes many industrial, newly industrializing and advanced transition economies, the latter mainly poor (or unstable) economies. Changes over time in the positioning of economies in this matrix may also be of interest. Take some instances of deteriorating performance. The United States and Taiwan Province of China were front-runners in 1988–1990 and fell back over time; the Philippines moved from above to below potential over the 12 years; Nigeria moved from above potential to an under-performer; and so on (table I.6). By contrast, Israel moved from being in the below-potential group to front-runner. And so on. Exploring the causes and policy implications of such changes is beyond the scope of this exercise, but clearly there are many issues to be explored, both in terms of what the indices cover and also what they do not.

In policy terms, assuming that countries want to maintain or improve their FDI positions, those falling into the first set in the four-fold matrix presented above have to ensure their continuing success and those falling into the last, to boost their performance in both attracting FDI and enhancing their potential. The other two are of more interest. The above-potential countries are “hitting above their weight” in drawing more FDI than their potential warrants, and the below-potential ones

Table I.5. Leading and lagging 20 economies in inward FDI performance and potential indices, 1998-1990, 1993-1995 and 1999-2001

Rank	Inward FDI performance ranks			Inward FDI potential ranks				
	Economy	1988-1990	1993-1995	1999-2001	Economy	1988-1990	1993-1995	1999-2001
Leading 20 economies								
1	Belgium and Luxembourg	8	24	1	United States	1	1	1
2	Angola	106	7	2	Singapore	13	4	2
3	Hong Kong, China	3	14	3	Norway	5	5	3
4	Ireland	59	51	4	United Kingdom	3	6	4
5	Malta	21	22	5	Canada	2	2	5
6	Singapore	1	2	6	Germany	4	3	6
7	Sweden	50	25	7	Sweden	6	9	7
8	Netherlands	13	41	8	Belgium and Luxembourg	10	11	8
9	Denmark	53	43	9	Netherlands	8	10	9
10	Brunei Darussalam	103	18	10	Finland	9	15	10
11	Czech Republic	..	30	11	Ireland	24	22	11
12	Gambia	9	32	12	Japan	12	8	12
13	Nicaragua	96	37	13	Hong Kong, China	17	13	13
14	Bolivia	46	27	14	France	7	7	14
15	Kazakhstan	..	17	15	Switzerland	11	14	15
16	Congo, Republic	84	6	16	Denmark	16	16	16
17	Guyana	58	1	17	Iceland	15	19	17
18	Moldova, Republic of	..	35	18	Korea, Republic of	20	17	18
19	Chile	10	21	19	Taiwan Province of China	21	21	19
20	Cyprus	27	79	20	Qatar	22	20	20
Lagging 20 economies								
121	Niger	56	118	121	Bangladesh	105	118	121
122	Cameroon	114	127	122	Togo	90	124	122
123	Haiti	81	135	123	Sudan	116	137	123
124	Zimbabwe	113	83	124	Ethiopia	114	125	124
125	Bangladesh	104	126	125	Burkina Faso	94	121	125
126	Rwanda	61	117	126	Niger	108	128	126
127	Congo, Democratic Republic	111	133	127	Kenya	84	101	127
128	Japan	105	128	128	Kyrgyzstan	..	134	128
129	Oman	32	94	129	Pakistan	92	113	129
130	Nepal	97	122	130	United Republic of Tanzania	98	114	130
131	Iran, Islamic Republic	112	123	131	Georgia	..	133	131
132	Kuwait	102	125	132	Benin	111	135	132
133	Malawi	41	129	133	Nepal	109	132	133
134	Libyan Arab Jamahiriya	69	136	134	Zambia	100	117	134
135	Saudi Arabia	83	131	135	Haiti	115	136	135
136	United Arab Emirates	92	92	136	Tajikistan	..	103	136
137	Yemen	115	13	137	Zimbabwe	82	102	137
138	Indonesia	54	57	138	Rwanda	113	140	138
139	Gabon	33	139	139	Congo, Democratic Republic of	103	139	139
140	Suriname	117	140	140	Sierra Leone	107	138	140

Source: UNCTAD.

are doing the opposite. The former should be concerned about raising their potential if they are to sustain past FDI performance, the latter about addressing the shortcomings that prevent their structural FDI potential from being realized.

In 1999–2001 economies performing below potential include such major industrial countries as Australia, Italy, Japan and the United States, and such newly industrializing economies as the Republic of Korea, the Philippines and Taiwan Province of China (table I.6). The group also includes the Russian Federation, Saudi Arabia and United Arab Emirates, all countries with enormous

resource bases that should be able to attract greater direct investment. And it has countries that have moved from being front-runners in the previous period: Australia, Costa Rica and Mexico.

The above-potential group includes Brazil, which scores poorly on recent growth, export shares and skill creation. The under-performers include all the South Asian economies and many poor and least developed countries, along with Turkey, with a weak record on risk and FDI stock. Front-runners include many developed countries such as France, Germany, Sweden and Switzerland and Asian newly industrializing economies.

Table I.6. Matrix of inward FDI performance and potential, 1988-1990, 1993-1995 and 1999-2001

High FDI performance		Low FDI performance	
1999-2001			
Front-runners		Below-potential	
High FDI potential	Argentina, Bahamas, Bahrain, Belgium and Luxembourg, Brunei Darussalam, Bulgaria, Canada, Chile, China, Croatia, Cyprus, Czech Republic, Denmark, Dominican Republic, Estonia, Finland, France, Germany, Guyana, Hong Kong (China), Hungary, Ireland, Israel, Jordan, Latvia, Lithuania, Malaysia, Malta, Mongolia, Netherlands, New Zealand, Norway, Panama, Poland, Portugal, Singapore, Slovakia, Spain, Sweden, Switzerland, Thailand, Trinidad and Tobago and United Kingdom.	Australia, Austria, Belarus, Botswana, Costa Rica, Egypt, El Salvador, Greece, Iceland, Italy, Japan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Mexico, Oman, Philippines, Qatar, Republic of Korea, Russian Federation, Saudi Arabia, Slovenia, Taiwan Province of China, United Arab Emirates, United States, Uruguay and Venezuela.	
Above-potential		Under-performers	
Low FDI potential	Albania, Angola, Armenia, Azerbaijan, Bolivia, Brazil, Ecuador, Gambia, Georgia, Honduras, Jamaica, Kazakhstan, Mali, Morocco, Mozambique, Namibia, Nicaragua, Papua New Guinea, Republic of Congo, Republic of Moldova, Sudan, TFYR Macedonia, Togo, Uganda, United Republic of Tanzania, Viet Nam and Zambia.	Algeria, Bangladesh, Benin, Burkina Faso, Cameroon, Colombia, Côte d'Ivoire, Democratic Republic of Congo, Ethiopia, Gabon, Ghana, Guatemala, Guinea, Haiti, India, Indonesia, Islamic Republic of Iran, Kenya, Kyrgyzstan, Madagascar, Malawi, Myanmar, Nepal, Niger, Nigeria, Pakistan, Paraguay, Peru, Romania, Rwanda, Senegal, Sierra Leone, South Africa, Sri Lanka, Suriname, Syrian Arab Republic, Tajikistan, Tunisia, Turkey, Ukraine, Uzbekistan, Yemen and Zimbabwe.	
1993-1995			
Front-runners		Below-potential	
High FDI potential	Argentina, Australia, Bahamas, Bahrain, Belgium and Luxembourg, Brunei Darussalam, Chile, China, Costa Rica, Czech Republic, Denmark, Dominican Republic, Estonia, France, Guyana, Hong Kong (China), Hungary, Indonesia, Ireland, Jamaica, Malaysia, Malta, Mexico, Netherlands, New Zealand, Norway, Panama, Papua New Guinea, Philippines, Poland, Qatar, Republic of Moldova, Singapore, Slovakia, Spain, Sweden and United Kingdom.	Austria, Botswana, Bulgaria, Canada, Cyprus, El Salvador, Finland, Germany, Greece, Iceland, Islamic Republic of Iran, Israel, Italy, Japan, Jordan, Kuwait, Libyan Arab Jamahiriya, Oman, Portugal, Republic of Korea, Russian Federation, Saudi Arabia, Slovenia, South Africa, Suriname, Switzerland, Taiwan Province of China, Thailand, Ukraine, United Arab Emirates, United States, Uruguay and Venezuela.	
Above-potential		Under-performers	
Low FDI potential	Albania, Angola, Azerbaijan, Bolivia, Colombia, Côte d'Ivoire, Ecuador, Egypt, Gambia, Ghana, Honduras, Kazakhstan, Kyrgyzstan, Latvia, Mali, Morocco, Mozambique, Myanmar, Namibia, Nicaragua, Nigeria, Paraguay, Peru, Republic of Congo, Tajikistan, Togo, Trinidad and Tobago, Tunisia, Uganda, United Republic of Tanzania, Viet Nam, Yemen and Zambia.	Algeria, Armenia, Bangladesh, Belarus, Benin, Brazil, Burkina Faso, Cameroon, Croatia, Democratic Republic of Congo, Ethiopia, Gabon, Georgia, Guatemala, Guinea, Haiti, India, Kenya, Lebanon, Lithuania, Madagascar, Malawi, Mongolia, Nepal, Niger, Pakistan, Romania, Rwanda, Senegal, Sierra Leone, Sri Lanka, Sudan, Syrian Arab Republic, TFYR Macedonia, Turkey, Uzbekistan and Zimbabwe.	
1988-1990			
Front-runners		Below-potential	
High FDI potential	Argentina, Australia, Bahrain, Belgium and Luxembourg, Botswana, Canada, Chile, China, Colombia, Costa Rica, Cyprus, Denmark, France, Greece, Hong Kong (China), Indonesia, Ireland, Malaysia, Malta, Mexico, Netherlands, New Zealand, Norway, Oman, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan Province of China, Thailand, Trinidad and Tobago, United Kingdom, United States and Venezuela.	Algeria, Austria, Bahamas, Brazil, Brunei Darussalam, Finland, Germany, Hungary, Iceland, Islamic Republic of Iran, Israel, Italy, Japan, Kuwait, Libyan Arab Jamahiriya, Panama, Poland, Qatar, Republic of Korea, Saudi Arabia, South Africa, Suriname, United Arab Emirates and Uruguay.	
Above-potential		Under-performers	
Low FDI potential	Benin, Bolivia, Dominican Republic, Ecuador, Egypt, Gabon, Gambia, Guatemala, Guyana, Honduras, Jamaica, Malawi, Myanmar, Niger, Nigeria, Papua New Guinea, Paraguay, Philippines, Sierra Leone, Syrian Arab Republic, Togo, Tunisia, Viet Nam and Zambia.	Angola, Bangladesh, Burkina Faso, Cameroon, Côte d'Ivoire, Democratic Republic of Congo, El Salvador, Ethiopia, Ghana, Guinea, Haiti, India, Jordan, Kenya, Lebanon, Madagascar, Mali, Morocco, Mozambique, Namibia, Nepal, Nicaragua, Pakistan, Peru, Republic of Congo, Rwanda, Senegal, Sri Lanka, Sudan, Turkey, Uganda, United Republic of Tanzania, Yemen and Zimbabwe.	

Source: UNCTAD.

D. Why the downturn?

The FDI downturn in 2001–2002 is a result of the interplay of factors operating at the macro, micro and institutional levels. The slow recovery from the global economic slump hit FDI in the developed world hardest, especially in its financial services and telecom industries. Most of the decline in FDI came from a dramatic drop in cross-border M&As. And with profitability slumping, divestments increased. Reduced reliance on intra-company loans and a slowdown in corporate restructuring reinforced the impact on FDI. Further aggravating the decline: a pause in privatizations and a loss of confidence in the wake of corporate scandals and the demise of some large corporations.

1. Macroeconomic factors

The most important macroeconomic factors were the slow growth, even recession in some countries—linked to the business cycle—in most parts of the world, particularly the main home and host countries (United States and the EU), and the decline in stock market valuations reflecting reduced transactions due to the economic slowdown as well as a correction of the excessively high stock market activity of the previous few years. Both these factors contributed to the steep fall in cross-border M&As, especially in the developed world. The economic slowdown affected greenfield FDI as well.

World real GDP growth is estimated to have declined from 4.7% in 2000 to 2.3% in 2001 (before increasing to 3.0% in 2002) (IMF 2003a). The United States had overvalued stock markets, a low savings rate, high levels of private sector debt, low corporate profits and large external deficits—aggravated by geopolitical uncertainties (UNDESA and UNCTAD 2003). Japan has yet to emerge from its prolonged slump, now a decade long, and most European countries have not succeeded in boosting their growth in recent years. For developing countries as a group, financial crises (especially Argentina), recessions in major export markets and falling commodity prices have slowed the pace of growth.

The main home and host countries for FDI had slower growth than other developed countries and much slower than developing and transition economies, making the latter groups more attractive to investors. Through a negative “wealth” effect, falling stock market values aggravated the impact

of the recession on both the FDI downturn and its unevenness.

Business cycles influence FDI flows (box I.2 and *WIR93*), although not in the same way for developed and developing countries (*WIR02*). In periods of high growth and expansion, firms typically have higher earnings to invest both at home and abroad. FDI outflows therefore increase during a cyclical upturn in line with higher domestic investment, displaying the same pro-cyclical behaviour that has been documented for domestic investment (Angell 1941; Gordon 1955; Dunning 1998). Conversely, a slowdown in economic growth exerts a negative impact on foreign (as well as domestic) investment.

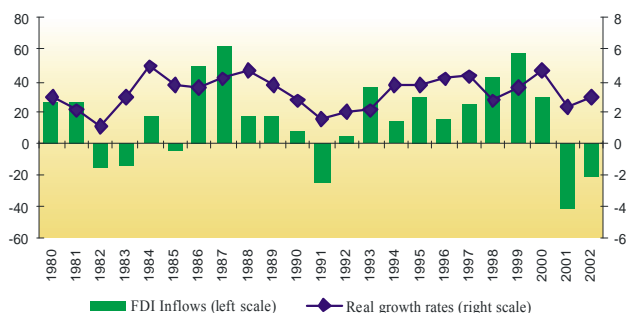
For the United States, for example, FDI outflows declined by 27% in 2001 but increased by 15% in 2002, while gross domestic private investment fell by 3% in each year. Both were up sharply in 1999 and 2000. The decline in FDI mirrors a fall in cross-border M&As—the main mode of FDI entry, especially in the developed world, in recent years. But a fall in domestic M&As is not reflected in a decline in domestic investment, because within countries M&As simply represent change of ownership of existing companies and not domestic investment (or additions to capital stock). In France, Germany and the United Kingdom as well, both FDI outflows and domestic investments moved in the same direction in response to business cycles, declining in 2002 (European Communities 2003).

The decline in 2002, like that in the previous year, largely reflected a 38% fall in cross-border M&As to \$370 billion (annex tables B.8–B.10). With the value of stocks traded on the world’s 49 stock markets declining by 15% to \$22 trillion in 2002, after an earlier decline by 16% in 2001, the value of M&As tumbled as well.¹⁰ Lower share prices narrowed the avenue for acquiring companies with equity shares. The share of cross-border M&As financed through the exchange of shares fell to only 11% in 2002, from 44% in 2000, the peak year of cross-border M&As. The decline is also attributable to a significant slowdown in corporate restructuring and consolidation—including that across international locations. Over the past 15 years cross-border M&As have consistently accounted for 25–30% of all M&As (figure I.8).

Box I.2. FDI booms and busts since 1970

Since 1970, there have been four major downturns in FDI inflows (box figure I.2.1): 1976 (down by 21%); 1982–1983 (down 14% a year on average); 1991 (decline of 24%); and 2001–2002 (down 31% a year on average). Each is correlated with periods of recession or slow growth in the world economy, particularly in the principal host/home countries. There is usually a one-to-two year lag between a setback in world growth and the decline in FDI flows (box figure I.2.1). The last two major downturns have also been characterized by sharp declines in cross-border M&A activity.

Box figure I.2.1. Growth rates of world FDI flows and GDP, 1980–2002
(Per cent)



Source: UNCTAD, FDI/TNC database and data from IMF, *World Economic Outlook*, 2003.

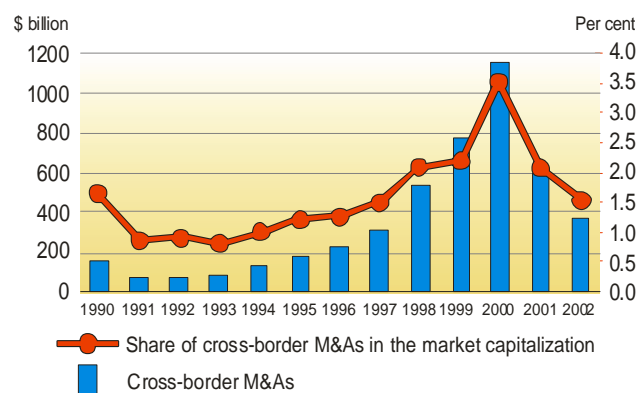
For developed countries FDI booms and busts are almost identical to those for the world as a whole. But for developing countries the number and timing of the FDI downturns often do not coincide with those for the rest of the world. This unevenness between developed and developing countries explains why the share of developing countries in world FDI increases in some years, only to fall later. The CEE region has not experienced any significant busts so far, with small declines in its FDI inflows in some years as the outcome of “lumpy” privatization or large investment projects.

The FDI downturn that began in 2001 is by far the most significant in its sharpness and in the difference between developed and developing countries, with the M&A bust concentrated in the developed world. The downturn in the early 1990s was also characterized by a prior flurry of cross-border M&A activity that came to an end. But the cross-border M&A wave of the late 1990s was at least five times larger (in real terms) than its predecessor; it also involved firms from a greater

number of industrialized countries and included many more services transactions (Evenett 2002). Compared with national stock market capitalizations, however, foreign acquisitions of domestic firms in this latest wave were small. The share of cross-border M&As in the capitalization of world stock markets was only 3.7% in the peak year of 2000, declining to 1.7% in 2002 (box figure I.2.2).

That the United States accounted for 38% of this global FDI downturn is not unprecedented. In the 1982–1983 downturn, the United States alone accounted for 76% of the decline; in the 1991 downturn it accounted for 51%. But in the 1976 downturn the countries with the largest declines in FDI inflows—such as the Netherlands (by 53%) and Italy (by 83%)—accounted for less than 5% of the decline. The recent global FDI picture seems to be contingent on the United States, the largest FDI recipient until 2001.

Box figure I.2.2. How big are cross-border M&As? The share of cross-border M&As in the market capitalization of world stock exchange markets, 1990–2002
(Billions of dollars and per cent)



Source: UNCTAD.

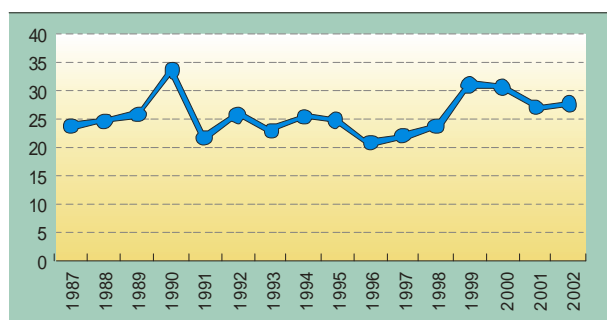
^a Includes 49 stock exchange markets in 44 countries.

FDI flows typically recover quickly after a downturn, regaining the strength to reach new heights. Of concern today is not only the downturn’s severity, but its duration. Only once before (1982–1983) has a downturn lasted two years. The latest downturn is poised to exceed that, as suggested by the preliminary data on FDI flows during the first few months of 2003^a and UNCTAD’s Investment Promotion Agency survey (box I.5).

Source: UNCTAD, based on data obtained from United States Department of Commerce, Bureau of Economic Analysis (<http://www.bea.gov/>); Evenett 2002.

^a For data, for example, see note 57 in chapter II.

Figure I.8. The share of cross-border M&As in total M&As worldwide, 1987–2002
(Per cent)



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

The number of cross-border M&A transactions slid from 7,894 in 2000 to 6,034 in 2001 and 4,493 in 2002. The average value per transaction also slid from \$145 million in 2000 to \$98 million in 2001 and to \$82 million in 2002—as the number of mega deals (worth over \$1 billion) fell from 175 in 2000 to 113 in 2001 to only 81 in 2002, the lowest since 1998 (table I.7; annex table A.I.9).

Table I.7. Cross-border M&As with values of over \$1 billion, 1987–2002

Year	Number of deals	Percentage of total	Value (Billion dollars)	Percentage of total
1987	14	1.6	30.0	40.3
1988	22	1.5	49.6	42.9
1989	26	1.2	59.5	42.4
1990	33	1.3	60.9	40.4
1991	7	0.2	20.4	25.2
1992	10	0.4	21.3	26.8
1993	14	0.5	23.5	28.3
1994	24	0.7	50.9	40.1
1995	36	0.8	80.4	43.1
1996	43	0.9	94.0	41.4
1997	64	1.3	129.2	42.4
1998	86	1.5	329.7	62.0
1999	114	1.6	522.0	68.1
2000	175	2.2	866.2	75.7
2001	113	1.9	378.1	63.7
2002	81	1.8	213.9	58.1

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

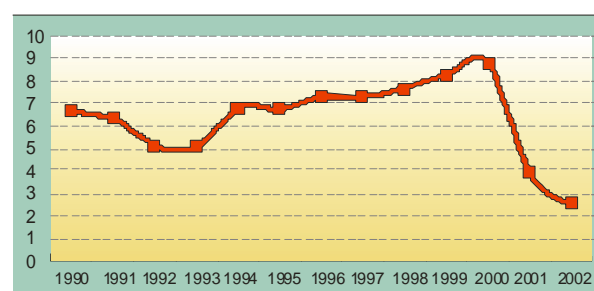
2. Microeconomic factors

Lower corporate profits, a decline in TNCs' ability or willingness to finance FDI through intra-company loans and a slowdown in corporate restructuring contributed to the downturn.

Corporate profits, strong until 2000, weakened in 2001 and 2002, reducing the opportunities and finance for FDI. For a third of the 100 largest TNCs identified by UNCTAD, profitability (return on assets¹¹) was only 2% in 2002, down from 7% in the late 1990s (figure I.9). TNCs have been hit particularly hard in Latin America, especially in Argentina and in the financial services industry (ECLAC 2003). Returns on FDI declined from 6.3% in 2000 to 4.8% in 2001, the lowest since the early 1990s.¹² Those returns were consistently higher in developing countries (5.8%) than in developed (4.4%) and CEE countries (3.9%) since the beginning of the 1990s.

Reinvested earnings, one of the three components of FDI, were down by half for all foreign affiliates in 2001, and they are likely to account for a fifth of FDI flows in 2002 (figure I.5). Lower profits may also have led to divestment, but data are not available to gauge its extent (box I.3).

Figure I.9. Profitability of the top 99 non-financial TNCs, 1990–2002
(Per cent)



Source: UNCTAD, based on information provided by Thomson Financial.

^a Defined as return on assets: net income before preferred dividends + ((interest expense on debt- interest capitalized) * (1-tax rate)) / last year's total assets * 100.

Large repayments of intra-company loans were the main element in reduced net FDI flows in many countries, particularly the United States. For 11 out of 30 countries that report the data on FDI inflows by components in 2002, intra-company loans were negative.¹³ The runup in the United States stock market during 1996–2000 allowed companies to sustain high debt, while retaining reasonable debt-to-equity ratios. But after the correction in 2000–2002, debt ratios for these same firms, including their foreign affiliates, became too high. So foreign affiliates may have had to repay intra-company loans to their parents to restore appropriate debt-to-equity ratios—and perhaps to

Box I.3. Divestment: factors and evidence

Has there been less new investment, or has divestment^a of existing stock increased? Divestment can involve dismantling ownership relationships across national borders, the result of a strategic decision about the geographic scope of a TNC's activities. It can also involve a change in the mode of servicing a foreign market, as from local production to exports or licensing. Or it can be a complete withdrawal from a host country.

Although it is difficult to gauge its magnitude, divestment can be important for some countries. In Portugal during 1989–1998, the annual average foreign plant closure rate was 5.9% a year (Mata and Portugal 2000). From the time of the initial investment 30–60% of FDI is likely to be divested over 10 years (Larimo 2000). More than half of a sample of foreign affiliates of Norwegian companies had divested within 10 years (Benito 1997). Divestment has also been significant for major home countries in recent years (annex table A.I.10).

The recent closure of many Japanese financial service affiliates was necessitated by the fact that economic difficulties in the home country of investing firms required a restructuring of their international operations. During 2000–2002, there were 61 closures but no new branches or affiliates, plunging the foreign assets of Japanese banks to only a third of those at their peak in 1998.^b

The process of economic development and a resulting shift in locational advantages may also give rise to divestments, but it is more often reflected in a shift in new FDI flows. As local technology and human resources are upgraded and wages rise, locational advantages in labour-intensive production may diminish, leading to plant

closures. Recent relocations from developed and some CEE countries to China are an example.

Also driving divestment are industry-specific changes in the economic environment, such as those associated with the industry life cycle (Belderbos forthcoming) or with consolidation (Benito 1997). Exit from an industry occurs in cycles, with the number of exits highest when industries mature and consolidate. This can lead to uneven divestment patterns across industries. Recent closures in the automobile industry (Ford divesting out of Portugal in 2000) and in high-tech knowledge-based industries can be attributed to rationalization and restructuring.

Strategic considerations drive divestment as well:

- When a decision to focus on core businesses leads to outsourcing. United States-based Gateway's decision to withdraw from Ireland and the United Kingdom in 2002 was in part driven by the replacement of foreign production facilities by outsourcing (Fried 2002).
- When TNCs merge, with foreign affiliates closed down (box table I.3.1).
- When the mode of servicing foreign markets shifts from FDI to exports or licensing. In 2001 Marks & Spencer franchised the business of its 10 stores in Hong Kong (China) to cut costs, a move that has proven successful in 30 other countries (Marks & Spencer 2001).
- When affiliates perform poorly. A 2001 survey of some 1,000 Japanese foreign affiliates that had been closed or were to be closed shows that more than 40% of these affiliates were shut down because of their performance (Japan METI 2002).

Box table I.3.1. Divestment after mergers: changes in the number of foreign affiliates^a and host countries in selected cases

Merger case (Partner names)	Merger year	Number of foreign affiliates and host countries	
		At the time of merger	2002
Vivendi Universal (Vivendi-Seagram)	2000 52 host countries ^b	904 foreign affiliates 50 host countries	744 foreign affiliates
BHP Billiton (BHP-Billiton)	2001 30 host countries ^b	184 foreign affiliates 20 host countries	60 foreign affiliates
Unilever (Unilever-Bestfoods)	2000 50 host countries ^b	275 foreign affiliates 44 host countries	242 foreign affiliates
Nestlé (Nestlé-Ralston Purina)	2001 63 host countries ^b	428 foreign affiliates 86 host countries	398 foreign affiliates

Source: UNCTAD.

^a Only majority-owned foreign affiliates.

^b Different host countries only, i.e., counting a country as "one" in which both companies (before the merger) had an affiliate.

Source: UNCTAD.

^a FDI statistics on a balance-of-payments basis do not report explicitly the magnitude of divestment from a country as they are reported in net values. Furthermore, if foreign affiliates are relocated to other host countries, there is no decline in global FDI.

^b *Nihon Keizai Shimbun*, 19 and 28 February 2003.

improve the parent's earnings per share. Moreover, as mentioned earlier (section B), the interest rate differentials between the United States and the EU and the reduced need of EU affiliates for loans to finance fewer M&As in the United States market were other possible factors behind the fall in intra-company loans that were caused by only a few transactions.

The slowdown of corporate expansion in some industries (such as telecoms), carried out mainly through M&A transactions and privatizations, added to the FDI downturn. In telecoms, restructuring had been responding to changes in supply and demand, technological advances and an increase in the number of suppliers. But, overcapacity, and the high costs of 3G licences for European firms, led to a significant decline in profits, almost halting further expansion.

E. Softening the impact

The FDI slowdown has naturally translated into smaller additions to the stock of FDI capital and the potential benefits from technology and other factors that accompany international production. But even minuscule FDI flows add to the stock of FDI, leaving its ability to generate benefits largely intact. Technology payments, primarily intra-firm, held almost steady in 2001, even though FDI flows halved (box I.4).

FDI flows accounted for 74% of net capital flows to developing countries in 2002, and their decline contributed to the 9% decline in net capital flows in that year, reducing the private external resources for development (figure I.1; World Bank 2003a). The impact was greater for countries that have FDI flows featuring heavily in the balance of payments. On the financial account (other items constant), lower FDI inflows could accentuate a balance-of-payments deficit. But lower income outflows associated with lower inward FDI could have the opposite impact. And lower exports associated with lower (export-oriented) FDI could push current accounts into deficit unless accompanied by offsetting changes in imports.

Competition for FDI, already on the rise, has intensified further through the proliferation of investment promotion agencies (IPAs), with more than 160 at the national level. If subnational IPAs are also considered, the number reached more than 400 in early 2003. Competition based on financial incentives has intensified, increasing the "bidding wars" for large projects (see Part Two). Competition based on non-financial incentives is

3. Institutional factors

Some important institutional factors have also contributed to the FDI downturn, among them the winding down of privatization. In infrastructure, private participation in the form of investment in 2001, including that through privatization, was \$57 billion, the same as in 1995 (World Bank 2002). Former leading FDI-through-privatization recipients, such as Brazil, Hungary and Poland, registered declines in FDI inflows in 2002 primarily because there were no large privatization deals. Investment following a privatization is unlikely to be of the same order as the initial investment.

Corporate scandals, the demise of large corporations and the associated loss of confidence hit industries (energy, telecoms and information technology) that were part of the FDI boom in the later 1990s. That dampened firms' willingness to invest and assume new risks.

also on the rise, with more countries offering guarantees (against nationalization or price controls) and protection (import bans on competing products) to selected foreign investors.

The current FDI downturn makes it all the more important for countries to retain existing FDI. This is particularly important for investment that does not have high barriers to exit (i.e. with low sunk costs) and which is not geared towards serving the domestic market. To prevent a relocation of existing investment from taking place, governments must continuously improve their locational advantages, although sometimes, as in a situation of changing comparative advantage, they have to let it go and seek FDI in new activities. When divestments are driven by shrinking opportunities worldwide due to an economic downturn, often coupled with financial difficulties facing the TNCs themselves, one temptation for some host countries is to offer TNCs incentives to locate in their territories.

Upgrading competitiveness also manifests itself in greater efforts to target investors or otherwise to attract FDI (witness Indonesia's declaration of 2003 as an Investment Year). The targeting of foreign investors in industries and activities with higher value added is becoming more widespread (such as HQ), as is better after-care services to existing foreign investors, in the hope of receiving greater sequential investment (Thailand is an example). Countries are also seeking to diversify FDI home countries (see chapter II).

Box I.4. Technology payments by developing countries and the FDI downturn

There are close links between inward FDI and outward payments of royalties and licence fees. TNCs are the leading source of international technology transfers in all forms: internal (to their affiliates) and external (to other companies). While a part of TNCs' internal technology transfer is not charged for separately, the bulk of their royalty and technical fees earnings come from their affiliates (*WIR99*). Around 76% of royalties and license fees earned abroad are intra-firm (based on data for Germany, Japan and the United States). And the share has risen steadily (annex tables A.I.11 and A.I.12). This rise reflects:

- The growing cost and risk of innovation-making preferable the internalization of the transfer of the resulting proprietary technologies while also often ensuring, through contractual arrangements with affiliates, minimum returns to innovation.
- The growth of technology-intensive FDI.
- The liberalization of technology policies.
- The relocation of high-tech activities overseas (*WIR02*).

How has the recent FDI downturn affected technology payments? Not much. As global FDI fell by half in 2001, overseas technology payments fell by only 4%. This difference is not surprising because technology payments are not expected to be related to current investment flows but to the level of economic activity and the stock of investment already in place. Royalty rates, in particular, are generally tied to sales. A decline in technology payments may thus reflect the economic climate rather than a fall in FDI flows.

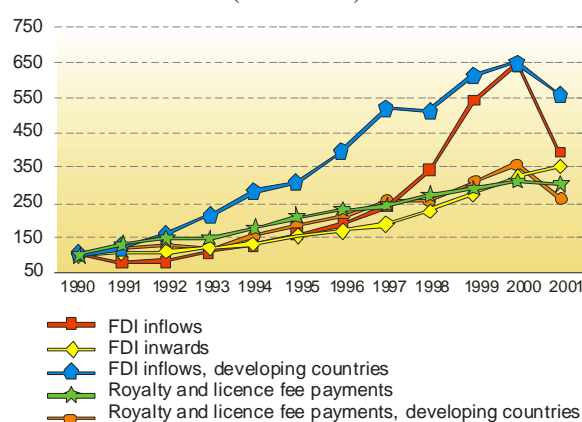
There was, however, a striking difference between developed and developing countries. In developed countries, inward FDI fell by 47% while technology payments stayed constant. In developing countries, FDI fell by 15% while technology payments fell by 26% (box figure I.4.1). For developed countries, the FDI stock and production activities giving rise to current technology payments would not be affected by the fall in M&As. But why did technology payments fall so sharply in the developing world?

One possibility is that the recession affected licensing-based activities more in developing

Source: UNCTAD.

countries than in developed countries, as with export-oriented production of electronics. In 2001 world exports of electronics fell by 8.5%, with developing country exports declining by 12%, and industrial country exports by 6%. But for East Asia the fall was 18%, if China is excluded. The region accounts for around 90% of electronics exports by the developing world and 77% of the technology payments by developing countries (UNIDO 2002).

Box figure I.4.1 FDI inflows and royalty and licence fee payments, by region and the world, 1990-2001 (1990=100)



Source: UNCTAD, FDI/TNC database and IMF, *Balance of Payments Statistics*, May 2003 CD-ROM.

Technology payments by developing countries have grown steadily since the 1980s. In 1981-1985 they grew by 4% a year, despite a fall in FDI inflows of 12% a year and in 1991-1995 by 13%, growth that continued in the second half of the 1990s. FDI grew by 15% in developing countries in the latter half of the 1990s.

The sudden fall in 2001 is evidently a deviation from the long-term trend. Not directly related to the decline in FDI, it may reflect a change in the terms and conditions governing international transfers of technology by TNCs in developing countries. A switch could be taking place towards lower reliance on explicit or separate payments for technology, possibly due to a shift towards greater foreign ownership of foreign affiliates.

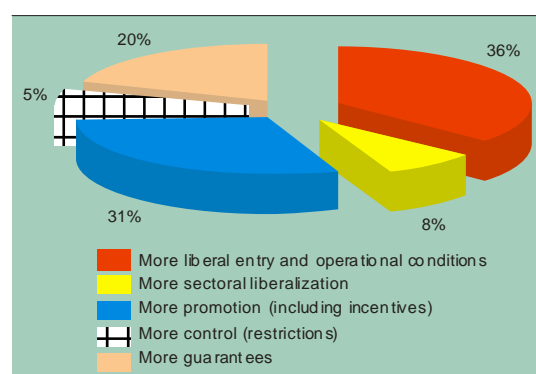
The downturn has reinforced the trend towards the liberalization of FDI policies and regulations. After the record number of favourable changes in national FDI legislation in 2001, 2002 saw another record: of 248 changes in legislation, of which 236 were favourable to FDI (table I.8), with a third related to promotional measures (figure

I.10). These policy developments have helped sustain FDI flows to developing countries during the downturn. Looking at the period 1991-2002, 1,551 (95%) out of the 1,641 changes introduced by 165 countries in their FDI laws were in the direction of greater liberalization (table I.8).

Many countries also entered bilateral investment treaties (BITs) and double taxation treaties (DTTs) in 2002: 82 BITs were concluded by 76 countries,¹⁴ and 68 DTTs by 64 countries.¹⁵ This brings the totals to 2,181 and 2,256 at the end of 2002 (figure I.11). The propensity to sign such treaties varies greatly (figures I.12 and I.13). Among developing countries and economies in transition, the leader for BITs is China (with 107) and for DTTs, India (with 81). Many countries in the Pacific have not yet signed a BIT, and Angola, Cambodia and Nicaragua have not signed a DTT.

A rising number of other bilateral and regional agreements address FDI issues (annex tables A.I.13 and A.I.14). Such agreements can soften the impact of the FDI downturn for some countries. Given the proliferation of investment agreements, Part Two of *WIR03* focuses on national FDI policies and international investment agreements.

Figure I.10. Types of changes in FDI laws and regulations, 2002^a



Source: UNCTAD, based on national sources.

^a Based on 248 changes.

Table I.8. Changes in national regulations of FDI, 1991-2002

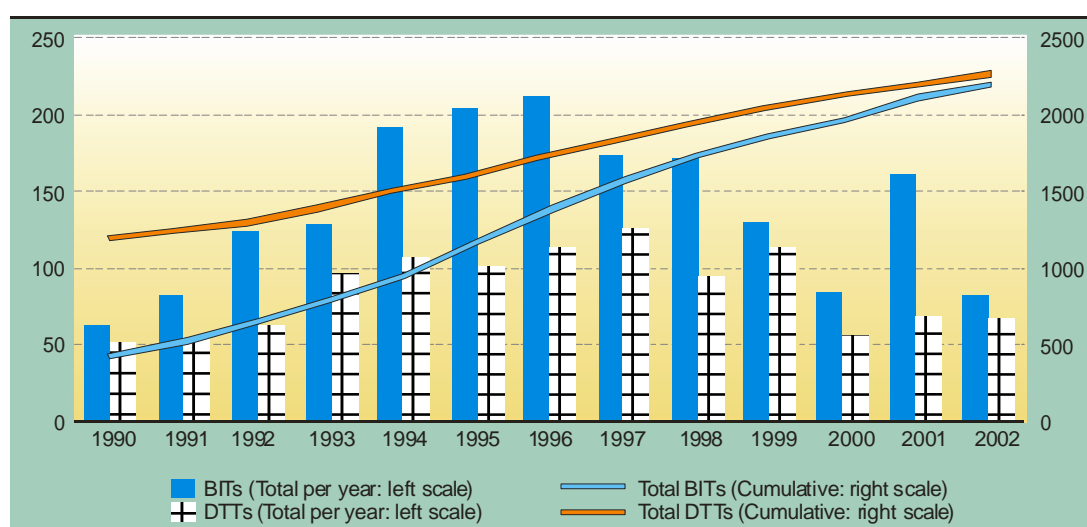
Item	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76	60	63	69	71	70
Number of regulatory changes of which:	82	79	102	110	112	114	151	145	140	150	208	248
More favourable to FDI ^a	80	79	101	108	106	98	135	136	131	147	194	236
Less favourable to FDI ^b	2	-	1	2	6	16	16	9	9	3	14	12

Source: UNCTAD, based on national sources.

^a Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.

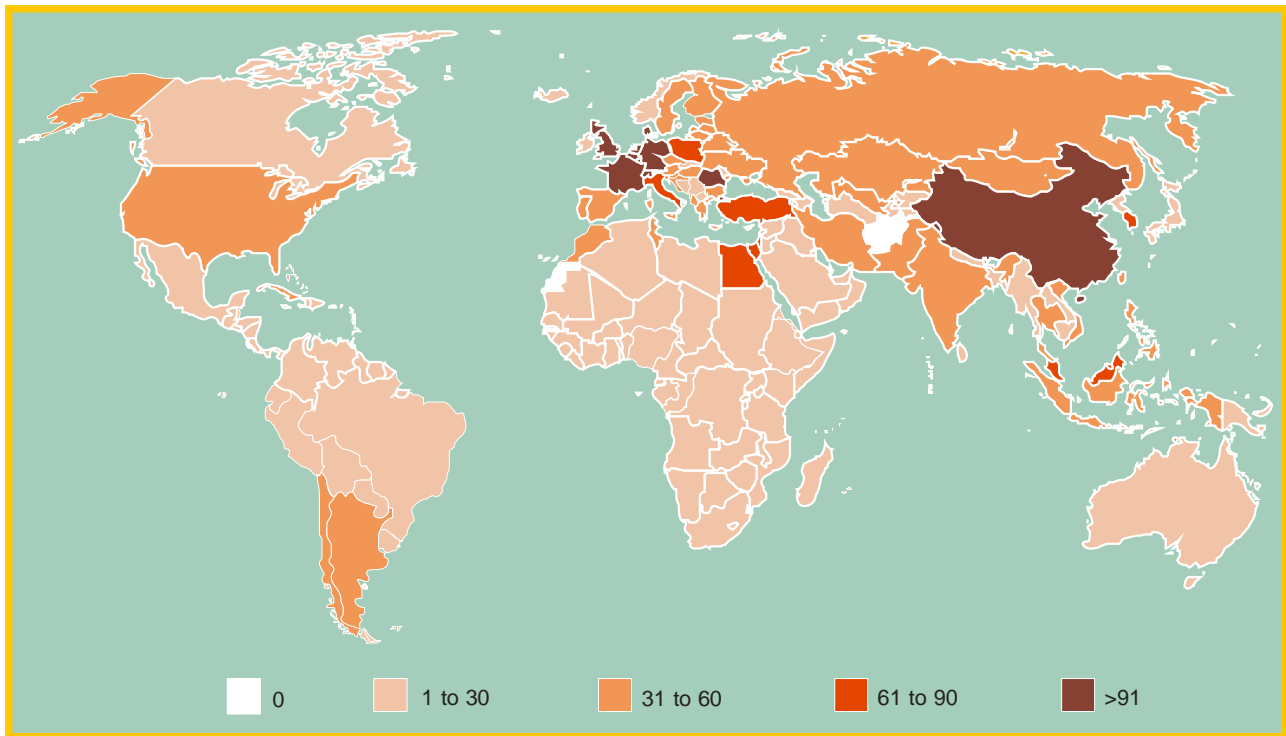
^b Including changes aimed at increasing control as well as reducing incentives.

Figure I.11. Number of BITs and DTTs concluded, 1990-2002



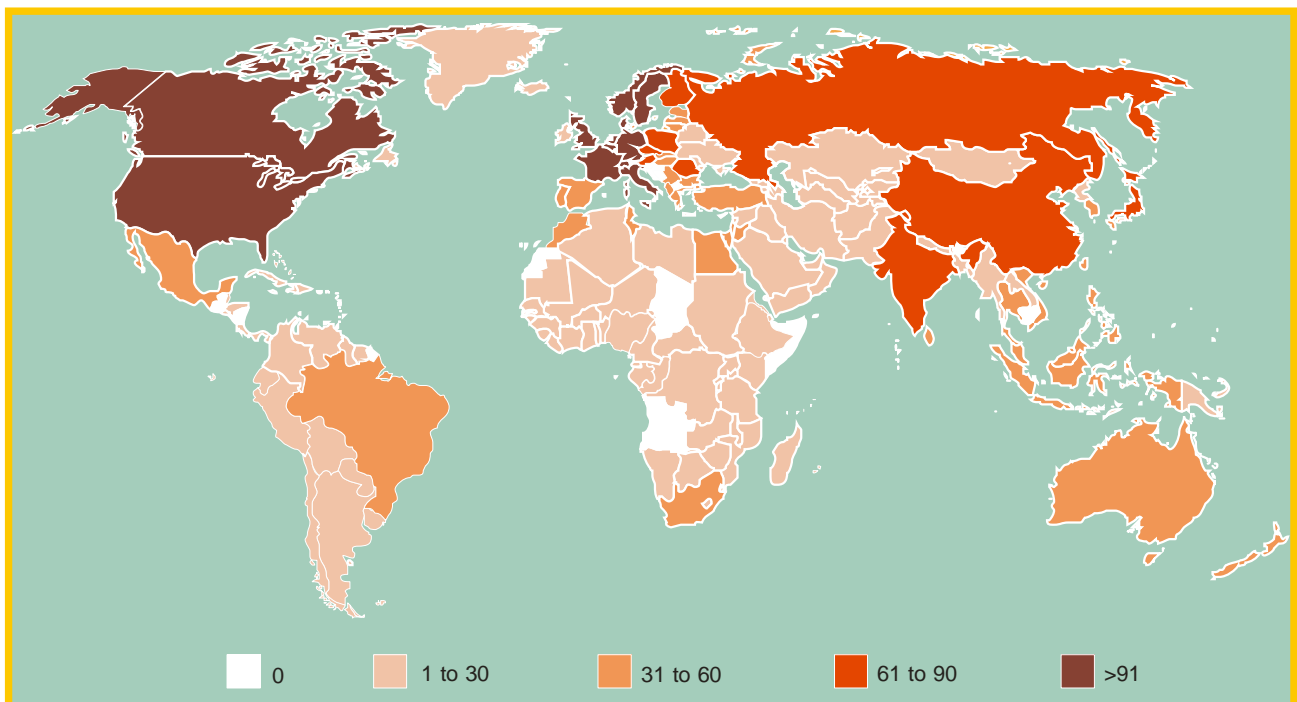
Source: UNCTAD, BITs and DTTs databases.

Figure I.12. Density mapping on BITs worldwide, 1 January 2003
(Total number of BITs concluded by individual countries)



Source: UNCTAD, database on BITs.

Figure I.13. Density mapping on DTTs worldwide, 1 January 2003
(Total number of DTTs concluded by individual countries)



Source: UNCTAD, database on DTTs.

F. Towards mega blocks?

The downturn has not changed the importance of FDI in the integration of global production activity and, barring a sustained downturn spanning several years, is unlikely to do so. In 2002 the world FDI stock stood at \$7.1 trillion, up more than 10 times since 1980. That stock is the basis of international production, by some 64,000 TNCs controlling 870,000 foreign affiliates (annex table A.I.1). Ebbs and flows in the yearly value of FDI, while important, augment the stock of FDI as long as they are positive. So the stock of FDI matters more than flows—for the structure of global specialization, for deepening global integration through production networks, and for generating the benefits associated with FDI and international production. It also matters for new FDI capital flows through the reinvestment of earnings and sequential flows to FDI.

In 2002 the estimated value added of foreign affiliates, at \$3.4 trillion, accounted for about a tenth of world GDP, or twice the share in 1982 (table I.1). The world stock of FDI generated sales by foreign affiliates of an estimated \$18 trillion, compared with world exports of \$8 trillion. Nearly a third of world exports of goods and non-factor services takes place within the networks of foreign affiliates, but that has not changed much since 1982. Employment by foreign affiliates reached an estimated 53 million workers in 2002, two and half times the number in 1982.

The developed world hosts two-thirds of world inward FDI stock and accounts for nine-tenths of the outward stock. The most striking change is that the EU has become by far the largest source. In 1980 the outward stocks of the EU and the United States were almost equal at around \$215 billion. But by 2002, the EU's stock (including intra-EU stock) reached \$3.4 trillion, more than twice that of the United States (\$1.5 trillion). The gap opened in the 1980s and accelerated in the late 1990s. Meanwhile, Japan has been stable relative to the EU, with its outward stock about a tenth that of the EU.

In 2002 the inward FDI stock of developing countries was about a third of their GDP, almost twice the 19% for developed countries. Back in 1980 the respective ratios were 13% and 5%, so the growth of FDI stock exceeded GDP growth in both groups of countries. Outward FDI stocks have changed even more for developing countries, increasing from 3% of GDP in 1980 to 13% in 2002, the result of new developing country TNCs.

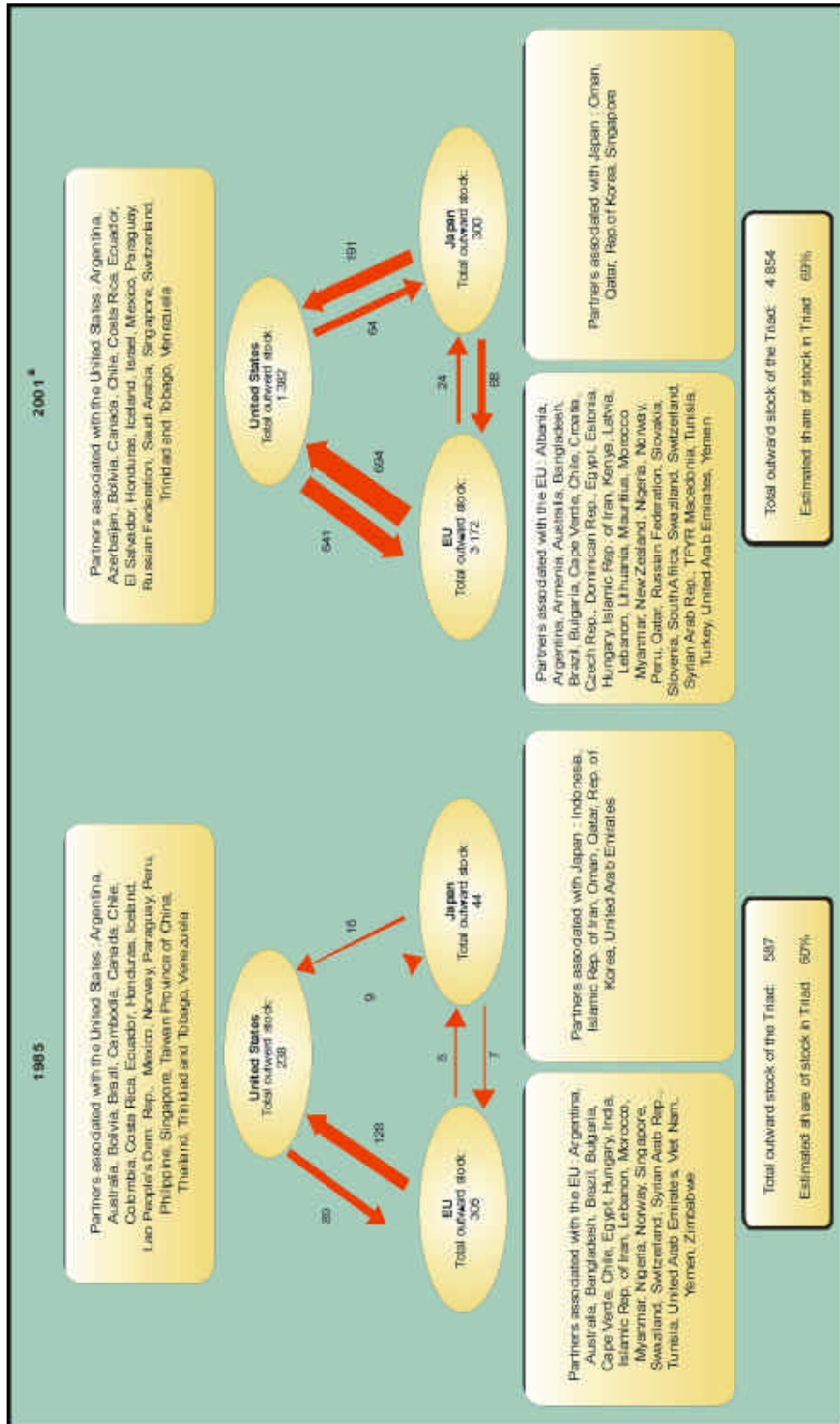
In 1980 the FDI stock originating from developing countries (at \$65 billion) accounted for 11% of the global outward FDI stock; by 2002 the corresponding share was 12%. South, East and South-East Asia is the most important developing region for outward FDI stock, with its stock exceeding Japan's for the first time in 1997 and becoming almost twice Japan's by 2002. The Latin America and Caribbean region registered a three-fold increase in its outward FDI stock between 1980 and 2002.

The concentration of FDI within the Triad (EU, Japan and the United States) remained high between 1985 and 2002 (at around 80% for the world's outward stock and 50–60% for the world's inward stock). Clusters of non-Triad countries have strong FDI links to each Triad member (figure I.14). There have, however, been some changes in the composition of these non-Triad host-country partners, especially for the United States and the EU. Over the past 15 years, 10 countries (five from developing Asia, three from Latin America and the Caribbean, and two from the developed countries) of the 23 countries that were associate partners¹⁶ of the United States in 1985 were no longer so by 2001, while six new associate partner countries emerged (Azerbaijan, El Salvador, Israel, Russian Federation, Saudi Arabia and Switzerland) (figure I.14). In the case of the EU, four out of 25 countries (India, Singapore, Viet Nam and Zimbabwe) exited, while 19 countries entered newly during this period; and for Japan, Singapore became a new associate partner by 2001 (for a total of four countries) while Indonesia, Islamic Republic of Iran and United Arab Emirates were no longer associate members.

This pattern reveals the emergence of FDI blocks, each comprising one Triad country and several associate partner countries. They overlap somewhat with trade blocks, each comprising a Triad member and a cluster of trading partners with strong trade links to it.¹⁷

The FDI block pattern is also roughly mirrored in—and supported by—international investment agreements (IIAs)—agreements that, at least in part, address FDI issues (figure I.15). To improve the investment climate in their partners, associate partners and Triad members have been concluding DTTs and BITs with them. The 2001 picture of the distribution of DTTs had a strong likeness to the Triad pattern of FDI stocks: the similarity index (Finger and Kreinin 1979) between

Figure I.14. FDI stocks among the Triad and economies in which FDI from the Triad members dominates, 1985 and 2001 (Billions of dollars)

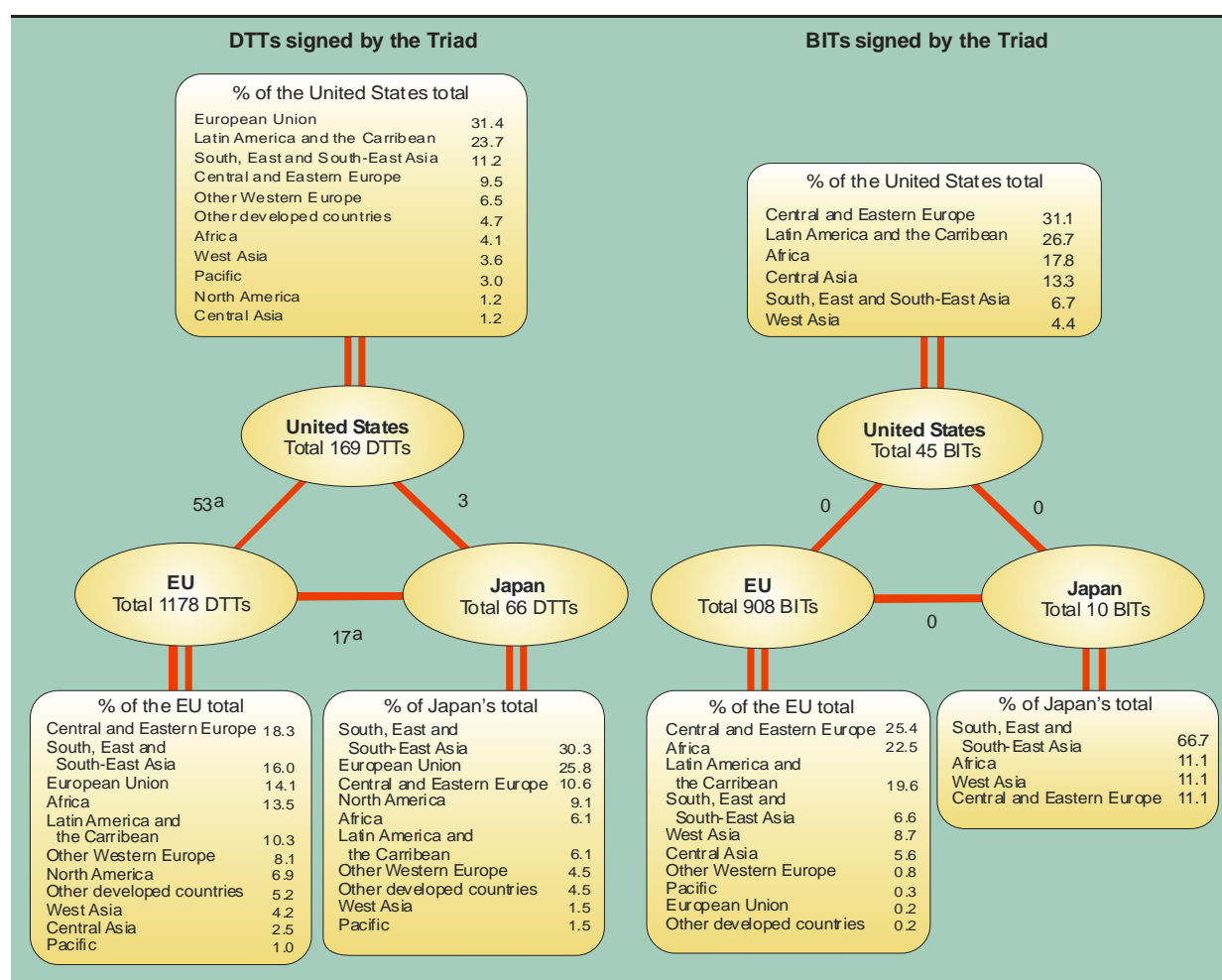


Source: UNCTAD, FDI/TNC database.

Note: Associate partners are the host economies in which the triad member accounts for at least 30% of the total FDI inward stocks or of the total FDI inward flows within a 3-year average. Approval data were used for the following economies: Bangladesh, Egypt, Kenya, Israel, Taiwan Province of China and Zimbabwe. Data may not necessarily be available for each economy during both years 1985 and 2001. The EU includes Austria (1990 instead of 1985 and 2000 instead of 2001), Denmark (1991 instead of 1985 and 2000 instead of 2001), France (1989 instead of 1985 and 1999 instead of 2001), Germany (2000 instead of 2001), Italy (1994 instead of 1985 and 1998 instead of 2001), Netherlands, Portugal (2000 instead of 2001), Sweden (1986 instead of 1985) and the United Kingdom (1987 instead of 1985 and 2000 instead of 2001) that account for about 80 per cent of the EU outward stock in 2001. Japan's outward stocks are cumulative flows on a balance-of-payments basis since 1968.

a Or latest year available.

Figure I.15. BITs and DTTs between the Triad and their geographical distribution, 2002
(Number and percentage distribution of totals)



Source: UNCTAD, databases on BITs and DTTs.

^a The number of treaties with individual countries of the EU.

the distribution pattern of outward FDI stock of each of the Triad members and that of their DTTs has a high value (table I.9).¹⁸ The corresponding index for BITs, however, has a lower value, suggesting that their distribution has a weak resemblance to that of Triad outward FDI stock.¹⁹ If, however, the propensity of individual Triad members to conclude DTTs and BITs with associate partners is compared with that to conclude them with non-associate partners, the former score higher for both DTTs and BITs. In other words, the Triad members have a greater propensity to conclude such IIAs with countries that are part of their respective Triad blocks (table I.10).

The similarity occurs for several reasons. Triad members tend to conclude bilateral trade agreements with their important associate partners to protect their investment; conversely, associate partners tend to conclude agreements with Triad members that are their main sources of FDI. The

complementary nature of trade and FDI (*WIR96*) reinforces this relationship. Bilateral and regional trade agreements have become de facto investment agreements as well, in that they typically contain investment provisions. So, their impact on trade

Table I.9. The similarity index between the geographical distribution pattern of BITs and DTTs and that of FDI outward stocks of the United States, the EU and Japan, 2001
(Per cent)

Bilateral treaties	United States	EU	Japan	Triad total
BIT	29	13	18	20
DTT	73	40	60	51

Source: UNCTAD.

Note: Based on 11 regional classifications (EU, Other Western Europe, North America, Other developed countries, Africa, Latin America and the Caribbean, West Asia, Central Asia, South, East and South-East Asia, the Pacific and CEE).

and FDI tends to be in the same direction. Moreover, bilateral and regional trade agreements pave the way for intra-regional FDI, strengthening the Triad member-partner FDI relationship.

Table I.10. The propensity to sign BITs and DTTs with associate partners and non-associate partners of the Triad members

Treaty	Associate partners ^a	Non-associate partners ^b
BITs		
Japan	0.25	0.05 ^c
EU ^d	3.57	3.5 ^c
United States	0.39	0.24 ^c
DTTs		
Japan	0.5	0.26
EU ^d	9.1	6.41
United States	0.79	0.43

Source: UNCTAD.

^a Ratio of the number of associate partners that conclude a BIT or a DTT with a Triad member to the total number of associate partners.

^b Ratio of the number of non-associate partners that conclude a BIT or a DTT with a Triad member to the total number of non-associate partners.

^c Only developing countries and CEE countries are included for BITs as developed countries do not conclude BITs with each other. (However, all countries are included for DTTs as they are concluded between any countries.)

^d A country can sign bilateral agreements with multiple EU countries. Thus the ratio is higher than 1.

Note: Based on 183 countries covered by UNCTAD's FDI/TNC database.

The similarities among the Triad FDI and BIT/DTT (and, for that matter, regional agreement) patterns have several implications. First, there is a broadening of economic space for both the Triad members and their partners from national to regional. Second, there may be an emergence of Triad-associate partner investment blocks, since investment positions are supported by both bilateral treaties and investment provisions in bilateral and regional trade agreements. The patterns feed into each other: DTTs, BITs and regional agreements may help generate more FDI, but the body of FDI already in place can also give rise to BITs and DTTs and promote deeper integration through FDI. For developing countries, investment block insiders (Triad members and the other members of the blocks) may gain more than outsiders as “mega” FDI and trade blocks emerge and are strengthened through bilateral and regional agreements—a question for further investigation.

In conclusion, the global stock of FDI continues to grow, albeit at a slower rate since 2001. The developed countries remain dominant as regards its ownership and location, although developing countries have made inroads, while least developed countries remain marginal. The Triad pattern continues to manifest itself, including through investment blocks. Bilateral and regional agreements mirror FDI patterns and reinforce them in mega economic blocks.

G. Prospects

Was the surge in investment flows in the 1990s the outcome of short-lived factors, such as the boom in cross-border M&As? And when will flows begin to rebound? UNCTAD predicts that FDI flows will stabilize in 2003. Flows to developing countries and developed countries are likely to remain at levels comparable to those of 2002, while those to CEE are likely to rise further. (The prospects for the different developing regions are discussed in chapter II.) In the longer run, beginning with 2004, global flows should rebound and return to an upward trend. As in the case of the downturn during 2001–2002, the prospects for a future rise depend on a number of factors at the macro, micro and institutional levels and on the possible impact of specific recent events on investors' plans. In addition, to the extent that WTO's Cancun Ministerial Meeting will improve business confidence and growth prospects, FDI flows could receive further impetus.

Macro factors

The consensus of the main multilateral agencies is that global recovery is already under way, but there are concerns about its sustainability and pace in 2003 and beyond (IMF 2003a; World Bank 2003b; UNDESA and UNCTAD 2003; OECD 2003a). Economic growth will pick up in 2003–2004 in both the United States and the Euro area, the two main sources of FDI, but it will continue to be weak in Japan. For developing countries, the projected growth of 5% in 2003 is about three percentage points above that for developed countries (1.9%). But the forecasts for 2003 have been revised downward, especially in East Asia, for the negative effects of SARS on the region's economy (IMF 2003a). China and India, the most populous developing countries, are forecast to grow by 7.5% and 5.1% in the next couple of years (IMF 2003a). Strong growth is also forecast for CEE. However, the danger of deflation in major

economies—setting off a downward spiral in economic activity—cannot be ruled out.

The index of industrial production in the developed countries, which declined to 118.1 in 2002 from 121.2 in 2000, is showing signs of recovery in 2003 (OECD 2003a). But the prospects vary widely by industry—brighter for consumer pharmaceuticals, electronics and semiconductors, but dimmer for automobiles, metals and machinery and aerospace.²⁰ Sharp declines in demand have weakened prospects in certain high-technology industries, especially in the United States. Business debt in the United States has risen since 1999, and business insolvencies in Japan and Germany have escalated. Even so, the Manufacturers Alliance Business Outlook Index in the United States rose to 67% in December 2002, its highest quarterly mark in five years (an index of 50% or better indicates an increase in manufacturing activity in the coming quarter).

The outlook for the services sector is also mixed. Major defaults have weakened financial institutions in all Triad economies. Excess capacity, especially in Europe, has held telecom firms back from new investments both at home and abroad. Sharp declines in demand have weakened investment prospects for air transportation and tourism. But the United States services sector increased every month beginning with February 2002 with the exception of March 2003.²¹ According to the Institute for Supply Management in the United States, the index of non-manufacturing business activity rose to 54.5 in May 2003 (above 50 denotes expansion). The outlook for 2003 for real estate, business services, financial services and retail trade is optimistic,²² while no upturn is foreseen in insurance, travel and transportation.²³

Micro factors

At the micro level, the recovery in economic growth and stronger demand in a range of industries should improve corporate profits, release financial constraints and encourage investments, including FDI. They will also foster conditions for a recovery to some extent in stock market performances and portfolio equity flows. That would boost the value of cross-border M&As through stock markets and increase the ability of TNCs to raise funds for investment by issuing new stock or borrowing on the value of their assets.

Worldwide M&A activity in 2003, however, continues to be weak, trailing the pace of the previous year. M&As with values of less than \$1

billion in the United States and transatlantic markets fell during the first four months of 2003 (Baird 2003). They held up better than the overall market in 2002. Reflecting this general trend, cross-border M&As are not likely to rebound this year. In fact, the number of cross-border M&As completed during the first six months of 2003 fell by a fifth to some 2,000, compared to 2,500 during the same period of 2002. Their value declined by one third to \$140 billion.²⁴ Market volatility could impede M&A transactions in 2003, but an improvement in market conditions would set the foundation for a positive trend in the coming years.

Improved market conditions and profit prospects should increase market-seeking FDI in a wide range of countries and expand the scope of efficiency-seeking FDI that TNCs continued to explore during the downturn. In the face of the economic slowdown, heightened competition forced TNCs to look for (or expand in) new and thriving markets. China is a case in point, a location where TNCs felt that they ought to be present, despite numerous obstacles. Markets need not be national, as the anticipated attractiveness of regional initiatives indicates.

The dismantling of trade barriers²⁵ has allowed TNCs to pursue integrated international production strategies and structures, driving them to acquire a portfolio of locational assets in bad times as well as good. This is gathering speed, especially for the relocation of labour-intensive and some skill-intensive activities to lower-cost locations with transportation and communication infrastructure. Consider the decisions of IBM to close its facilities in Hungary in 2002 and relocate to China (EIRO 2002; Horvath 2002). Small and medium-sized enterprises are also under pressure to reap the cost-cutting and efficiency benefits of business process outsourcing. International outsourcing has grown rapidly in the past couple of years, with the offshore operations by major United States firms.²⁶

Institutional factors

As regards institutional factors, despite the winding down of many privatization programmes, there is still potential for privatization in several countries and industries. In late 2002 China allowed private and foreign investors to acquire controlling stakes in domestically listed companies, including State enterprises (UNCTAD 2002a). India also has considerable potential for the privatization of State-owned enterprises.²⁷

In some CEE countries, new privatizations might start if government announcements materialize. In the Russian Federation, the Government approved a February 2003 plan to privatize more than 3,000 State-owned enterprises, with assets estimated at \$2.2 billion.²⁸ Romania's Petrom, the largest oil company in Eastern Europe, is being privatized this year with foreign participation, as are *Polskie Huty Stali*, a large steel company in Poland and several oil companies in the Russian Federation. Serbia and Montenegro is required by law to privatize all State-owned enterprises by 2005, but progress so far has been slow.

The liberalization of FDI at the national level picked up speed during the downturn (table I.6). Several bilateral and regional initiatives may boost FDI in the years ahead (chapter II). And under the current round of negotiations of the General Agreements in Trade in Services (GATS) in the WTO, scheduled to be completed by 1 January 2005, members were supposed to submit their initial market opening offers by the end of March 2003. The negotiations are tackling many behind-the-border restrictions in services. Liberalization in this area could boost FDI flows and strengthen the integration of international production.

The stock of FDI already in place gives rise to two trends that have, to some extent, been supporting FDI flows. First, it generates revenues and earnings, a proportion of which is reinvested (figure I.16). Second, it requires additional capital investment to make up for depreciation and ensure that assets remain in working order.

On the downside, heightened security concerns have caused some TNCs to adopt a "wait and see" attitude, though only a few TNCs cancelled planned investments (*WIR02*; UNCTAD 2003a; MIGA 2002). More recent events, including the war in Iraq, have also increased security concerns, with longer term implications for FDI expansion.

IPAs are optimistic about the prospects, as revealed by a survey by UNCTAD in the first quarter of 2003 (box I.5). Other forecasts range from predicting that the next FDI boom will begin in 2004 to predicting no immediate increase in FDI (box I.6). UNCTAD expects FDI flows to remain stagnant in 2003 and begin to rebound in 2004, barring exceptional circumstances.

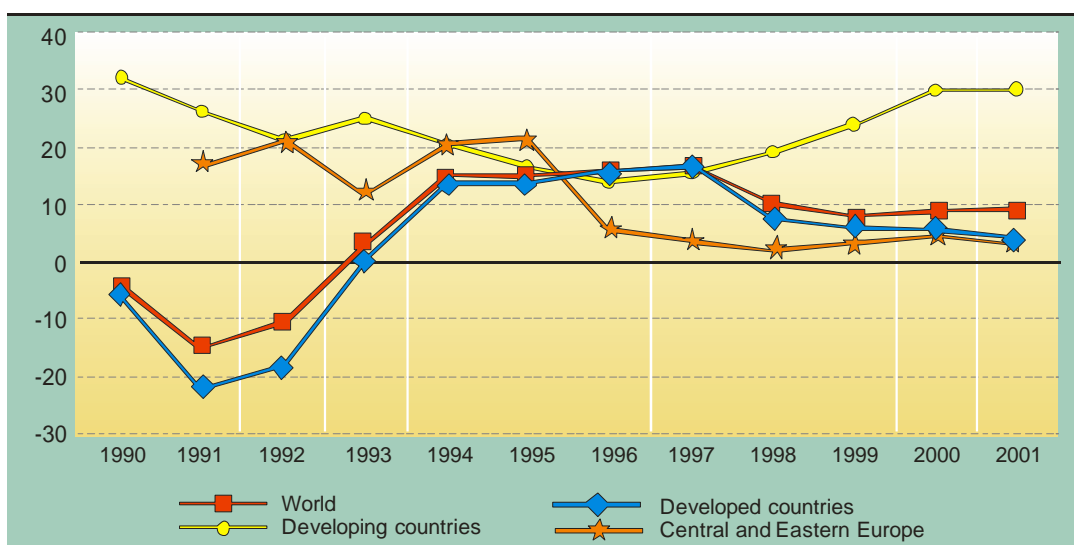
Box I.5. UNCTAD's survey of investment promotion agencies

According to an UNCTAD survey of 106 national IPAs worldwide, completed in March 2003,^a global FDI flows will remain sluggish in the short term and gain new steam in the medium term. The survey also suggests that greenfield investment will gain importance as a mode of entry. Among industries, tourism and telecoms will lead the recovery, with developing countries more active in outward FDI.

In spite of differences by region, a large proportion of the IPAs expressed concerns about the short term while a majority were optimistic about the medium term (box figure I.5.1). More than 40% of the respondents expected the FDI

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Figure I.16. Reinvested earnings as a percentage of FDI inflows, by region, 1990-2001
(Per cent)

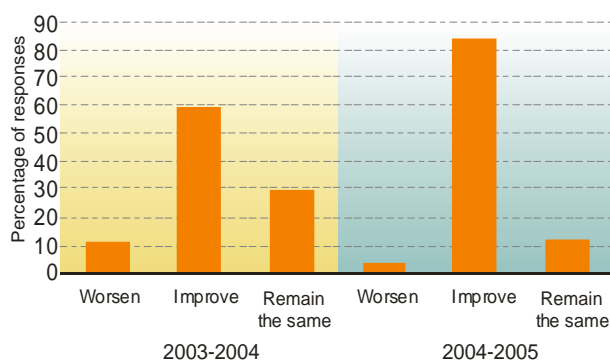


Source: UNCTAD, based on IMF, *Balance of Payments Statistics*, May 2003 CD-ROM.

Box. I.5. UNCTAD's survey of investment promotion agencies (concluded)

outlook for their countries to remain the same or worsen in 2003-2004. But for 2004-2005, this declined to 16%, leaving 84% of the respondents expecting prospects to improve. IPAs in developing countries were much more optimistic than those in the developed world (box figure I.5.2). Respondents from Africa and Asia were almost certain their countries would attract more FDI in 2004/2005.

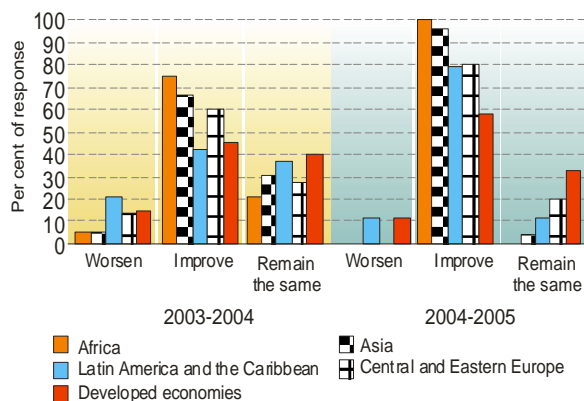
Box fig. I.5.1. IPAs perceive that FDI prospects in their countries will be improving^a



Source: UNCTAD.

^a The survey question was: "How do you perceive the prospects for FDI inflows to your country in the short- and medium-term, as compared to the last two years (2001-2002)?"

Box fig. I.5.2. Perceptions of FDI prospects vary from region to region^a



Source: UNCTAD.

^a The survey question was: "How do you perceive the prospects for FDI inflows to your country in the short- and medium-term, as compared to the last two years (2001-2002)?"

For investment strategies, there seems to be a shift from M&As to greenfield projects. More than 60% of the respondents found that greenfield investment would be the preferred mode of entry into their countries in 2003-2005, up from 56% in 2001-2002. The view was stronger in developing

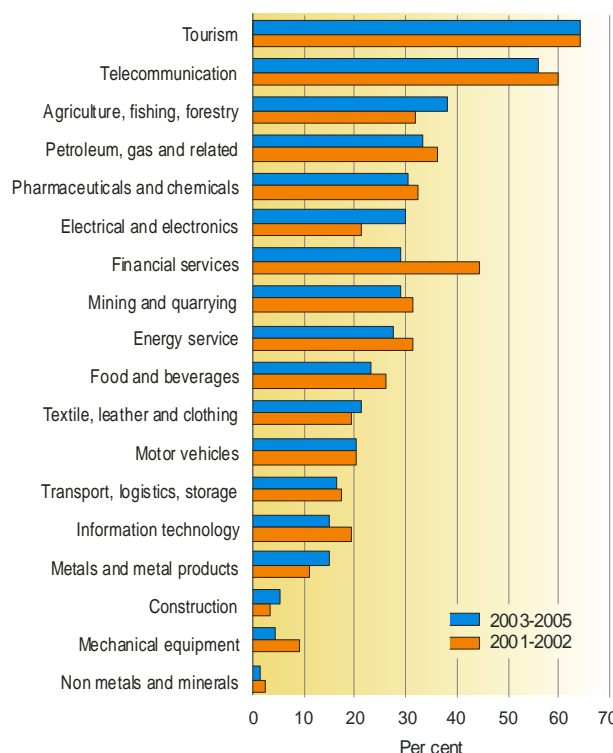
Source: UNCTAD.

^a The UNCTAD questionnaire survey covered 154 countries that have a national IPA or a government entity with an investment-promotion function. Out of the 154 national IPAs (i.e. one national IPA per country), 106 IPAs responded, for a 69% response rate (72% for developed countries, 64% for developing countries and 79% for CEE countries).

^b A number of responses did not mention specific industries but only economic sectors in general. These responses are not reflected in this figure.

regions (68%) (except Asia) and CEE (57%). The industrial composition of FDI may change as well.^b Most IPAs felt that tourism and telecoms would be the most important recipients of FDI in 2003-2005 (box figure I.5.3). Agriculture, petroleum, pharmaceuticals and chemicals follow closely. FDI flows to electrical and electronics, textile and clothing, and metals and metal products may also increase in a number of countries.

Box fig. I.5.3. A shift is expected in the industrial composition of FDI^a



Source: UNCTAD.

^a The survey question was: "Do you foresee any shift in the industry distribution of FDI in your country? Please list the three industries that have received and are likely to receive more FDI".

Note: A number of responses have not mentioned specific industries but only economic sectors in general. These responses are not reflected in this figure.

Developing countries are also gaining importance in outward FDI. The United States, the United Kingdom and Germany remain the main sources of FDI, but China, India and Saudi Arabia are emerging as important investors, with a strong presence in developing economies. And some corporate functions are more significant as targets in attracting FDI, with respondents citing corporate HQ functions and R&D outsourcing as additional triggers for FDI flows into their countries.

Box I.6. Is a recovery in FDI flows on the way?

Several recent surveys and publications gauge the prospects for FDI in the short and medium term. The findings of the main ones are:

- The 2002 survey by the Japan Bank for International Cooperation on the outlook for Japanese FDI in manufacturing, conducted in July/August 2002, shows that 80% of 508 responding TNCs would strengthen and expand their foreign operations over the next three years, up from 72% in 2001.
- The Japan External Trade Organization, in cooperation with the Ministry of Economy, Trade and Industry, carries out monthly surveys of the business outlook in Asia by surveying Japanese companies operating in that region. The latest, published in May 2003, reveals an overall deterioration being expected during the next two-to-three months in Asia, including China, in particular East China (because of the effects of SARS)—for the first time since this survey started in July 2002.
- The International Chamber of Commerce and the IFO research institute conduct a quarterly *World Economic Survey* of more than 1,000 business executives, economists and analysts from more than 80 countries. The findings of the latest, published in December 2002, show that business expectations for the next six months suffer from a general fall in confidence, and only a marginally improved outlook is expected thereafter. The three-to-five year outlook is brighter, with economic growth expected to improve.
- PriceWaterhouseCoopers conducted the fifth *Global CEO Survey* of more than 1,100 business executives from over 30 countries in October 2002–January 2003. It found that firms generally are not curtailing expansion projects that fulfil their long-term strategic objectives. They are also outsourcing more business processes, especially non-core business functions.
- A survey of 314 leading CEOs of Canadian companies between August and November 2002 by KPMG and Ipsos-Reid found that 86% of the CEOs were optimistic about competing in the global marketplace, but only 40% planned to expand into new markets in 2003.
- According to the *World Investment Prospects 2003*, published by the Economist Intelligence Unit, FDI flows will decline again in 2003 but rebound in 2004 and grow strongly over

the subsequent four years. The United States is expected to regain its position as the world's top FDI recipient. Another boom is expected in cross-border M&As. The forces driving the next FDI boom are better business environments, technological change, deregulation, industrial consolidation, heightened global competition, the creation of a single financial market in Europe and good investment opportunities in emerging markets.

- In its May 2003 report, *Capital Flows to Emerging Market Economies*, the Institute for International Finance forecast an increase in private capital flows into 29 emerging markets (developing and CEE countries) for 2003, after a decline for the second year running in 2002. FDI flows to emerging markets are forecast to fall marginally in 2003, to about \$109 billion, the lowest level since 1996, as TNCs continue to be cautious about investment spending under the present global economic outlook and as the pace of structural reform and privatization slows down in many countries. FDI is expected to increase in emerging markets in Asia and the Pacific from \$55 billion in 2002 to \$60 billion in 2003, and in Africa/Middle East from \$3 billion to \$4 billion.
- The International Monetary Fund in its *World Economic Outlook 2003* predicted that FDI flows to emerging markets would increase modestly to \$148 billion in 2003, from \$139 billion in 2002, but decline marginally in 2004. The World Bank, in its *Global Development Finance 2003*, forecast that FDI flows to developing countries will remain virtually unchanged in 2003, at \$145 billion (box table I.6.1).

Box table I.6.1. World Bank's estimates of FDI inflows to developing countries, 2002–2004
(Billions of dollars)

Region	2002	2003	2004
Total	143	145	159
East Asia and Pacific	57	61	69
Europe and Central Asia	29	30	32
Latin America and the Caribbean	42	38	39
Middle East and North Africa	3	3	4
South Asia	5	6	7
Sub-Saharan Africa	7	7	8

Source: World Bank, 2003a.

Note: The geographical coverage of developing countries in this table is different from that used in this Report.

Source: UNCTAD, based on Economist Intelligence Unit 2003; Institute for International Finance 2003; International Chamber of Commerce/IFO Research Institute 2003; International Monetary Fund 2003a; Japan Bank for International Cooperation 2003; JETRO 2003a; PricewaterhouseCoopers (PwC) 2003a; KPMG 2003; World Bank 2003a.

Notes

- 1 The relative variance as measured by the standard deviation divided by the average of the variable is 0.5 for FDI flows, 0.64 for portfolio flows and 5.9 for commercial bank loans between 1990 and 2002.
- 2 The transnationality index of both developed and developing countries in 1999 was less than 20% (*WIR02*, p. 21), but it rose to more than 20% in 2000 in both groups of economies. Similarly the index for CEE rose by a few percentage points.
- 3 The lending rate was 4.68% in the United States, compared with 6.13% in the Euro area in 2002. But during 1997-2001 the lending rate was higher in the United States than in the Euro area, by as much as two percentage points. Lending rates in Japan were very low throughout the period—and FDI outflows from Japan to the United States (small as they were) increased.
- 4 EU TNCs engaged in far fewer cross-border M&A transactions in the United States: from 400 in 2001 they fell to 241 deals in 2002. The value of completed cross-border M&As in the United States by EU firms halved in 2001 and halved again in 2002 to only \$47 billion, compared with \$203 billion in 2000. The value of cross-border M&As by United States firms in the EU rose from \$34 billion in 2001 to \$39 billion in 2002, however, these levels were about half those in 2000 (data from UNCTAD, cross-border M&A database).
- 5 This is based on an assumption that a dollar of cross-border M&As corresponds to a dollar of FDI flows. However, due to differences in the nature of data, these two types of data do not match (see *WIR00* for the nature of the data on cross-border M&As).
- 6 For further discussion on this subject, including the methodology on the FDI Performance Index and the FDI Potential Index, see www.unctad.org/wir.
- 7 Data for the last two years allow inflows into Belgium and Luxembourg to be separated; much of inward FDI goes to Luxembourg and may be driven by tax considerations rather than long-term productive activity.
- 8 The correlation coefficient for the former is much lower (0.80) than for the latter (0.95).
- 9 It goes without saying that under-performance in this context does not necessarily mean that the countries are under-performing in general economic terms.
- 10 Information from the World Federation of Exchanges (<http://www.world-exchanges.org/WFE/home.asp?menu=196&document=559>). The data cover 49 markets in 44 countries.
- 11 The profitability as measured by the return on assets is often used as an indicator of a firm's performance (Gomes and Ramaswamy 1999; Ruigrok and Wagner 2003).
- 12 Based on inward FDI data. The rates of return on FDI are calculated as income on FDI divided by the average value of the stocks at the beginning and the ending years. The data are from balance-of-payments statistics.
- 13 These economies are Argentina, Chile, Hong Kong (China), Ireland, Israel, Malaysia, Norway, Paraguay, Singapore, the United Kingdom and the United States.
- 14 Asian and Pacific countries were parties to 45 BITs, including 10 signed between countries within the region. Developed countries were parties to 44 BITs, CEE countries to 24 (including 5 signed within the region), African countries to 20 (including 2 between African countries) and Latin American and Caribbean countries to 13.
- 15 Developed countries were parties to 42 DTTs (including 11 signed between themselves), CEE countries to 29 (including 6 between themselves), Asian and Pacific countries to 27 (including 4 between themselves), African countries to 9 (including 3 intra-regional ones) and Latin America and Caribbean countries to 5.
- 16 See figure I.14 for the definition.
- 17 On the basis of the application of the same criterion as for associate partners in FDI (countries that have more than 30% of their respective trade (exports plus imports) with the Triad member, there are 89, 28 and three associate trade partners for the EU, the United States and Japan, respectively. Of these, 26 countries are common to the two blocks (FDI and trade) for the EU, eight in for the United States and one for Japan.
- 18 The similarity index is measured by:

$$\text{Index} = \sum (\min(a_i, b_i)) \text{ for all } i$$
 where $i = 1 \dots N$ is the region i and “ a_i ” and “ b_i ” are the corresponding FDI and BIT/DTT shares. If for each region the FDI and BIT/DTT shares are equal, then the structures are identical and the index will be 100. The higher the index, the greater the similarity in the structures of FDI and BIT/DTT.
- 19 Out of the 19 countries identified as associate partners of the United States (based on the 2001 data), 8 countries have BITs and 15 have DTTs with the United States. In the case of the EU, these numbers reach 35 for BITs and 38 for DTTs out of the 40 associate partners. Out of the 4 associate partners of Japan, one country (Republic of Korea) has a BIT with Japan, and two countries (Republic of Korea and Singapore) have DTTs with Japan.
- 20 “Industry outlook 2003”, *Business Week*, 13 January 2003.
- 21 “May non-manufacturing ISM report on business”, *Press Release*, Institute for Supply Management, 4 June 2003.
- 22 “Expect recovery to continue to second half of 2003 say purchasing and supply executives”, *Press Release*, Institute for Supply Management, 20 May 2003.
- 23 *Business Week*, *idem*.
- 24 Information provided by Thomson Financial.
- 25 According to the World Bank and the IMF 2001, for industrial countries the post-Uruguay Round bound simple average tariff rate across all products is now 4%, while for developing countries it is at 25% (with considerable variation across products and countries).
- 26 OutsourcingCenter 2003.
- 27 In India, the Government's plan is to raise about \$2.8 billion by selling State-run companies in the current fiscal year ending March 2004 (“Indians in privatization strike”, *BBC News*, 21 May 2003) and some of that could be through FDI. Recent additions to the Government's privatization plans include two of India's leading oil companies (“No turning back, oil PSU divestment on: PM”, *Economic Times*, 23 May 2003). However, there is still a need to develop a consensus around key issues (“Divestment to miss targets, consensus needed”, *Economic Times*, 23 May 2003).
- 28 *Oxford Analytica Daily Brief*, 18 March 2003.

