UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

World Investment Report 2006

FDI from Developing and Transition Economies: Implications for Development

PREFACE
ACKNOWLEDGEMENTS &
OVERVIEW

United Nations
New York and Geneva, 2006

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PREFACE

This year's *World Investment Report* highlights the changing role of developing countries and transition economies in global foreign direct investment and the international production system. It examines their emergence as significant sources of foreign direct investment as well as the underlying factors and broader implications.

The *Report* stresses that such outward investment offers an additional avenue for developing countries to link up to global markets and production systems. If managed successfully, these investments can help firms access markets, natural resources, foreign capital, technology or various intangible assets that are essential to their competitiveness but that may not be readily available in their home countries. Appropriate policies are needed to mitigate the risks and costs and seize the opportunities arising from outward investment.

From a host-country perspective the rise of transnational corporations from developing and transition economies expands the range of potential sources of finance, technology and management know-how. This is of particular relevance to low-income countries. As shown in the *Report*, inflows of foreign investment into many least developed countries come primarily from other developing countries. It is important to consider how this form of South-South cooperation can be further strengthened to promote mutual development gains.

Developed countries and their firms will face new competition for various resources and assets, but they will also find new opportunities for economic collaboration. They will have to become accustomed to many more transactions involving investors from developing and transition economies as they expand internationally. In fact, the emergence of these new sources of investment has broader implications for international economic relations as it reflects their growing clout in the world economy.

Finally, the emergence of transnational corporations from developing and transition economies imparts greater momentum to South-South cooperation. New investment corridors are opening up between Latin America, Africa and Asia as part of this dynamic activity, with positive prospects for advancing development. To capitalize on this opportunity, policy-makers from home and host developing countries need to gear themselves into action and, for this, they will require insightful knowledge and analysis. This year's *World Investment Report* is a step towards this goal.

Kofi A. Annan
Secretary-General of the United Nations

New York, July 2006

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ABBREVIATIONS

AGOA	African Growth and Opportunity Act (of the United States)
ASEAN	Association of Southeast Asian Nations
BIT	bilateral investment treaty
CARICOM	Caribbean Community
CIS	Commonwealth of Independent States
COMESA	Common Market for Eastern and Southern Africa
CSR	corporate social responsibility
DFI	developoment finance institution
DTT	double taxation treaty
ECA	export credit agency
ECLAC	Economic Commission for Latin America and the Caribbean
ECOWAS	Economic Community of West African States
EIU	Economist Intelligence Unit
EMU	European Monetary Union
EPA	economic partnership agreement
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
GATS	General Agreement on Trade in Services (WTO Agreement)
GCC	Gulf Cooperation Council
GDP	gross domestic product
GFCF	gross fixed capital formation
GLC	government-linked company
IAIGC	Inter-Arab Investment Guarantee Corporation
ICSID	International Centre for Settlement of Investment Disputes
ICT	information and communications technology
IDP	investment development path
IIA	international investment agreement
IPA	investment promotion agency
IPR	intellectual property right
ISDS	investor-State dispute settlement
ISO	International Standards Organization
IT	information technolgy
LAC	Latin America and the Caribbean
LDC	least developed country
M&A	merger and acquisition
MERCOSUR	Mercado Común del Sur (Southern Common Market)
MIGA	Multilateral Investment Guarantee Agency
MFA	Multi-Fibre Arrangement
MFN	most-favoured nation
NEPAD	New Partnership for Africa's Development
NIE	newly industrializing economy
NOI	net outward investment
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacture
PC	personal computer
R&D	research and development
SADC	Southern African Development Community
SAFE	State Administration of Foreign Exchange (China)
SAGIA	Saudi Arabian General Investment Authority
SME	Small and medium-sized enterprises
SPE	special purpose entity
TNC	transnational corporation
TPO	Trade promotion organization
TRIPS	Trade-related Aspects of Intellectual Property Rights (WTO agreement)
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
WAIPA	World Association of Investment Promotion Agencies
WTO	World Trade Organization

OVERVIEW

ANOTHER YEAR OF FDI GROWTH

Foreign direct investment in 2005 grew for the second consecutive year, and it was a worldwide phenomenon.

Inflows of foreign direct investment (FDI) were substantial in 2005. They rose by 29% – to reach $916 billion – having already increased by 27% in 2004. Inward FDI grew in all the main subregions, in some to unprecedented levels, and in 126 out of the 200 economies covered by UNCTAD. Nevertheless, world inflows remained far below the 2000 peak of $1.4 trillion. Similar to trends in the late 1990s, the recent upsurge in FDI reflects a greater level of cross-border mergers and acquisitions (M&As), especially among developed countries. It also reflects higher growth rates in some developed countries as well as strong economic performance in many developing and transition economies.

Inflows to developed countries in 2005 amounted to $542 billion, an increase of 37% over 2004, while to developing countries they rose to the highest level ever recorded – $334 billion. In percentage terms, the share of developed countries increased somewhat, to 59% of global inward FDI. The share of developing countries was 36% and that of South-East Europe and the Commonwealth of Independent States (CIS) was about 4%.

The United Kingdom saw its inward FDI surge by $108 billion to reach a total of $165 billion, making it the largest recipient in 2005. Despite a decline in the level of inward FDI, the United States was the second largest recipient. Among developing economies, the list of the largest recipients compared with previous years remained stable, with China and Hong Kong (China) at the top, followed by Singapore, Mexico and Brazil. Regionally, the 25-member European Union (EU) was the favourite destination, with inflows of $422 billion, or almost half of the world total. South, East and South-East Asia received $165 billion, or about a fifth of that total, with the East Asian subregion accounting for about three quarters of the regional share. North America came next with $133 billion, and South and Central America followed with $65 billion. West Asia experienced the highest inward FDI growth rate, of 85%, amounting to $34 billion. Africa received $31 billion, the largest ever FDI inflow to that region.

Global FDI outflows amounted to $779 billion (a different amount from that estimated for FDI inflows due to differences in data reporting and collecting methods of countries). Developed countries remain the leading sources of such outflows. In 2005, the Netherlands reported outflows of $119 billion, followed by France and the United Kingdom. However, there were significant increases in outward investment by developing economies, led by Hong Kong (China) with $33 billion. Indeed, the role of developing and transition economies as sources of FDI is increasing. Negligible or small until the mid-1980s, outflows from these economies totalled $133 billion last year, corresponding to some 17% of the world total. The implications of this trend are explored in detail in Part Two of this Report.

It was spurred by cross-border M&As, with increasing deals also undertaken by collective investment funds.

Cross-border M&As, especially those involving companies in developed countries, have spurred the recent increases in FDI. The value of cross-border M&As rose by 88% over 2004, to $716 billion, and the number of deals rose by 20%, to 6,134. These levels are close to those achieved in the first year of the cross-border M&A boom of 1999-2001. The recent surge in M&A activity includes several major transactions, partly fuelled by the recovery of stock markets in 2005. There were 141 mega deals valued at more than $1 billion – close to the peak of 2000, when 175 such deals were observed. The value of mega deals was $454 billion in 2005 – more than twice the 2004 level and accounting for 63% of the total value of global cross-border M&As.

A new feature of the recent M&A boom is increasing investment by collective investment funds, mainly private equity and related funds. A number of factors, including historically low interest rates and increasing financial integration,

have led private equity firms to undertake direct investments abroad, which are estimated to have reached $135 billion in 2005 and accounted for 19% of total cross-border M&As. Unlike other kinds of FDI, private equity firms tend not to undertake long-term investment, and exit their positions with a time horizon of 5 to 10 years (or an average of 5-6 years), long enough not to be regarded as typical portfolio investors. Thus host countries, and developing ones in particular, need to be aware of this difference in time horizon. At the same time, foreign ownership can bring market access and new technologies, and private equity investment can help host-country enterprises at a critical juncture to move to a new phase of development.

Most inflows went into services, but the sharpest rise in FDI was in natural resources.

Services gained the most from the surge of FDI, particularly finance, telecommunications and real estate. (Since data on the sectoral distribution of FDI are limited, these observations are extrapolated from data relating to cross-border M&As, which accounted for a significant share of inflows.) The predominance of services in cross-border investments is not new. What *is* new is the further and sharp decline in the share of manufacturing (four percentage points lower in cross-border M&A sales over the preceding year) and the steep rise of FDI into the primary sector (with a sixfold increase in cross-border M&A sales), primarily the petroleum industry.

There has been a significant increase in developing-country firms in the universe of transnational corporations.

Transnational corporations (TNCs), most of them privately owned, undertake FDI. However, in some home countries (notably in the developing world) and in some industries (especially those related to natural resources) a number of major State-owned enterprises are also increasingly expanding abroad. According to estimates by UNCTAD, the universe of TNCs now spans some 77,000 parent companies with over 770,000 foreign affiliates. In 2005, these foreign affiliates generated an estimated $4.5 trillion in value added, employed some 62 million workers and exported goods and services valued at more than $4 trillion.

The TNC universe continues to be dominated by firms from the Triad – the EU, Japan and the United States – home to 85 of the world's top 100 TNCs in 2004. Five countries (France, Germany, Japan, the United Kingdom and the United States) accounted for 73 of the top 100 firms, while 53 were from the EU. Heading the list of the global top 100 non-financial TNCs are General Electric, Vodafone and Ford, which together account for nearly 19% of the total assets of these 100 companies. The automobile industry dominates the list, followed by pharmaceuticals and telecommunications.

However, firms from other countries are advancing internationally. Total sales of TNCs from developing countries reached an estimated $1.9 trillion in 2005 and they employed some 6 million workers. In 2004, there were five companies from developing economies in the list of the top 100 TNCs, all with headquarters in Asia, three of them State-owned. These five companies – Hutchison Whampoa (Hong Kong, China), Petronas (Malaysia), Singtel (Singapore) Samsung Electronics (the Republic of Korea) and CITIC Group (China) – topped the list of the largest 100 TNCs from developing countries. (Since 1995, the *World Investment Report* has published a list of the top 50 TNCs, but in this Report the list has been expanded to cover 100 TNCs.) In 2004, 40 of the firms were from Hong Kong (China) and Taiwan Province of China, 14 from Singapore and 10 from China. Altogether, 77 of the top 100 TNCs had their headquarters in Asia; the remaining were equally distributed between Africa and Latin America.

Liberalization continues, but some protectionist tendencies are also emerging.

In terms of regulatory trends relating to investment, the pattern observed in previous years has persisted: the bulk of regulatory changes have facilitated FDI. They have involved simplified procedures, enhanced incentives, reduced taxes and greater openness to foreign investors. However, there have also been notable moves in the opposite direction. In both the EU and the United States, growing concerns have arisen over proposed foreign acquisitions. In early 2006, the acquisition by DP World (United Arab Emirates) of P&O (United Kingdom), a shipping and port management firm, along with that firm's management of some ports in the United States, led to United States protests on the grounds of security. Similarly, in Europe concerns were voiced over a bid by Mittal Steel to acquire Arcelor, and broader European opposition to the EU's own directive relating to the liberalization of services. Some notable regulatory steps were also taken to protect

economies from foreign competition or to increase State influence in certain industries. The restrictive moves were mainly related to FDI in strategic areas such as petroleum and infrastructure. For example, the Latin American oil and gas industry became the focus of attention, particularly following the Bolivian Government's decision to nationalize that industry in May 2006.

The web of international agreements of relevance to FDI continued to expand. By the end of 2005, the total number of bilateral investment treaties (BITs) had reached 2,495, and double taxation treaties (DTTs) 2,758, along with 232 other international agreements containing investment provisions. A number of developing countries are actively involved in such rule-making, including through more South-South cooperation. A notable trend involves the conclusion of further free trade agreements and various economic cooperation arrangements dealing with investment. The universe of international investment agreements (IIAs) is becoming increasingly complex. The recent IIAs tend to deal with a broader set of issues, including public concerns related, for example, to health, safety or the environment. While such quantitative and qualitative changes may contribute to creating a more enabling international framework for foreign investment, they also mean that governments and firms have to deal with a rapidly evolving system of multilayered and multifaceted set of rules. Keeping this framework coherent and using it as an effective tool to further countries' development objectives remain key challenges.

Africa attracted much higher levels of FDI.

In *Africa,* FDI inflows shot up from $17 billion in 2004 to an unprecedented $31 billion in 2005. Nonetheless, the region's share in global FDI continued to be low, at just over 3%. South Africa was the leading recipient, with about 21% ($6.4 billion) of the region's total inflows, mainly as a result of the acquisition of ABSA (South Africa) by Barclays Bank (United Kingdom). Egypt was the second largest recipient, followed by Nigeria. As in the past, with a few exceptions such as Sudan, most of the region's 34 least developed countries (LDCs) attracted very little FDI. The leading source countries remained the United States and the United Kingdom, along with France and Germany further behind. Most of the FDI was in the form of greenfield investments.

FDI flows to Africa in 2005 went mainly into natural resources, especially oil, although services (e.g. banking) also figured prominently. High commodity prices and strong demand for petroleum led to an increase in exploration activities in a number of African countries, including Algeria, Egypt, Equatorial Guinea, the Libyan Arab Jamahiriya, Mauritania, Nigeria and Sudan. TNCs from the United States and the EU continued to dominate the industry, but a number of developing-country TNCs, such as CNOOC from China, Petronas from Malaysia and ONGC Videsh from India, are increasingly expanding into Africa. Total FDI into six African oil-producing countries – Algeria, Chad, Egypt, Equatorial Guinea, Nigeria and Sudan – amounted to $15 billion, representing about 48% of inflows into the region in 2005.

Although outward FDI from Africa declined in 2005, several African TNCs deepened their internationalization, including through cross-border M&As. For example, Orascom, acquired Wind Telecommunicazioni of Italy through Weather Investments of Egypt. Most of the FDI from South Africa, the leading investor in Africa, went to developing countries in 2005.

Manufacturing attracted less FDI than natural resources and services. However, some sector-specific developments are worth highlighting. Automotive TNCs have set up export-oriented production facilities in South Africa, generating employment opportunities and export revenues. Conversely, fragmented markets, poor infrastructure and a lack of skilled workers, coupled with the ending in 2005 of the quotas established under the Multi-Fibre Arrangement (MFA), contributed to some divestment in the ready-made garments industry in countries like Lesotho. These divestments suggest that preferential market access (as provided by the United States' African Growth and Opportunities Act and the EU's Everything But Arms initiative) is not in itself sufficient to attract and retain manufacturing FDI in a globalizing environment. If African countries are to become internationally competitive, it is essential that they strengthen the necessary linkages between their export sectors and the rest of the economy by building and fostering domestic capabilities in areas such as physical infrastructure, production capacity and institutions supportive of private investment.

There have been positive developments in terms of regulatory regimes, and many African countries have signed new bilateral agreements related to investment and taxation. However, attracting quality FDI – the kind that would significantly increase employment, enhance skills and boost the competitiveness of local enterprises – remains a challenge. Africa's industrial progress

requires competitive production capacity, in addition to better market access.

South, East and South-East Asia is still the main magnet for inflows into developing countries ...

FDI inflows into *South, East and South-East Asia* reached $165 billion in 2005, corresponding to 18% of world inflows. About two thirds went to two economies: China ($72 billion) and Hong Kong, China ($36 billion). The South-East Asian subregion received $37 billion, led by Singapore ($20 billion) and followed by Indonesia ($5 billion), Malaysia and Thailand ($4 billion each). Inflows to South Asia were much lower ($10 billion), though they grew significantly in several countries, with the highest level ever for India of $7 billion.

Over half of the inflows to the region came from developing home economies, mostly within the region. The figures for inward stock show significant growth in the share of these sources over the past decade, from about 44% in 1995 to about 65% in 2004, with a corresponding decline in the share of developed-country sources.

Manufacturing FDI has been increasingly attracted to South, East and South-East Asia, although specific locations have changed as countries have moved up the value chain. The sector continues to attract large inflows, especially in the automotive, electronics, steel and petrochemical industries. Viet Nam has become a new location of choice, attracting new investment by companies such as Intel, which is investing $300 million in the first semiconductor assembly plant in that country. In China, investment in manufacturing is moving into more advanced technologies; for example, Airbus plans to set up an assembly operation for its A320 aircraft. There is, however, a shift towards services in the region, in particular banking, telecommunications and real estate.

Countries in South, East and South-East Asia continue to open up their economies to inward FDI. Significant steps in this direction were taken in 2005, particularly in services. For example, India is now allowing single-brand retail FDI as well as investment in construction, and China has lifted geographic restrictions on operations of foreign banks and travel agencies. A few measures were also introduced to address concerns over cross-border M&As in countries such as the Republic of Korea.

South, East and South-East Asia is also an emerging *source* of FDI (among developing countries), with outflows of $68 billion in 2005. Although this implies a drop of 11% from 2004, Chinese outflows increased and seem set to rise further in the next few years. Many of the region's countries have accumulated large foreign reserves, which may lead to more outward FDI. Among the main recent FDI deals involving companies from this region were Temasek's (Singapore) purchase of an 11.5% stake in Standard Chartered (United Kingdom) in 2006, and CNPC's (China) takeover of Petrokazakhstan in 2005. China and India have been energetically pursuing the acquisition of oil assets, and have even cooperated on some bids.

... while West Asia received an unprecedented level of inflows.

FDI inflows into the 14 economies of West Asia soared by 85%, the highest rate in the developing world in 2005, to reach a total increase of about $34 billion. High oil prices and consequently strong GDP growth were among the main factors that drove this increase. In addition, the regulatory regime was further liberalized, with an emphasis on privatization involving FDI notably in services: for instance, power and water in Bahrain, Jordan, Oman and the United Arab Emirates, transport in Jordan, and telecommunications in Jordan and Turkey.

The United Arab Emirates collectively received inflows of $12 billion, to become the largest recipient of FDI in West Asia in 2005. The next largest was Turkey, primarily on account of a few mega cross-border M&A sales in services. FDI inflows in West Asia have gone mainly into services, including real estate, tourism and financial services. Much of the FDI in real estate has been intraregional. There is also increasing FDI in manufacturing, especially in refineries and petrochemicals, in which Saudi Arabia alone received some $2 billion in 2005. There is little FDI in the primary sector, as most West Asian countries do not permit it in upstream activities in the energy industry.

West Asia is becoming a significant outward direct investor. Traditionally, most of the region's petrodollars have gone into bank deposits and portfolio purchases abroad, particularly in the United States. This is changing in both form and location. Unlike the previous periods of high oil revenues, the present phase is witnessing substantial outward FDI in services, in developing as well as developed countries. One motivation for

this has been to forge stronger economic ties with the emerging Asian giants, China and India, but investment has also gone into Europe and Africa. Deals such as the above-mentioned acquisition of P&O by DP World, and the purchase of Celtel International (Netherlands) by Kuwait's Mobile Telecommunications illustrate this trend. Notable cases of South-South FDI include the purchase of a 25% share by Saudi Aramco in a refinery in Fujian, China, and a possible Saudi equity partnership with India's ONGC in a refinery in Andhra Pradesh, India.

Latin America and the Caribbean continued to receive substantial FDI.

Latin America and the Caribbean saw inflows of $104 billion, representing a small rise over 2004. Excluding the offshore financial centres, inflows increased by 12%, to reach $67 billion in 2005. Economic growth and high commodity prices were contributory factors. The region registered exceptional GDP growth rates in 2004-2005, surpassing those of the world average for the first time in 25 years. Strong demand for commodities contributed to a noticeable improvement in the regional trade balance. A significant proportion of the FDI inflows consisted of reinvested earnings, reflecting a marked increase in corporate profits. Trends varied by country: while inflows decreased in Brazil (- 17%), Chile (-7%) and Mexico (-3%), they rose significantly in Uruguay (81%), more than trebled in Colombia, almost doubled in Venezuela, and increased by 65% and 61% in Ecuador and Peru respectively.

Sectorally, the share of FDI in services in total FDI flows continued to decline, from 40% in 2004 to 35% in 2005 – a very low share compared with other regions. Some TNCs continued to withdraw from the region, in part due to disputes with host governments in areas such as public utilities (e.g. the withdrawal from Argentina of Suez and EDF (both French firms)). Manufacturing accounted for just over 40% of inflows, including a relatively large number of M&As, such as SABMiller's takeover of breweries in Colombia and Peru, Grupo Techint's (Argentina) purchase of the steel-maker Hylsamex (Mexico), and Camargo Correa's (Brazil) acquisition of the cement-maker, Loma Negra (Argentina).

Even though a number of countries in the region introduced more restrictive policies, FDI in the primary sector grew significantly, attracting nearly 25% of inflows. Despite introducing a requirement on TNCs in the petroleum industry to operate under new contracts Venezuela received FDI inflows of $1 billion. In Colombia, petroleum-related FDI soared to $1.2 billion, a 134% rise, and in Ecuador it increased by 72% in the first half of 2005. Investment in the mining industry also expanded. In Colombia, for example, it grew by nearly 60% to $2 billion, in Chile to $1.3 billion, in Peru to $1 billion and in Argentina to $850 million.

Notwithstanding significant differences accross countries, there appears to be a trend towards greater State intervention in the region, above all in the oil industry, and other natural resources. As a result of the large windfall earnings generated by the exploitation of natural resources and high commodity prices, several governments are introducing rules that are less favourable to FDI than those established in the 1990s, when commodity prices were at record lows. For instance, oil and gas resources have been nationalized in Bolivia; and the Government of Venezuela took control of 32 oilfields previously under private control, and created new State-owned companies in sectors such as sugar processing, retailing and communications. In addition, a broader shift in policy is under way in some countries, which aims at addressing income inequalities attributed to previous policy regimes.

Regional cooperation in the area of investment experienced several setbacks in 2005. Negotiations on establishing a 34-country Free Trade Agreement of the Americas stalled owing to opposition by five countries (including Argentina and Brazil); the free-trade talks between Ecuador and the United States were suspended following a takeover by the Government of Ecuador of Occident Petroleum's production infrastructure.

FDI outflows from Latin America and the Caribbean increased by 19% to $33 billion in 2005, with TNCs from the region acquiring assets mainly in telecommunications and heavy industries. As a significant share of these investments is within Latin America and the Caribbean, it also contributes to FDI inflows into the region.

FDI flows to South-East Europe and the Commonwealth of Independent States remained relatively high...

FDI flows to South-East Europe and the CIS in 2005 remained at a relatively high level ($40 billion), increasing only slightly over the previous year. Inflows were fairly concentrated: three countries – the Russian Federation, Ukraine and

Romania, in that order – accounted for close to three quarters of the total. FDI outflows from the region grew for a fourth consecutive year, reaching $15 billion, with the Russian Federation alone responsible for 87% of the total outflows. The countries of the region have different policy priorities related to inward and outward FDI, reflecting their varying economic structures and institutional environments. In natural-resource-based economies, such as the Russian Federation, Azerbaijan and Kazakhstan, most of the policy issues concern management of the windfall earnings from high international oil prices, and the definition – or redefinition – of the role of the State.

…while there was an upturn in FDI to developed countries.

FDI inflows into developed countries rose by 37% to $542 billion, or 59% of the world total. Of this, $422 billion went to the 25-member EU. The United Kingdom – the largest single recipient of global FDI – received $165 billion. The main contributory factor was the merger of Shell Transport and Trading (United Kingdom) with Royal Dutch Petroleum (the Netherlands), a deal valued at $74 billion. Other major FDI recipients, that registered significant increases in their FDI inflows included France ($64 billion), the Netherlands ($44 billion) and Canada ($34 billion). The 10 new EU members together attracted $34 billion, a rise of 19% over 2004 and another new record high. Inflows into the United States amounted to $99 billion, a significant decline from 2004. Although well over 90% of all inflows into developed countries originated from other developed countries, several notable investments by TNCs from developing countries also took place, including Lenovo's (China) takeover of IBM's personal computer division and the above-mentioned purchase of Italian Wind Telecomunicazioni by Orascom of Egypt through Weather Investments.

As a result of the Shell merger mentioned above, the Netherlands emerged as the leading source of FDI in 2005, followed by France ($116 billion) and the United Kingdom ($101 billion). Overall, however, outflows from developed countries declined somewhat, from $686 billion to $646 billion, mainly due to a fall in outflows from the United States. The American Jobs Creation Act of 2004 contributed to the decline, as it allowed repatriated earnings of United States foreign affiliates to be taxed at a lower rate than the normal one, leading to a one-off fall in reinvested earnings.

FDI into developed countries increased in all three sectors: primary, manufacturing and services. In keeping with the global trend, investment in natural resources increased significantly. In manufacturing, some of the new EU members (especially the Czech Republic, Hungary, Poland and Slovakia) consolidated their positions as preferred locations for automotive production. Hyundai Motors, for instance, announced plans to set up new plants in the Czech Republic and in Slovakia. The new EU members are likely to maintain their comparative advantages (e.g. their average wage is 30% of the average wage in the older EU countries) for some time, and their automotive production is expected to double over the next five years, to 3.2 million vehicles.

In 2005, there were intense political discussions on various aspects of FDI, and especially cross-border M&As, in developed countries. On the one hand, some countries, particularly the 10 new EU member States, continue to privatize, reduce corporate income taxes and provide new incentives to attract more FDI. On the other hand, various concerns have been raised in a number of countries following the increased M&A activity. National security concerns, for example, led to a blocking of the purchase of Unocal (United States) by CNOOC (China); the Governments of Spain and France tried to prevent the buyouts of Endesa and Suez, respectively, by companies from other EU countries, and steps were taken to protect national champions. Japan has postponed the approval of cross-border M&As through share swaps and adopted some restrictions in the retail industry for instance.

Overall, FDI should continue to grow in the short term.

World FDI inflows are expected to increase further in 2006. This prospect is based on continued economic growth, increased corporate profits – with a consequent increase in stock prices that would boost the value of cross-border M&As – and policy liberalization. In the first half of 2006, cross-border M&As rose 39% compared to the same period in 2005. However, there are factors that may dampen further FDI growth. These include the continuing high oil prices, rising interest rates and increased inflationary pressures, which may restrain economic growth in most regions. Also, various economic imbalances in the global economy as well as geopolitical tensions in some parts of the world are adding to the uncertainty.

FDI FROM DEVELOPING AND TRANSITION ECONOMIES

Developing and transition economies have emerged as significant outward investors…

Although developed-country TNCs account for the bulk of global FDI, an examination of different data sources shows a growing and significant international presence of firms – both private and State-owned – from developing and transition economies. Their outward expansion through FDI provides development opportunities for the home economies concerned. However, it is eliciting mixed reactions from recipient countries in different parts of the world. Some welcome the increased FDI from these economies as a new source of capital and knowledge; for others it also represents new competition.

A small number of source economies are responsible for a large share of these FDI outflows, but companies from more and more countries see the need to explore investment opportunities abroad to defend or build a competitive position. FDI from developing and transition economies reached $133 billion in 2005, representing about 17% of world outward flows. Excluding FDI from offshore financial centres, the total outflow was $120 billion – the highest level ever recorded. The value of the stock of FDI from developing and transition economies was estimated at $1.4 trillion in 2005, or 13% of the world total. As recently as 1990, only six developing and transition economies reported outward FDI stocks of more than $5 billion; by 2005, that threshold had been exceeded by 25 developing and transition economies.

Data on cross-border M&As, greenfield investments and expansion projects as well as statistics related to the number of parent companies based outside the developed world confirm the growing significance of TNCs from developing and transition economies. Between 1987 and 2005, their share of global cross-border M&As rose from 4% to 13% in value terms, and from 5% to 17% in terms of the number of deals concluded. Their share of all recorded greenfield and expansion projects exceeded 15% in 2005, and the total number of parent companies in Brazil, China, Hong Kong (China), India and the Republic of Korea has multiplied, from less than 3,000 to more than 13,000 over the past decade.

Sectorally, the bulk of FDI from developing and transition economies has been in tertiary activities, notably in business, financial and trade-related services. However, significant FDI has also been reported in manufacturing (e.g. electronics) and, more recently, in the primary sector (oil exploration and mining). Data on cross-border M&As confirm the dominance of services, which constituted 63%, by value, of M&As undertaken by companies based in developing and transition economies in 2005. By industry, the highest shares that year were recorded for transport, storage and communications, mining, financial services, and food and beverages.

The geographical composition of FDI from developing and transition economies has changed over time, the most notable long-term development being the steady growth of developing Asia as a source of FDI. Its share in the total stock of FDI from developing and transition economies stood at 23% in 1980, rising to 46% by 1990 and to 62% in 2005. Conversely, the share of Latin America and the Caribbean in outward FDI fell from 67% in 1980 to 25% in 2005. The top five home economies accounted for two thirds of the stock of FDI from developing and transition economies, and the top 10 for 83%. In 2005, the largest outward FDI stock among developing and transition economies was in Hong Kong (China), the British Virgin Islands, the Russian Federation, Singapore and Taiwan Province of China.

A sizeable share of FDI originates from *offshore financial centres*. The British Virgin Islands is by far the largest such source, with an outward FDI stock in 2005 estimated at almost $123 billion. From a statistical point of view, trans-shipping FDI via offshore financial centres makes it difficult to estimate the real size of outward FDI from specific economies and by specific companies. In some years, flows from these centres have been particularly large. However, since 2000, their outward FDI has declined considerably and now amounts to around one tenth of the total flows of FDI from developing and transition economies.

According to UNCTAD's *Outward FDI Performance Index,* which compares an economy's share of world outward FDI against its share of world GDP, FDI from Hong Kong (China) was 10 times larger than would be expected, given its share of world GDP. Other developing economies with

comparatively high outflows included Bahrain, Malaysia, Panama, Singapore and Taiwan Province of China. Meanwhile, many countries with relatively large outward FDI in absolute terms, such as Brazil, China, India and Mexico, are at the opposite end of the spectrum, suggesting considerable potential for future expansion of FDI.

...generating considerable South-South investment flows.

The emergence of these new sources of FDI may be of particular relevance to low-income host countries. TNCs from developing and transition economies have become important investors in many LDCs. Developing countries with the highest dependence on FDI from developing and transition economies include China, Kyrgyzstan, Paraguay and Thailand, and LDCs such as Bangladesh, Ethiopia, the Lao People's Democratic Republic, Myanmar and the United Republic of Tanzania. Indeed, FDI from developing countries accounts for well over 40% of the total inward FDI of a number of LDCs. For example, in Africa, South Africa is a particularly important source of FDI; it accounts for more than 50% of all FDI inflows into Botswana, the Democratic Republic of the Congo, Lesotho, Malawi and Swaziland. Moreover, the level of FDI from developing and transition economies to many LDCs may well be understated in official FDI data, as a significant proportion of such investment goes to their informal sector, which is not included in government statistics.

UNCTAD estimates show that South-South FDI has expanded particularly fast over the past 15 years. Total outflows from developing and transition economies (excluding offshore financial centres) increased from about $4 billion in 1985 to $61 billion in 2004; most of these were destined for other developing or transition economies. In fact, FDI among these economies increased from $2 billion in 1985 to $60 billion in 2004. As FDI of transition economies account for a very small proportion of these transactions, this estimate can also be used as a proxy for the size of South-South FDI.

The bulk of South-South FDI (excluding offshore financial centres) is intraregional in nature. In fact, during the period 2002-2004, average annual intra-Asian flows amounted to an estimated $48 billion. The next largest stream of FDI within the group of developing countries was within Latin America, mainly driven by investors in Argentina, Brazil and Mexico. Intraregional flows within Africa were an estimated $2 billion reflecting, in particular, South African FDI to the rest of the continent. Interregional South-South FDI has gone primarily from Asia to Africa, while the second largest has been from Latin America to Asia. Perhaps somewhat surprisingly, total flows from Asia to the Latin American region were modest during the period 2002-2004, and those between Latin America and Africa were negligible.

New global and regional players are emerging, especially from Asia...

The diversity of the home economies now emerging as significant sources of FDI precludes any far-reaching generalizations of the characteristics of TNCs from developing and transition economies, but it is possible to identify certain salient features. Although most of their TNCs are relatively small, a number of large ones with global ambitions have also appeared on the scene. They tend to be involved in particular industries, with notable variations between different home economies and regions. Compared with their developed-country counterparts, a relatively high degree of State ownership can be observed among the largest TNCs from developing and transition economies. However, these stylized observations should be interpreted with care, as there are important differences between regions and countries, as well as between individual companies.

Although more economies are emerging as FDI sources, there is still a relatively *high concentration* of countries from which the major TNCs originate: from South Africa in Africa, from Mexico and Brazil in Latin America, and from the Russian Federation in the CIS. There is less concentration in Asia, where the four newly industrializing economies, along with China, India, Malaysia and Thailand, are home countries for a growing number of companies that have expanded abroad. At the same time, a number of smaller TNCs from a wider range of developing countries are also increasing their foreign activities, mostly at the regional level. There are also an increasing number of large TNCs from developing and transition economies that feature in lists of the largest companies in the world. For example, around 1990, there were only 19 companies from developing and transition economies listed in the Fortune 500; by 2005, the number had risen to 47.

In terms of *industrial distribution* a few industries are better represented than others, but with important regional variations. Some TNCs from developing and transition economies have risen to leading global positions in industries such as automotives, chemicals, electronics, petroleum refining and steel, and in services such as banking, shipping, information technology (IT) services and

construction. In some specific industries, such as container shipping and petroleum refining, developing-economy TNCs have a particularly strong presence.

In all developing regions and in the Russian Federation, major TNCs have emerged in the primary sector (oil, gas, mining) and resource-based manufacturing (metals, steel). Some of them are now competing head-on with their developed-country rivals. Examples include Sasol (South Africa) in Africa; CVRD (Brazil), ENAP (Chile), Petrobras (Brazil) and Petroleos de Venezuela (Venezuela) in Latin America; Baosteel, CNPC and CNOOC (China), Petronas (Malaysia), Posco (Republic of Korea) and PTTEP (Thailand) in Asia; and Gazprom and Lukoil (Russian Federation).

Another cluster of activities involving many developing-economy TNCs are financial services, infrastructure services (electricity, telecommunications and transportation) and goods that are relatively difficult to export (cement, food and beverages). Because of their non-tradable nature, these economic activities typically require FDI if a company wishes to serve a foreign market. With a few exceptions (such as Cemex and the former South African companies, Old Mutual and SABMiller), however, most of the developing-country TNCs in these areas are mainly regional players, with limited (if any) activities in other parts of the world.

A third cluster of activities consists of those that are the most exposed to global competition, such as automotives, electronics (including semi-conductors and telecommunications equipment), garments and IT services. Almost all the major TNCs from developing or transition economies in these industries are based in Asia. Electronics companies such as Acer (Taiwan Province of China), Huawei (China) and Samsung Electronics (Republic of Korea), the automobile firms, Hyundai Motor and Kia Motor (Republic of Korea), or smaller TNCs in the IT services industry, such as Infosys or Wipro Technologies (India), are already among the leaders in their respective industries.

In all regions studied, intraregional FDI plays a key role in TNC-controlled international networks. This is especially true in Latin America and the CIS, but also to a large extent in Africa and Asia. The subregion of East and South-East Asia has the largest number of TNCs with global aspirations. Of the top 100 developing-country TNCs in 2004, as many as 77 were based in this subregion. Five of them are also among the top 100 global TNCs: Hutchison Whampoa (Hong Kong, China), Petronas (Malaysia), Singtel (Singapore), Samsung Electronics (Republic of Korea) and CITIC Group (China).

...as developing-country TNCs respond to the threats and opportunities arising from globalization with their own distinctive competitive advantages.

The increase in the number and diversity of developing-country TNCs over the past decade is largely due to the continuing impact of globalization on developing countries and their economies. The dynamics are complex, but within them the combination of competition and opportunity – interwoven with liberalization policies across developing and developed regions – is particularly important. As developing economies become more open to international competition, their firms are increasingly forced to compete with TNCs from other countries, both domestically and in foreign markets, and FDI can be an important component of their strategies. This competition, in turn can impel them to improve their operations and it encourages the development of firm-specific competitive advantages, resulting in enhanced capabilities to compete in foreign markets.

Firms may respond directly to international competition or opportunities by utilizing their existing competitive advantages to establish affiliates abroad. This type of TNC strategy is referred to as "*asset exploiting*". Firms can also opt for an "*asset augmenting*" strategy in order to improve their competitiveness by exploiting their limited competitive advantages to acquire created assets such as technology, brands, distribution networks, R&D expertise and facilities, and managerial competences that may not be available in the home economy. They may even combine both strategies.

While developed-country TNCs are most likely to utilize firm-specific advantages based on ownership of assets, such as technologies, brands and other intellectual property, evidence shows that developing-country TNCs rely more on other firm-specific advantages, derived from production process capabilities, networks and relationships, and organizational structure. There are, however, significant variations by country, sector and industry. For example, TNCs in the secondary sector as a whole are most likely to possess and utilize advantages in both production process capabilities and ownership of assets (in that order), with less reliance on advantages grounded in networks and relationships, and organizations. In contrast, for TNCs in the primary sector, production process advantages are preponderant, while in the tertiary sector, networks and relationships represent

the main advantage. There is some tendency to convergence with developed-country TNCs, mostly as economies become more developed (e.g. the advantages of TNCs from the Republic of Korea lie increasingly in their ownership of key technologies), but for the present a large diversity of advantages underlies the internationalization of developing-country TNCs.

Many of these TNCs also enjoy non-firm-specific competitive advantages: for example, those deriving from access to natural resources or reservoirs of knowledge and expertise in their home countries. These locational advantages might be available to all firms based in an economy, but a number of developing-country TNCs are adept at combining various sources of advantage (including firm-specific ones) into a strong competitive edge.

Many of the developing and transition economies that are home to large TNCs and are investing significant amounts of FDI overseas – such as Brazil, China, India, the Russian Federation, South Africa and Turkey – are doing so much earlier (and to a greater degree) than would be expected on the basis of theory or past experience. This intensification of FDI by these countries can be traced to around the early 1990s. The likely reason for this shift lies in the impact of globalization on countries and companies, especially through increased international competition and opportunities.

Their outward expansion is driven by various factors …

Four key types of push and pull factors, and two associated developments help explain the drive for internationalization by developing-country TNCs.

First, market-related factors appear to be strong forces that push developing-country TNCs out of their home countries or pull them into host countries. In the case of Indian TNCs, the need to pursue customers for niche products – for example, in IT services – and the lack of international linkages are key drivers of internationalization. Chinese TNCs, like their Latin American counterparts, are particularly concerned about bypassing trade barriers. Overdependence on the home market is also an issue for TNCs, and there are many examples of developing-country firms expanding into other countries in order to reduce this type of risk.

Secondly, rising costs of production in the home economy – especially labour costs – are a particular concern for TNCs from East and South-East Asian countries such as Malaysia, the Republic of Korea and Singapore, as well as Mauritius (which has labour-intensive, export-orientated industries, such as garments). Crises or constraints in the home economy, for example where they lead to inflationary pressures, were important drivers in countries such as Chile and Turkey during the 1990s. However, interestingly, costs are less of an issue for China and India – two growing sources of FDI from the developing world. Clearly, this is because both are very large countries with considerable reserves of labour, both skilled and unskilled.

Thirdly, competitive pressures on developing-country firms are pushing them to expand overseas. These pressures include competition from low-cost producers, particularly from efficient East and South-East Asian manufacturers. Indian TNCs, for the present, are relatively immune to this pressure, perhaps because of their higher specialization in services and the availability of abundant low-cost labour. For them, competition from foreign and domestic companies based in the home economy is a more important impetus to internationalize. Similarly, competition from foreign TNCs in China's domestic economy is widely regarded as a major push factor behind the rapid expansion of FDI by Chinese TNCs. Such competition can also sometimes result in pre-emptive internationalization, as when Embraer (Brazil) and Techint (Argentina) invested abroad in the 1990s, ahead of liberalization in their respective home industries. Domestic and global competition is an important issue for developing-country TNCs, especially when these TNCs are increasingly parts of global production networks in industries such as automobiles, electronics and garments.

Fourthly, home and host government policies influence outward FDI decisions. Chinese TNCs regard their Government's policies as an important push factor in their internationalization. Indian firms, on the other hand, have been enticed by supportive host-government regulations and incentives, as well as favourable competition and inward FDI policies. South African TNCs, among others, mention transparent governance, investment in infrastructure, strong currencies, established property rights and minimal exchange-rate regulations as important pull factors. Most importantly, liberalization policies in host economies are creating many investment opportunities, for example through privatizations of State-owned assets and enterprises.

Apart from the above mentioned factors, there are two other major developments driving developing-country TNCs abroad. First, the rapid growth of many large developing countries – foremost among these being China and India – is

causing them concern about running short of key resources and inputs for their economic expansion. This is reflected in strategic and political motives underlying FDI by some of their TNCs, especially in natural resources. Second, there has been an attitudinal or behavioural change among the TNCs discussed in this chapter. They increasingly realize that they are operating in a global economy, not a domestic one, which has forced them to adopt an international vision. These two developments, along with push and pull factors – especially the threat of global competition in the home economy and increased overseas opportunities arising from liberalization – adds empirical weight to the idea that there is a structural shift towards earlier and greater FDI by developing-country TNCs.

...which, together with TNCs' motives and competitive advantages, result in most of their FDI being located in developing countries.

In principle, four main motives influence investment decisions by TNCs: *market-seeking, efficiency-seeking, resource-seeking* (all of which are asset exploiting strategies) and *created-asset-seeking* (an asset-augmenting strategy).

Surveys undertaken by UNCTAD and partner organizations on outward investing firms from developing countries confirm that, of these motives, the most important one for developing-country TNCs is market-seeking FDI, which primarily results in intraregional and intra-developing-country FDI. Within this, there are differences in patterns of FDI, depending on the activity of the TNC: for example, FDI in consumer goods and services tends to be regional and South-South orientated; that in electronic components is usually regionally focused (because of the location of companies to which they supply their output); in IT services it is often regional and orientated towards developed countries (where key customers are located); and FDI by oil and gas TNCs targets regional markets as well as some developed countries (which remain the largest markets for energy).

Efficiency-seeking FDI is the second most important motive, and is conducted primarily by TNCs from the relatively more advanced developing countries (hence higher labour costs); it tends to be concentrated in a few industries (such as electrical and electronics and garments and textiles). Most FDI based on this motive targets developing countries; that in the electrical/electronics industry is strongly regionally focused, while FDI in the garments industry is geographically more widely dispersed. Generally, resource-seeking and created-asset-seeking motives for FDI are relatively less important for developing-country TNCs. Not unexpectedly, most resource-seeking FDI is in developing countries and much created-asset-seeking FDI is in developed countries.

Apart from the above motives, a common one for TNCs from some countries is that of strategic objectives assigned to State-owned TNCs by their home governments. Some governments have encouraged TNCs to secure vital inputs, such as raw materials for the home economy. For example, both Chinese and Indian TNCs are investing in resource-rich countries, especially in oil and gas (to expand supplies, in contrast to targeting customers as does market-seeking FDI in this industry). In the case of Chinese TNCs, the quest for secure supplies of a wide range of raw materials is complemented by parallel and sustained Chinese diplomatic efforts in Africa, Central Asia, Latin America and the Caribbean, and West Asia.

In terms of location of FDI, the net result of the relevant drivers, advantages and motives is that most investments are in other developing countries (e.g. because of similarities in consumer markets, technological prowess or institutions) or within their region (i.e. neighbouring countries with which they are familiar).

TNCs from developing countries and transition economies are here to stay. As they expand overseas, they gain knowledge, which potentially benefits them in two ways. First, they learn from experience and improve their ability to operate internationally. Second, they gain expertise and technology to enhance their firm-specific advantages, thereby improving their competitiveness and performance. This improved competitiveness has implications for home countries. By the same token, developing-country TNCs can have an impact on host developing economies in a number of ways, ranging from financial resource flows and investment to technology and skills.

Increased competitiveness is one of the prime benefits that developing-country TNCs can derive from outward FDI ...

The most important potential gain for a firm from outward FDI is increased competitiveness, that is, the ability to survive and grow in an open economy, and attain its ultimate objectives of maximizing profits and retaining or increasing market share. Outward FDI can be a direct path to market expansion. In certain circumstances, it is the only path, for example when there are trade barriers that inhibit exports or when the TNC is in the business of providing a service that is non-

tradable. Many developing-country TNCs have indeed expanded their markets through outward FDI, either through M&As or through greenfield investments. Outward FDI can also contribute to a company's competitiveness by increasing its efficiency. Rising domestic costs, especially labour costs, have led a number of East and South-East Asian TNCs to invest in less expensive locations, with significant efficiency gains.

In the above-mentioned surveys of outward investing firms from developing countries conducted by UNCTAD and partner organizations, market expansion in a broad sense (including market diversification) was the benefit most frequently mentioned, followed by efficiency gains. Case studies confirm that outward FDI has indeed enabled developing-country firms to enter new markets and expand their businesses. In a range of industries, such as white goods and personal computers, a number of Asian TNCs, such as Acer (Taiwan Province of China), Arcelik (Turkey), Haier (China) and Lenovo (China), have successfully expanded their markets through FDI, which has helped them grow into global players. Some companies from other developing regions have also ventured beyond their borders and become successful players in regional and even global markets. For instance, in 2005, Cemex (Mexico) became the third largest cement-making company in the world, with more than two thirds of its sales in developed countries.

Enhancing enterprise competitiveness through outward FDI is a complex undertaking. It goes beyond the immediate gains arising from market expansion and/or cost-cutting, and includes upgrading technology, building brands, learning new management skills, linking up with global value chains, and moving up these chains into more advanced activities. Some of these tasks can be protracted and, in straight financial terms, bring little or no gain in the short run. This is particularly likely when the outward FDI is asset-augmenting rather than asset-exploiting, since in the former case the acquired assets must first be assimilated.

Firms that invest abroad tend to be more competitive than their domestically oriented peers. However, these firms are also subject to risks inherent in projects undertaken abroad. Some of these projects may fail for various reasons, with potential negative effects on the parent company. One of the reasons is the disadvantage of being foreign, another is the existence of cultural, social and institutional differences between home and host economies, and the third is the increasing need for coordinating activities and concomitant organizational and environmental complexities.

…while home countries can also benefit.

Outward FDI from developing countries can also contribute directly and indirectly, to a home economy as a whole. Arguably, the most important potential gain for home countries from outward FDI is the improved competitiveness and performance of the firms and industries involved. Such gains may translate into broader benefits and enhanced competitiveness for the home country at large, contributing to industrial transformation and upgrading of value-added activities, improved export performance, higher national income and better employment opportunities. Improved competitiveness of outward investing TNCs can be transmitted to other firms and economic agents in home countries through various channels, including via linkages with, and spillovers to, local firms, competitive effects on local business, and linkages and interactions with institutions such as universities and research centres. In sum, the more embedded the outward investing TNCs are, the greater will be the expected benefits for the home economy.

Evidence suggests that under appropriate home-country conditions, improved competitiveness of outward investing firms can indeed contribute towards enhancing industrial competitiveness and restructuring in the home economy as a whole. For instance, broader upgrading has occurred in whole industries in which firms have engaged in outward FDI. Examples are the IT industry in India, the consumer electronics industry in the Republic of Korea and China, and the computer and semiconductor industries in Taiwan Province of China.

At the same time, outward FDI may pose several risks for the home economy: it can lead to reduced domestic investment, hollowing out of parts of the economy and loss of jobs. As always, the beneficial impacts have to be weighed against possible damaging impacts. The benefits are usually reaped when certain preconditions are met, for example a reasonably competitive home market or the absorptive capacity to profit from advanced technology. The net outcome of the different economic and non-economic impacts for a home economy depends on the underlying motives and strategies of firms for investing overseas and on the characteristics of the home economy itself.

While outward FDI entails the transfer of capital from home to host country, it can also generate inflows in the form of repatriated profits, royalties and licensing fees, and payments by the host country for increased imports from the home

country (often in the form of intra-firm trade). In general, in the immediate aftermath of the outward investment, net financial flows tend to be negative but then gradually become positive. Outward FDI also seems to have a delayed but positive effect on domestic investment.

The trade impacts of outward FDI on the home economy depend significantly – as in the case of developed-country FDI – on the motivations and types of investment undertaken. If the TNCs seek natural resources, outward FDI could lead to an increase in imports of those resources and exports of the inputs required for extraction. Market-seeking FDI can be expected to boost exports of intermediate products and capital goods from the home economy to the host country. If the motivation is efficiency or cost-reduction, outward FDI could enhance exports as well as imports, especially intra-firm trade, and their extent and pattern, depending on the geographic spread of the TNCs' integrated international production activities. Results of some studies on Asian developing home economies and data on trade by affiliates of developing-country TNCs in the United States and Japan suggest a positive relationship between home-country exports and outward FDI from developing countries.

Regarding employment, the impacts also vary according to the motivation of FDI. Efficiency-seeking FDI may raise many questions from a home-economy perspective. Even if it leads to a greater demand for higher skills at home, this may be of limited use to workers with low skills. Other kinds of FDI appear to have positive employment effects in the long run, depending considerably on the motivations of firms and their types of investments abroad. Evidence related to some Asian economies, such as Hong Kong (China) and Singapore, suggests that, under appropriate conditions, outward FDI can generate additional jobs in higher-skilled technical and managerial categories while reducing those in unskilled ones. On balance, in those economies, the job-creating effects of outward FDI exceeded its job-reducing effects. Much would depend, however, on the capacities of the human resources in the home country to adapt to changes in the structure of the home economy.

Developing host countries may also gain from the rise in South-South FDI.

For developing host economies, FDI from other developing countries provides a broader range of potential sources of capital, technology and management skills to tap. For low-income developing countries, it can be of great importance. As indicated above, in a number of LDCs, it accounts for a large share of total FDI inflows. To the extent that firms from developing countries invest appreciable amounts in other developing countries, that investment provides an important additional channel for further South-South economic cooperation.

Because the motivations and competitive strengths of developing-country TNCs and the locational advantages sought by these firms diverge in several respects from those of TNCs from developed countries, their impact on host developing economies may carry certain advantages over that of FDI from developed countries. For example, the technology and business model of developing-country TNCs are generally somewhat closer to those used by firms in host developing countries, suggesting a greater likelihood of beneficial linkages and technology absorption. Developing-country TNCs also tend to use greenfield investments more than M&As as a mode of entry. This applies especially to investment in developing host countries. In this sense, their investments are more likely to have an immediate effect in improving production capacity in developing countries.

The trade impacts of FDI from developing countries also vary according to motives. Efficiency-seeking FDI is most likely to boost exports, which may include local value addition of various kinds. One recent prominent kind of efficiency-seeking FDI has been in the garments industry, which has had substantial export-boosting effects in LDCs in particular. However, local sourcing and backward linkages in this industry have been limited, with the result that the ending of MFA quotas has led to a reduction in such FDI, for instance in Lesotho. In market-seeking FDI, especially in manufacturing, the effect is mainly one of import substitution. Resource-seeking FDI, of course, is export-oriented almost by definition, and may allow the host country to diversify its markets.

A major advantage for host developing countries of FDI by developing-country TNCs, as compared to that from developed-country TNCs, is the greater employment-generating potential of the former. The main reason is that developing-country TNCs may be oriented more towards labour-intensive industries, and may be more inclined to use simpler and more labour-intensive technologies, especially in manufacturing. Empirical evidence on average employment per affiliate in host developing countries suggests developing-country TNCs hire more people than

do developed-country TNCs. In the case of sub-Saharan Africa, for example, it has been found that the labour intensity of developing-country TNCs tends to be higher than that of developed-country TNCs in the majority of industries covered. Foreign affiliates of developing-country TNCs, on average, created more jobs per million dollars of assets than did those of developed-country TNCs. The effects of FDI on wages are generally positive, as TNCs as a whole pay higher wages than local employers. Although data specific to developing-country TNCs are limited, indirect evidence suggests that, at least for skilled labour, they offer higher wages than host-country domestic firms.

But South-South FDI – like all FDI – also carries risks that can give rise to concerns. One is that foreign TNCs might dominate the local market. Another is that some host countries might feel threatened by the presence of too many firms from a single home country. For example, the dominance of South African TNCs has triggered some unease in neighbouring host countries. There is also the issue of undue political influence when an investing enterprise is State-owned, which is the case with many developing-country TNCs in natural resources. The political and social aspects of TNCs' activities may also give rise to controversy, partly due to the size of their operations. In developing host economies, such problems have sometimes been exacerbated by the absence of an adequate regulatory framework and disparity in the allocation of economic benefits from inward FDI. In economies where domestic industries are underdeveloped, governments may not have the capabilities to ensure that acceptable labour and environmental standards, for example, are adhered to when foreign firms introduce new production processes or working methods.

In sum, outward FDI from developing countries provides a potential avenue for gains from economic cooperation among developing countries. As investment by developing-country TNCs have certain inherent characteristics, including a greater orientation towards labour-intensive industries, it is of considerable relevance to low-income countries. At the same time, outward FDI from developing countries is a relatively new phenomenon. The limited evidence presented in this Report suggests that for home as well as host developing countries, the positive effects of FDI from developing countries may outweigh the negative ones; however further research is necessary to deepen the understanding of the impact of such FDI on developing economies.

The expansion of outward FDI from developing countries is paralleled by changing policies in home countries...

The emergence of TNCs from some developing and transition economies as key regional or global players is paralleled by important changes in both developed and developing countries of policies governing FDI and related matters. The ability of countries – be they sources or recipients of such investment – to benefit from such investment activity is influenced by active policies. By providing the appropriate legal and institutional environment, home country governments can create conditions that will induce their firms to invest overseas in ways that will produce gains for the home economy.

From a home-country perspective, more and more developing and transition economies are dismantling previous barriers to outward FDI. While some form of capital control is often still in place to mitigate the risk of capital flight or financial instability, restrictions are mostly aimed at limiting other international capital flows than FDI. Only a handful of developing countries retain outright bans on outward FDI. Countries are increasingly recognizing the potential benefits from outward FDI. A number of governments, especially in developing Asia, are even actively encouraging their firms to invest abroad using a variety of supportive measures to that end. Such measures include information provision, match-making services, financial or fiscal incentives, as well as insurance coverage for overseas investment.

There is no one-size-fits-all policy that can be recommended to deal with outward FDI. Every home country has to adopt and implement policies that fit its specific situation. Whether a country will benefit by moving from "passive liberalization" to "active promotion" of outward FDI depends on many factors, including the capabilities of its enterprise sector, and the links of the investing companies with the rest of the economy. Certain local capabilities are needed to exploit successfully the improved access to foreign markets, resources and strategic assets that outward FDI can bring about. Moreover, a certain level of absorptive capacity in the domestic enterprise sector may also be required to generate broader benefits from outward FDI. In many low-income countries, it may therefore be appropriate to focus on creating a more attractive business environment and enhancing domestic firm capabilities.

Still, for those countries that decide to encourage their firms to invest abroad, it is advisable to situate policies dealing specifically with outward FDI within a broader policy framework aimed at promoting competitiveness. The importance of generating domestic capabilities to benefit from outward FDI makes it appropriate to connect outward FDI-specific policies to those applied in areas such as development of small and medium-sized enterprises, technology and innovation. Moreover, outward FDI is only one of several ways in which a country and its firms can connect with the global production system. Government efforts to promote outward FDI can therefore benefit from close coordination with those related to attracting inward FDI, promoting imports or exports, migration and technology flows.

The most elaborate use of measures to promote outward FDI is found in South, East and South-East Asia. In several countries of this region, governments discharge their promotional policies via trade promotion organizations, investment promotion agencies (IPAs), export credit agencies and/or EXIM banks. A range of policy instruments is applied in innovative ways, often targeting specific types of outward FDI. Some governments in Africa and Latin America have also publicly stressed the importance of outward FDI, but these statements have rarely been followed by concrete promotional measures.

Particular attention is warranted to the role of outward FDI in the context of "South-South" cooperation. Governments in Asia and Africa have outlined specific programmes to facilitate such investment. Some of these programmes are aimed at strengthening intra-regional development (as in the case of infrastructure-related FDI by South African State-owned enterprises), while others are inter-regional in scope. This is an area that needs to be further explored and supported through closer collaboration among developing-country institutions. An interesting recent UNCTAD initiative to this end is the establishment of the G-NEXID network, which will allow for the sharing of experiences among EXIM banks from developing countries.

...various policy responses in host countries ...

There are also policy implications for host countries. A key question is what developing host countries can do to leverage fully the expansion of FDI from the South. In terms of enhancing the positive impact of such FDI, they need to consider the full range of policies that can influence the behaviour of foreign affiliates, and their interaction with the local business environment. This requires taking into account the specific characteristics of different industries and activities in designing a strategy to attract desired kinds of FDI. In addition, it is important to promote the amount and quality of linkages between foreign affiliates and domestic firms. Host-country governments can use various measures to encourage linkages between domestic suppliers and foreign affiliates and strengthen the likelihood of spillovers in the areas of information, technology and training. In terms of addressing potential concerns and negative effects associated with inward FDI, there is no principal difference between the policies to apply in the case of FDI from developed countries and in the case of FDI from developing and transition economies.

The scope for "South-South" FDI has led many developing host countries to adopt specific strategies to attract such investment. In a 2006 UNCTAD survey of IPAs, more than 90% of all African respondents stated that they currently targeted FDI from other developing countries, notably from within their own region. Indeed, for African IPAs, South Africa tops the list of developing home countries targeted, while in Latin America and the Caribbean, Brazil is the most targeted country. Meanwhile, developed-country IPAs also court investors from developing and transition economies. A significant number of such agencies have already set up local offices for that purpose in places like Brazil, China, India, the Republic of Korea, Singapore and South Africa. This expanded diversity of potential sources of FDI may imply greater bargaining power of recipient countries to the extent that they are able to attract a greater number of investors to compete for existing investment opportunities.

Notwithstanding the interest in FDI from developing and transition economies, some stakeholders are less enthusiastic about some of the new investors. Several cross-border M&As by TNCs with links to their respective governments have generated national-security concerns, and others have spurred fears of job cuts. Countries in which State-owned TNCs embark on internationalization through FDI need to be aware of the potential sensitivities involved. In some host countries, State ownership is seen as an increased risk of a transaction being undertaken for other than purely economic motives. This is especially the case if the acquisitions relate to energy, infrastructure services or other industries with a "security dimension". Whether private or State-owned, investors from developing or transition economies that are anxious to tap the markets and resources of developed countries may also face

growing pressure to address more fully issues related to corporate governance and transparency.

As far as the recipient countries are concerned, business leaders, trade unions as well as policymakers may have to get used to an increased frequency of transactions involving companies from developing and transition economies as acquirers of domestic firms. There may be important benefits to a host country from having more companies competing to acquire local assets. Countries need to be careful in their use of legislation aimed at protecting national security interests, keeping in mind the risk of fuelling possible retaliation and protectionism.

…and it has implications also for the management of CSR issues…

Issues of corporate social responsibility (CSR) may also become more important as developing-country firms expand abroad. Discussions related to CSR have traditionally revolved around developed-country TNCs and their behaviour abroad; more recently the managements of TNCs from developing and transition economies are also being exposed to similar issues. While adherence to various internationally adopted CSR standards may entail costs for the companies concerned, it can also generate important advantages – not only for the host country, but also for the investing firms and their home economies. A number of developing-country TNCs have already incorporated CSR policies into their business strategies, some of them even becoming leaders in this area. For example, more than half of the participating companies in the United Nations Global Compact are based in developing countries. Moreover, some developing countries are establishing a regulatory and cultural environment that supports CSR standards. These initiatives are sometimes driven by governments and at other times by business associations, non-governmental organizations or international organizations.

…and for international rule making.

Beyond the national level of policy-making, there is a marked increase in South-South investment cooperation through IIAs, in parallel to the growth of FDI from the South. The increase of FDI from some of these economies is also likely to generate growing demand from their business community for greater protection of their overseas investments. As a consequence, in addition to using IIAs as a means to promote inward FDI, some developing-country governments will increasingly consider using IIAs to protect and facilitate outward investments. This may influence the content of future treaties and result in an additional challenge for those developing country governments to balance their need for regulatory flexibility with the interests of their own TNCs investing abroad.

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Policymakers in countries at all levels of development need to pay greater attention to the emergence of new sources of FDI with a view to maximizing the developmental impact of this recent phenomenon. There is scope for policymakers from developing and transition economies to share their experience in this area. South-South cooperation between host and home countries may enhance opportunities for cross-border investments and contribute to their mutual development. From a South-North perspective, there is a similar need for dialogue, increased awareness and understanding of the factors that drive FDI from the South and of their potential impacts. UNCTAD and other international organizations can play an important role in this context by providing analysis, technical assistance and, not least, forums for an exchange of views and experiences, in order to help countries realize the full benefit of the rise of FDI from developing and transition economies.

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