

**United Nations Conference on Trade and Development**

# **World Investment Report**

**2005** **Transnational Corporations and  
the Internationalization of R&D**



**United Nations  
New York and Geneva, 2005**

## CHAPTER II

# REGIONAL TRENDS: DEVELOPING REGIONS LEAD RISE IN FDI

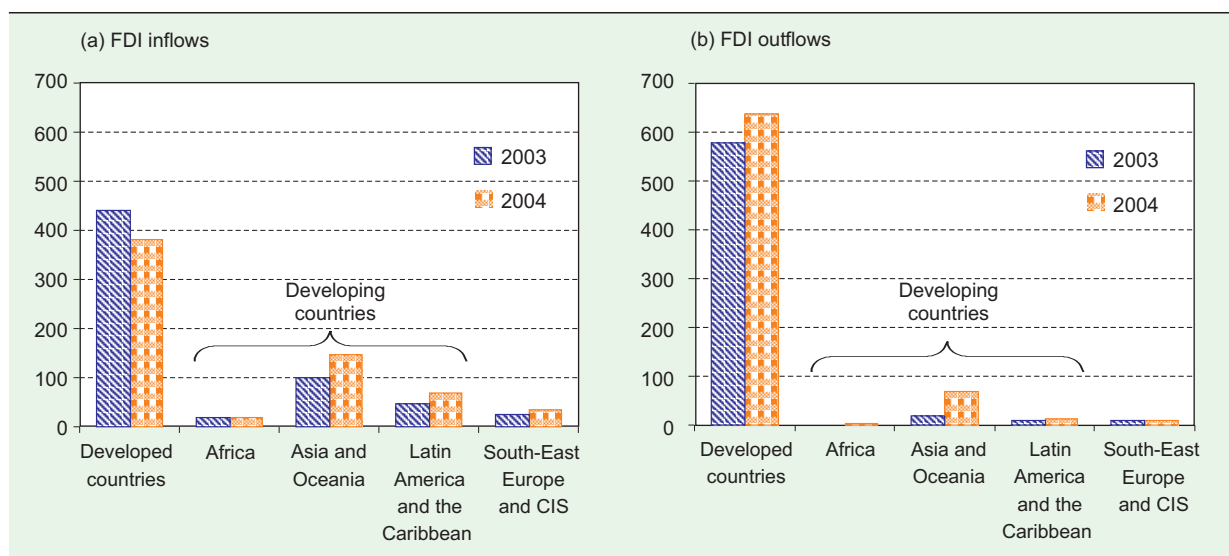
## Introduction

As chapter I shows, FDI inflows to developed countries dropped again in 2004, a decline that was offset by rising flows to developing countries and South-East Europe and the Commonwealth of Independent States (CIS) (figure II.1). Not only did this put an end to the downturn that had begun in 2001, it also represented the highest ever level of investment flows to these countries. Increases were noted for all developing regions except Africa where FDI inflows remained stable at a high level. As in 2003, the continued decline of inflows to developed countries was due primarily to large repayments of intra-company loans by foreign affiliates in some host countries, particularly Germany and the Netherlands. France and

Luxembourg, both major recipients of FDI in 2003, received less of it in 2004, while inflows to the United Kingdom and the United States recovered. The Russian Federation accounted for the bulk of the higher flows to South-East Europe and the CIS, a new country grouping (box I.2).

Developed countries remain the main sources of FDI globally (figure II.1). As in the case of inflows, the United States and the United Kingdom, in that order, accounted for the largest shares of FDI outflows in 2004. France and Germany also ranked among the top four home economies. Developing economies, particularly those from Asia, are emerging sources of FDI; in 2004 Asia and Oceania contributed more than four-fifths of outward FDI from developing countries.

**Figure II.1. FDI flows by region, 2003, 2004**  
(Billions of dollars)



Source: UNCTAD ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

## A. Developing countries

### 1. Africa: FDI inflows remain buoyant, sustained by investments in primary production

In 2004, Africa's FDI inflows remained at the relatively high level reached in 2003 (\$18 billion) (figure II.2), following a 39% increase in 2003.<sup>1</sup> High prices for minerals such as copper, diamonds, gold and platinum, and particularly for oil, along with the consequent improved profitability of investment in natural resources encouraged TNC investment in the region. Cross-border M&As in the mining industry increased to more than three times their 2003 value. Inflows rose in 40 out of the 53 countries in Africa and fell in 13, including in some of the region's top FDI recipients such as Angola, Morocco and Nigeria. The five top home countries of FDI for Africa in 2004 were France, the Netherlands, South Africa, the United Kingdom and the United States, together accounting for well over half of the flows to the region. Although inflows in 2004 were relatively high, Africa's share in world FDI inflows remained small at 3%. Continued high demand for commodities, a more stable policy environment and increasing participation in infrastructure networks by African TNCs are expected to boost FDI in Africa in 2005. At the

same time, FDI outflows from African countries more than doubled in 2004.

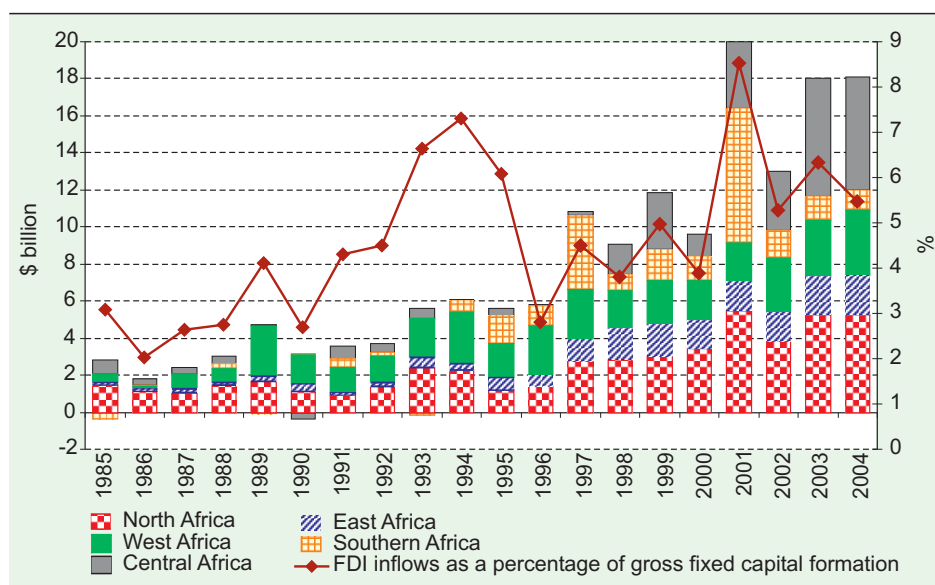
#### a. Trends: FDI continues to flow, mostly to natural resources

The level of FDI flows to Africa remained virtually unchanged in 2004, at \$18 billion. Most of the inflows were in natural-resource exploitation, spurred by rising commodity prices.<sup>2</sup> The profitability of natural-resource exploitation in the region increased,<sup>3</sup> which also induced TNCs to engage in cross-border M&As in the primary sector. This further pushed up FDI inflows (see annex table A.II.1 for major cross-border M&A deals).

Still, Africa's share of world FDI flows was only 3% in 2004. Over the past ten years this share has risen by less than one percentage point. On a per capita basis, FDI inflows to Africa rose from \$8 in 1995 to \$20 in 2004, but this represented only about half of the per capita FDI inflows to China, for example, which stood at \$46 in 2004. FDI inflows accounted for 5.5% of Africa's gross fixed capital formation in 2004 (figure II.2).

Among the different subregions, North Africa<sup>4</sup> attracted the highest inflows in 2004, with all the countries in the subregion, except the Libyan Arab Jamahiriya, on the list of the top 10 host countries for FDI in Africa (figure II.3).

Figure II.2. Africa: FDI inflows and their share in gross fixed capital formation, 1985-2004



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex tables B.1 and B.3.

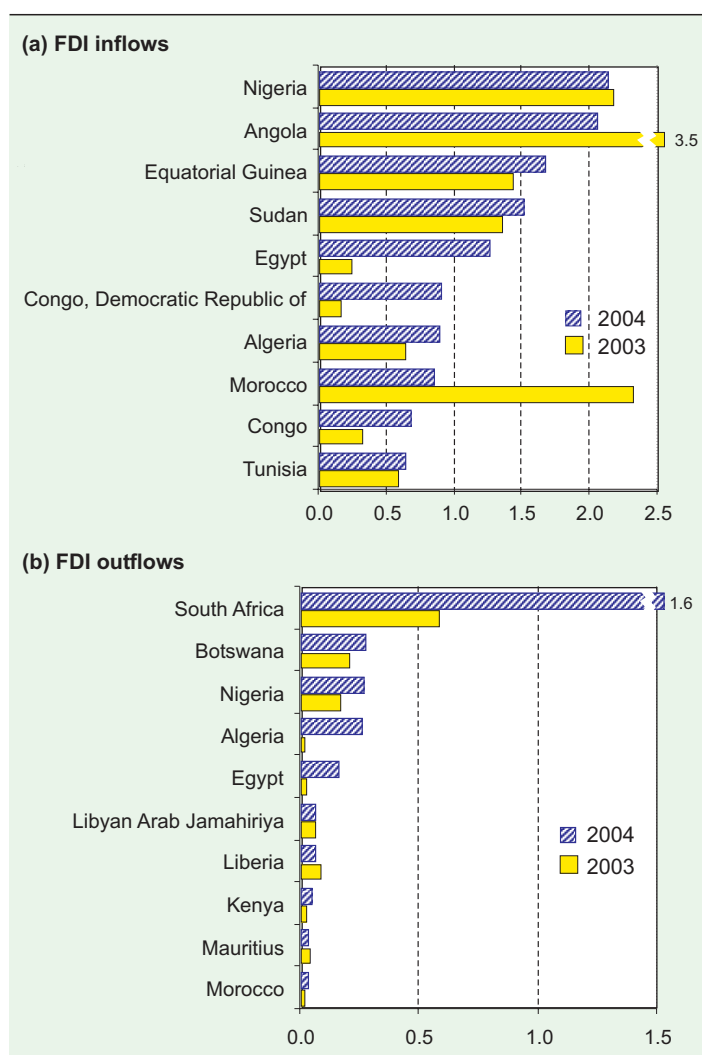
The subregion attracted 29% of Africa's total inflows, particularly in oil and gas. Sudan topped the list, mainly as a result of FDI in petroleum from China, India and Malaysia. Investment links have also been established with several members of the CIS (e.g. the Russian Federation) and with some Gulf countries. Oil and natural gas exploitation also contributed to inflows to Algeria and Egypt. Inflows to Morocco declined by more than half to \$0.9 billion in 2004 because of a slowdown in the privatization of the country's public enterprises. In Tunisia inflows were stable.

East Africa<sup>5</sup> and West Africa<sup>6</sup> also received higher inflows in 2004, but they declined in Central Africa<sup>7</sup> and Southern Africa.<sup>8</sup> While FDI flows to South Africa fell, most of the small host

economies received higher inflows. However, as in previous years, such flows remained below the \$0.1 billion level in 2004 (table II.1), especially in the natural-resource-poor and least developed countries (LDCs). In countries long affected by political conflict such as Burundi and Somalia, there were virtually no inflows until 2003, with a few exceptions. In many of these LDCs, the size of the domestic market is small and some of the market-access initiatives put in place to encourage investment in export-oriented industries have been constrained by the lack of appropriate human and other resources. Marking a change in this regard, Coca-Cola opened a new bottling plant worth \$8.3 million in Mogadishu, Somalia in 2004, the largest single investment in that country since 1991.<sup>9</sup>

**Figure II.3. Africa: FDI flows, top 10 economies,<sup>a</sup> 2003, 2004**

(Billions of dollars)



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Ranked on the basis of the magnitude of FDI flows in 2004.

Rising oil prices contributed to relatively high levels of FDI inflows to the major oil-producing African countries, especially Sudan and Equatorial Guinea (figure II.3). Although FDI inflows decreased in Angola and Nigeria, the levels, nevertheless, remained high in those two countries.<sup>10</sup> These four countries, together with Egypt, were the top recipients of FDI to Africa in 2004. With over \$1 billion each in inflows, their combined total amounted to \$8.6 billion (or a little under 50% of Africa's total inflows), while the top ten host countries accounted for 69% in 2004.

As a result, the composition of FDI inflows to Africa in 2004 (as well as in 2003) was significantly tilted towards natural resources, particularly in the petroleum industry. The share of this industry exceeded 60% of total inflows in Angola, Egypt, Equatorial Guinea and Nigeria, four of the five largest host countries in Africa (figure II.4). It has also accounted for the largest share of FDI in Algeria, the Libyan Arab Jamahiriya and Sudan in recent years. In South Africa as well, a major transaction in the oil industry dominated FDI inflows in 2004: Tullow Oil Plc of the United Kingdom merged with Energy Africa Ltd of South Africa, resulting in a \$0.5 billion investment.

In some countries efforts to diversify the economy, and in some cases to reduce dependence on the hydrocarbons industry by opening up new industries to foreign participation, are beginning to pay off. In 2004, for example, there were sizeable

Table II.1. Africa: country distribution of FDI inflows, by range, 2003, 2004

Range	2003	2004
	Economy <sup>a</sup>	Economy <sup>a</sup>
More than \$2.0 billion	Angola, Morocco and Nigeria	Nigeria and Angola
\$1.0-1.9 billion	Equatorial Guinea and Sudan	Equatorial Guinea, Sudan and Egypt
\$0.5-0.9 billion	South Africa, Chad, Algeria, Tunisia and United Republic of Tanzania	Democratic Republic of the Congo, Algeria, Morocco, Congo, Tunisia, South Africa and Ethiopia
\$0.1-0.4 billion	Ethiopia, Botswana, Mozambique, Congo, Egypt, Mauritania, Uganda, Gabon, Zambia, Côte d'Ivoire, Democratic Republic of the Congo, Namibia, Libyan Arab Jamahiriya, Ghana and Mali	Chad, United Republic of Tanzania, Côte d'Ivoire, Zambia, Gabon, Mauritania, Namibia, Uganda, Mali, Ghana, Mozambique, Libyan Arab Jamahiriya and Guinea
Less than \$0.1 billion	Kenya, Guinea, Mauritius, Seychelles, Senegal, Benin, Lesotho, Togo, Zimbabwe, Burkina Faso, Gambia, Eritrea, Cape Verde, Madagascar, Niger, Djibouti, Malawi, Sao Tome and Principe, Rwanda, Guinea-Bissau, Central African Republic, Sierra Leone, Liberia, Comoros, Cameroon, Somalia, Burundi and Swaziland	Senegal, Swaziland, Mauritius, Benin, Gambia, Togo, Seychelles, Zimbabwe, Sao Tome and Principe, Lesotho, Botswana, Kenya, Madagascar, Burkina Faso, Djibouti, Eritrea, Cape Verde, Liberia, Niger, Malawi, Rwanda, Somalia, Guinea-Bissau, Sierra Leone, Burundi, Comoros, Cameroon and Central African Republic

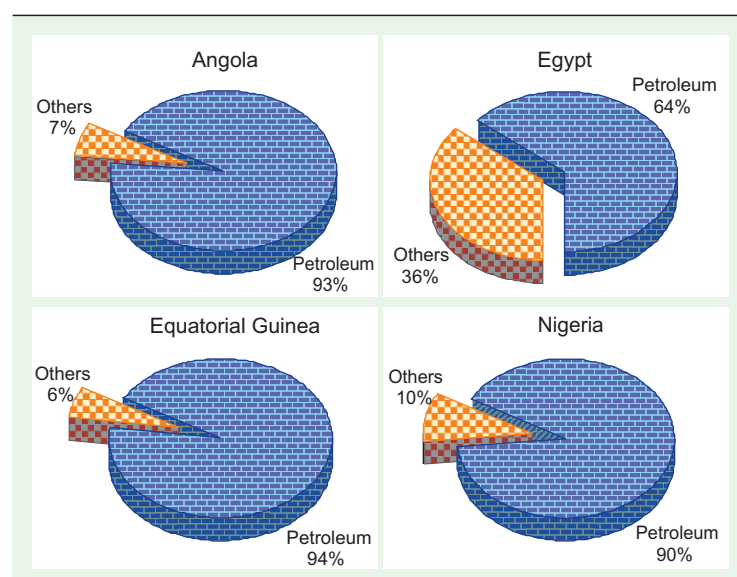
Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Listed in order of the magnitude of FDI inflows for each respective year.

investments in the telecommunications industry in Algeria.<sup>11</sup> In Morocco a 16% stake of Maroc Telecom (MT) was sold to Vivendi, which was due to be paid in early 2005.<sup>12</sup> In Egypt, liberalization and privatization have prompted FDI in a range of industries such as cement, telecoms and tourism. In Sudan, inflows of FDI from China are expected for the building of a new

power plant and a refinery north of Khartoum and for the refurbishing of a long-neglected railway system. In Tunisia, FDI inflows in the manufacturing industry constituted 39% of total flows to the country, and in recent years, they have also gone to major infrastructure projects in energy and telecommunications.

Figure II.4. Share of petroleum in FDI inflows to four major African countries, 2004



Source: UNCTAD, based on national sources and official communications.

About 63% of the cross-border M&As in Africa in 2004 were related to mining activities, up from 13% in 2003 (table II.2). Greenfield FDI inflows to natural resources also increased marginally (annex table A.I.3). For instance, Gold Fields (South Africa), Junior Orezone Resources (Canada) and Riverstone Resources (Canada) increased their investment in the Essakan gold joint venture in Burkina Faso. Reefion Mining of Australia enlarged its diamond activities in Namibia. In addition, West Africa Gold Inc. (now Great West Gold Inc.) of the United States expanded its investment in gold, platinum and palladium extraction in Mali. About a third of all registered greenfield FDI projects were in manufacturing and nearly half were in the services sector (annex table A.I.3).

Notwithstanding growing interest among Asian investors, most of Africa's FDI inflows originate mainly from

developed countries (Western Europe, the United States) and South Africa. The top five home countries for FDI flows to Africa are France, the Netherlands, South Africa, the United Kingdom and the United States, which together accounted for more than half of total inflows to Africa in 2003.

FDI outflows from Africa more than doubled, to \$2.8 billion in 2004. Most of these outflows, about 57%, were the result of cross-border acquisitions by TNCs from South Africa, following an increasingly liberalized outward investment policy in that country. For instance, AngloGold (South Africa) purchased Ashanti Goldfields (Ghana) which has major FDI projects in Guinea, the United Republic of Tanzania and Zimbabwe, and Gold Fields (South Africa) acquired IAMGOLD (Canada). In another deal, Allied Technologies (South Africa) acquired the Econet Wireless Group of Botswana. TNCs from some other African countries are also investing within and outside the region. Examples include the expansion of the operations of Orascom Telecom Holding (Egypt) into Iraq and other Asian countries, and the expansion of production by Oriental Resources of Nigeria in Chad. Algeria, Egypt, Nigeria and South Africa together accounted for 81% of the FDI outflows from Africa in 2004 (annex table B.1).

### **b. Policy developments: efforts to stabilize the environment for FDI inflows**

In terms of policy changes, there was a further wave of FDI-friendly measures and initiatives at the national, regional and global levels to attract more FDI into African countries in 2004. Most of these measures focused on liberalizing legal frameworks and improving the investment climate.

Egypt, the Libyan Arab Jamahiriya and Mauritius introduced at least four policy changes each. Among the countries implementing policy reform, Algeria, the Democratic Republic of the Congo, Egypt, Ghana, Madagascar, Mauritania, Mauritius, Senegal, the United Republic of Tanzania and Uganda generally simplified aspects of their FDI regulations, including through the establishment of more transparent FDI regimes. Nigeria implemented reforms allowing foreign banks to merge with local commercial banks. The Democratic Republic of the Congo and the United Republic of Tanzania reduced the levels of tax and royalty payments. Other specific changes included the adoption in *Egypt* of an antitrust law as part of a concerted drive to improve the country's business environment, and the

**Table II.2. Africa: distribution of cross-border M&A sales, by sector and industry, 2003, 2004**

(Millions of dollars and per cent)

Sector/industry	2003		2004		Growth rate in 2004 (%)
	Value	%	Value	%	
<b>Primary</b>	<b>828</b>	<b>12.9</b>	<b>2 918</b>	<b>63.5</b>	<b>252</b>
Mining	828	12.9	2 918	63.5	252
<b>Manufacturing</b>	<b>5 066</b>	<b>78.8</b>	<b>1 144</b>	<b>24.9</b>	<b>-77</b>
Food, beverages and tobacco	1 657	25.8	46	1.0	-97
Wood and wood products	3	-	-	-	-
Printing, publishing and allied services	-	-	10	0.2	-
Oil and gas; petroleum refining	3 130	48.7	1 076	23.4	-66
Chemicals and chemical products	110	1.7	-	-	-
Stone, clay, glass and concrete products	-	-	-	-	-
Metals and metal products	166	-	-	-	-
Machinery	-	-	4	0.1	-
Miscellaneous manufacturing	-	-	9	0.2	-
<b>Services</b>	<b>532</b>	<b>8.3</b>	<b>533</b>	<b>11.6</b>	<b>-</b>
Electricity, gas and water distribution	329	5.1	19	0.4	-94
Hotels and restaurants	-	-	33	0.7	-
Trade	2	-	44	1.0	2 059
Transport, storage and communications	2	-	331	7.2	16 472
Finance	89	1.4	65	1.4	-27
Business activities	107	1.7	25	4.9	-76
Community, social and personal service activities	3	-	15	0.3	497.5
<b>All industries</b>	<b>6 427</b>	<b>100.0</b>	<b>4 595</b>	<b>100.0</b>	<b>-28</b>

Source: UNCTAD, cross-border M&A database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).



announcement by the Central Bank of *Zimbabwe* of a new guarantee to pay back the entire capital within three months if investors decided to leave.<sup>13</sup>

Some noticeable national policy and institutional changes are also taking place in the petroleum industry, the main attraction in several African countries for FDI inflows in 2004 (box II.1), in an attempt to enhance the favourable impact of oil revenues on national development.

In Kenya, the Government completed a bidding process to privatize Kenyan Telkom. However, FDI policy in Kenya appears to have become stricter in some areas (box II.2).

Many African countries also stepped up their investment promotion efforts in 2004. For example, Egypt initiated a number of measures including the simplification of investment procedures; it is also reviewing the fiscal regime. In addition, it is restructuring the General Authority for Investment and Free Zones (GAFI). Similar efforts are under way in Morocco regarding the Investment Directorate. A number of countries, including Egypt, Morocco and Tunisia, are trying to promote their countries as investment destinations through the organization of investors' meetings and annual conferences.

### Box II.1. Africa: several producer-countries seek to improve policies and management of the petroleum industry

Several African petroleum-producer countries adopted or proposed new policies and institutional changes with respect to petroleum exploration and exploitation in 2004. Some of these changes aim at improving the management of the oil industry in order to enhance the benefits to the local economy. Others aim at creating a better environment for production activities in the oil industry. Major new policies and institutional changes have included the following:

- The Government of *Angola* proposed a new legislation requiring oil companies to route all their payments through the domestic banking system. This measure is expected to lead to a large influx of FDI-related foreign exchange into Angola, sharply boosting transactions and revenue for domestic banks and increasing the banking sector's ability to offer credit to domestic enterprises.

The legislation also sets out requirements on the procurement of goods and hiring of services by oil companies operating in Angola. Oil companies are expected to:

- hold competitive tenders to contract the supply of goods and the provision of support services for their operations;
- ensure that Angolan companies benefit from preferential treatment in competitive tenders for services and goods. Domestic firms should be awarded the relevant contract when their bid is no more than 10% higher than the bids submitted by foreign competitors. If the Angolan authorities enforce the order strictly, it will have a significant impact on the scope

of services that may be directly provided by foreign contractors to oil operators. As a result, foreign service companies wishing to do business in Angola are likely to opt increasingly for structuring their businesses through joint ventures with local partners.

- The *Democratic Republic of the Congo* is reorganizing the corporate structure of its national oil company, Société Nationale des Pétroles du Congo (SNPC), into a holding company with seven affiliates. Of particular interest to investors is SNPC Refining, which is to be privatized.
- The Government of the *Libyan Arab Jamahiriya* adopted a new exploration and production-sharing agreement called EPSA-IV. The Government is intended to offer fresh incentives to foreign companies to invest in oil and gas exploration and development, and it will make the contracting process more efficient and transparent.
- In *Mali*, a new oil code was adopted in June 2004. The initial time span allowed for oil prospecting is four years, renewable for two further periods of four years each. The attribution of prospecting and exploration permits as well as their renewal is subject to the payment of fixed taxes. Permit holders are liable for the payment of charges on the production of oil and a tax of 35% on profits, but they benefit from tax exemption on petroleum products.
- In *Mauritania*, a bill proposing a simplified tax system for oil producers was adopted. The new text complements an act dating back to 1988 and defines the framework for the execution of contracts and the rights and obligations of all parties.

Source: UNCTAD, based on national sources.

Various bilateral, regional and multilateral treaties were also concluded, which complemented national regulations for promoting FDI. African countries concluded 33 new bilateral investment treaties (BITs) and 15 new double taxation treaties (DTTs) in 2004 (figure II.5). These brought the cumulative numbers of BITs and DTTs for the region to 615 and 404 respectively. In addition, the Libyan Arab

Jamahiriya and India agreed on liberalizing visa regimes for business people from the two countries, and signed a bilateral investment promotion agreement in 2004. Tunisia concluded a free trade agreement (FTA) with members of the European Free Trade Area (EFTA), and Morocco concluded one with the United States. Egypt concluded a framework agreement with the Southern Common Market (MERCOSUR),

**Box II.2. Kenya: UNCTAD's Investment Policy Review recommends an alternative approach to minimum capital requirements for FDI inflows**

In the 1970s, Kenya was a prime location for FDI inflows in East Africa. However, deteriorating infrastructure and a poor track record of policies in the 1980s and 1990s discouraged inflows of FDI for about two decades. Inflows declined to one-fifth of those of neighbouring Uganda in 2004, and stood at \$46 million. On a per capita basis, this represented \$1.4 compared with Uganda's \$8.5. As a result, Kenya is now among the developing countries that have attracted the least FDI relative to their size over the past decade. FDI inflows have nevertheless had a crucial impact on the development of the country's export-oriented horticulture industry, contributed to the revival of Kenya Airways and accelerated the development of the mobile telecommunications network in the country.

In 2002 the new Government indicated its interest in improving the investment framework so as to support private sector development and wealth creation. In 2004, the Parliament adopted an Investment Promotion Bill to promote and facilitate investment by assisting investors to obtain licences and providing other incentives for related purposes. Its two core incentives are entitlements to business licences for an initial period along with the allotment of six residence and work permits for foreign staff in FDI projects.

However, the new Act requires *all* foreign investors to have their projects screened and approved, and it imposes a minimum investment requirement of \$500,000 on prospective foreign investors. This requirement was introduced to avoid the crowding out of small national investors, and to encourage only "serious" foreign investors into Kenya. However, this approach is unlikely to respond adequately to the country's legitimate concerns; it could even create a barrier to beneficial FDI inflows: almost 75% of foreign investment projects registered in 2000-2004 were worth less

than \$500,000. The minimum investment is likely to deter FDI in low-capital but knowledge-intensive service industries that could bring benefits to Kenya in some areas in which it has a comparative advantage. As a concrete example, Homegrown, which has evolved into Kenya's largest horticulture and floriculture company and a major source of employment and spillovers, started with an initial investment well below the current requirement of \$500,000.

The *Investment Policy Review of Kenya* completed by UNCTAD in early 2005 recommends the adoption of an alternative approach to regulating FDI entry which would effectively lift the screening and minimum capital requirements and make investment certificates optional. Targeted protection to sensitive industries, in turn, could be considered, if deemed necessary. The Government of Kenya has recognized that the general restrictions imposed on FDI entry are likely to be counter-productive and has introduced a few key amendments to the Investment Promotion Act. If adopted by the Parliament, these amendments will remove the compulsory screening of FDI and the minimum capital requirement. In turn, optional investment certificates would remain a condition for specific incentives and be subject to a lower capital requirement of \$100,000.

Like many other African countries, Kenya has not attracted significant FDI inflows into manufacturing and R&D activities. In this context, it might be useful to target FDI promotion efforts to attract FDI in projects in areas such as technological inputs, R&D activities, and processing and manufacturing activities. That would imply that projects that may initially have low initial financial capital values but bring, for example, valuable manufacturing and R&D inputs would be allowed to operate.

Source: UNCTAD forthcoming d.



and ratified the EU-Egypt Association Agreement (signed in 2001), which is expected to promote trade and exports, improve bilateral relations with the EU and encourage European investment in Egypt. Five economic and partnership agreements between the EU and regional groupings of African countries were being negotiated in 2004 (but have yet not been concluded).

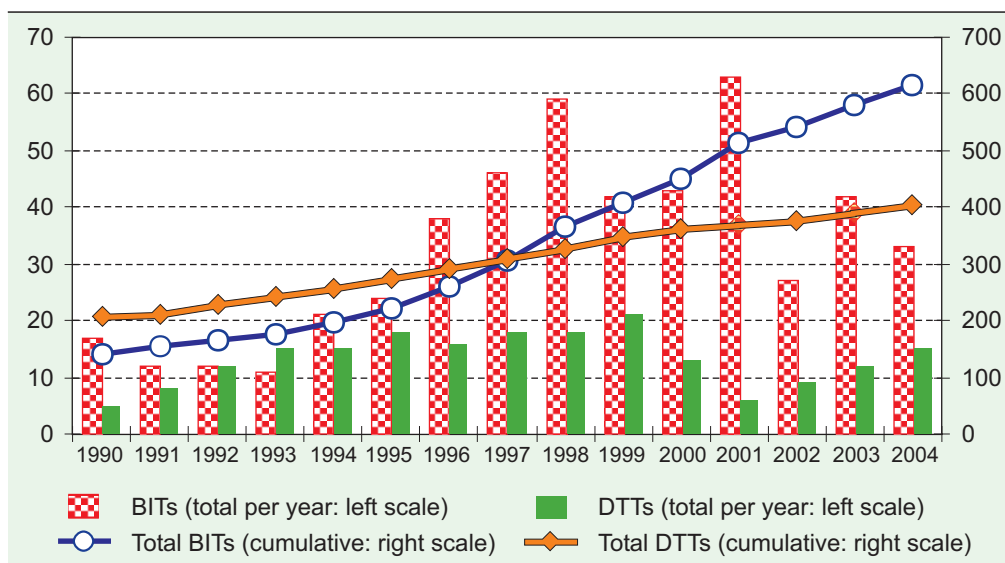
The Government of the United States amended key provisions of the African Growth and Opportunity Act (AGOA) in 2004 (box II.3) that allow more flexible rules of origin. From 2005, however, with the ending of the quotas limiting some countries' exports under the World Trade Organization's (WTO) Agreement on Textiles and Clothing (ACT), the preferential advantage provided by the AGOA may not suffice to attract FDI into textiles and clothing. There will be increased competition, especially from Asian countries, the exports of which were previously restricted by the quotas.

In 2004, the Multilateral Investment Guarantee Agency (MIGA) of the World Bank, through its guarantee programme, supported four new FDI projects in power generation, business services, banking and IT services, and undertook 28 technical assistance activities in the region.<sup>14</sup> At the same time, the African Trade Insurance Agency (ATI) – the region's only pan-African multilateral import and export credit and political risk guaranty agency<sup>15</sup> – adopted measures to protect foreign investors in Africa against trade risks. The region now has better market access

(as a result of the Everything-but-Arms (EBA) initiative of the EU, Japan's 99% rule<sup>16</sup> for LDCs, AGOA and the Generalized System of Preferences (GSP)), and national policies are more stable. Despite these measures and efforts, African countries' capacity to target FDI strategically in manufacturing and services has been constrained by economic and social factors. Impediments range from small market size and poor regulation to meagre financial resources and low skills. The annual gross national income per capita, for instance, is around \$500 in sub-Saharan Africa, and investment in sectors such as education remains insufficient.

The continued low levels of FDI in manufacturing in many African countries are explained by two main factors: a failure to move rapidly on developing economic and social policies that are important for FDI inflows (as well as on development in general); and years of reforms in the 1980s that placed insufficient emphasis on capacity building. As a result, the international market-access measures and initiatives provided for African countries have not been very successful in attracting FDI, particularly in manufacturing, given the lack of capacity to exploit FDI in a number of countries. The future of FDI in Africa's development lies in an integrated and genuine partnership between the private sector and governments to strengthen human resource capabilities, for example through training of the labour force (*WIR03*). Initiatives such as AGOA can only have a stronger impact

**Figure II.5. Africa: BITs and DTTs concluded, cumulative and annual, 1990-2004**  
(Number)



Source: UNCTAD, BIT/DTT database ([www.unctad.org/iia](http://www.unctad.org/iia)).

### Box II.3. AGOA Acceleration Act 2004: some new key provisions

The United States has made AGOA a cornerstone of its policy of promoting trade and investment in Africa. In 2004, the United States Government enacted a law – the AGOA Acceleration Act of 2004 – that amended the original initiative. The law now has the following key features:

The Act extends the expiration of the programme from 2008 until 2015, and the third-country fabric provision is extended for three years, from September 2004 until September 2007, including a phase-down in year three. The cap of the third-country provision will remain at the full current level available in years one and two. In the third year, the cap will be phased down by 50%.

The law includes a statement of Congressional policy that textile and apparel provisions under the programme should be interpreted in a broad and trade-expanding manner to maximize opportunities for imports from Africa. This is accompanied by minor technical corrections to prevent restrictive interpretations by customs officials. The Act includes a modification of the rules of origin to allow use of non-AGOA products for all import categories and continued use of fabrics from AGOA countries – such as South

Africa – which also become free trade partners with the United States.

The Act increases the de minimis rule from its current 7% to 10%. It states that apparel products assembled in sub-Saharan Africa, which would otherwise be considered eligible for AGOA benefits except for the presence of some fibres or yarns not wholly formed in the United States or the beneficiary sub-Saharan African country, will still be eligible for benefits as long as the total weight of all such fibres and yarns is not more than a certain percentage (currently 7%) of the weight of the article.

The Act also expands the current “folklore” AGOA coverage to include ethnic fabric made on machines, and supports many of the aims of the New Partnership for Africa’s Development (NEPAD) initiative, including regional integration among African countries.

AGOA was intended to apply to 48 African countries, but by the end of 2004 only 37 had qualified.<sup>a</sup> To date, only 18 of these countries met the rules-of-origin requirements, creating the legal conditions required for taking advantage of the scheme. However, only seven countries attracted any FDI inflows.<sup>b</sup>

*Source:* “AGOA Acceleration Act for 2004 (AGOA III) summary”, AGOA website ([www.agoa.gov](http://www.agoa.gov)).

<sup>a</sup> The 37 African countries are: Angola, Benin, Botswana, Burkina Faso, Cameroon, Cape Verde, Chad, Congo, the Democratic Republic of the Congo, Djibouti, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, South Africa, Swaziland, the United Republic of Tanzania, Uganda and Zambia.

<sup>b</sup> For a description of progress with respect to exports and FDI in export-oriented production in some AGOA beneficiary countries, including Lesotho, Mauritius, Mozambique, South Africa, Swaziland, and Uganda, see *WIR04*, p.91, ff4. In Mali, a \$12.5-million cotton-thread factory opened in February 2004. This facility is one of the sub-Saharan African plants outside South Africa capable of producing quality thread for use in manufacturing apparel for export under AGOA. Mauritians were among the investors. The factory created 200 new jobs ([www.agoa.gov](http://www.agoa.gov)).

on FDI inflows if African countries implement development-oriented economic and social policies.

Africa’s ability to industrialize successfully could weaken unless supported by strong domestic investment capacity, which is particularly important given the region’s declining share of global FDI inflows in manufacturing. The scope for industrialization lies not just in improving its market access and the investment climate but, more significantly, in strengthening its domestic industrial

capabilities. For the latter, governments may choose to use public policies and finance to attract the type of FDI they need in the manufacturing industries, as illustrated by some policies in South Africa (box II.4).

However, attracting FDI into the manufacturing sector in Africa is becoming difficult as competition grows from the other developing countries, particularly in Asia. Factors such as good physical infrastructure and appropriate human skill levels have become increasingly important in attracting FDI projects,

especially as a number of international trade advantages such as those provided by the Multi-Fibre Arrangement (MFA), AGOA and others have already, or will eventually, come to an end. This scenario may, however, change with new initiatives for Africa such as those proposed by the renewed emphasis on the Millennium Development Goals by the United Nations and by the Commission for Africa that was set up in 2004 by the Government of the United Kingdom (box II.5).

### c. Prospects: cautiously positive

The significant rise in commodity prices that started in 2004, and the resulting high profitability of investments, are expected to lead

to further increases in FDI in Africa in 2005. Furthermore, the United States is expected to increase its share of oil imports from Africa from the current level of 18% to 25% by 2015.<sup>17</sup> Pressure on TNCs to access more petroleum resources, slash costs and take advantage of high prices is expected to set off a new wave of cross-border M&As in the region. United States and European TNCs (such as Chevron Corp. (United States) in Angola and Total (France) in Nigeria) are already expanding or planning to expand their investments. In the mining industry, significant projects are planned as well, for instance in diamond, copper and cobalt in the Democratic Republic of the Congo.<sup>18</sup>

In infrastructure projects, TNCs are also likely to invest in some African countries. Eskom of South Africa, for instance, is already involved

#### Box II.4. Attracting FDI to South Africa through Government development assistance programmes

South Africa's FDI flows over the past five years have fluctuated between \$6.8 billion in 2001 and \$600 million in 2004. Two of its current development assistance programmes, the National Industrial Participation Programme and the Foreign Investment Grant (FIG), were designed to use the government's financial capacity to attract FDI inflows to manufacturing projects, with some success.

The National Industrial Participation Programme is an offset scheme that requires a commitment by suppliers doing more than \$10 million worth of business with the Government or the companies it owns to facilitate industrial development in the country.<sup>a</sup> Under the scheme, when the Government purchases goods or services in which the import content exceeds \$10 million, the foreign suppliers incur an obligation to reinvest a portion of their profits from sales inside the country. Procurement programmes tied to this arrangement include the Government's strategic defence procurement package and purchases made by State-owned enterprises such as Telkom, South African Airways, Eskom, Transnet and Petro S.A. The programme is obligatory and is focused on the transport, energy, and information and telecommunications

industries. About 125 FDI projects have so far been facilitated by this programme resulting in investments of \$750 million and exports of \$1.5 billion by the end of 2004.<sup>b</sup> The value of purchase obligations currently being monitored by the Department of Trade and Industry is approximately \$14 billion, the bulk of which comes from the Government's strategic defence package. In 2003, the programme yielded a big offset package: an \$8.7 billion commitment from aircraft supplier BAE Systems of the United Kingdom and Saab of Sweden.<sup>c</sup> The full offset obligations are due to be discharged over a period of seven years (by April 2011).

The FIG was created as a cash incentive scheme for foreign investors who invest in new manufacturing enterprises in South Africa. In the FIG programme, a foreign entrepreneur can be compensated for up to 15% of the costs of moving new machinery and equipment to South Africa, up to a maximum amount of 3 million rand (\$0.5 million) per entity. The scheme aims at promoting FDI as well as enhancing the level of technology and overall economic growth in South Africa. It is open to foreign investors who hold at least 50% of the shares in the relevant company.

Source: Department of Trade and Industry website ([www.dti.gov.za](http://www.dti.gov.za)).

<sup>a</sup> "Jet-propelled investment", *FDI Magazine*, April/May 2005 ([www.fdimagazine.com](http://www.fdimagazine.com)).

<sup>b</sup> Data from the Department of Trade and Industry. Even though South Africa has had successes with the offset programme, some of the past commitments did not materialize.

<sup>c</sup> "Jet-propelled investment", *op. cit.*

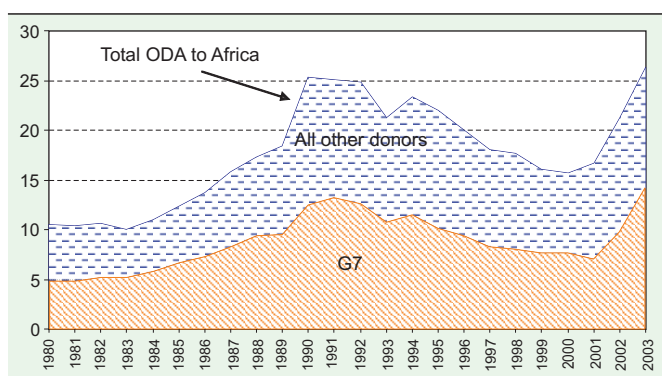
### Box II.5. The Report of the Commission for Africa: recommendations to help boost investment

Africa is a major recipient of official development assistance (ODA) as a source of financing for development. After declining for much of the 1990s, ODA to the region has risen substantially in recent years, from \$16 billion in 2000 to \$26 billion in 2003 (box figure II.5.1). Most of the region's ODA comes from developed countries, with the United Kingdom being one of the major donor countries (box table II.5.1).

In 2004, the Prime Minister of the United Kingdom established a Commission for Africa "to define the challenges facing Africa, and provide clear recommendations on how to support the changes needed to reduce poverty" (Commission for Africa 2005, p. 1). Its Report, released in March 2005, recommends a substantial increase in aid to Africa – an additional \$25 billion per year to be implemented by 2010 – emphasizing the need for innovative financial methods to secure funding.<sup>a</sup> It calls for changes by the recipients as well as donors in an integrated package focusing on governance and capacity building, peace and security, investment in people, growth and poverty reduction, and trade to ensure that aid is well spent. It proposes a "Marshall Plan" to pull Africa out of poverty, just as the Marshall Plan involving large amounts of aid from the United States enabled Europe to rebuild its industrial infrastructure after the Second World War.

Several of the report's recommendations are directly relevant to boosting both local and foreign investment in African economies. The Report notes that infrastructure and policy measures in Africa have not been adequate, nor have they been improved or expanded. It points out that private

Box figure II.5.1. Africa: ODA inflows, 1980-2003  
(Billions of dollars)



Source: UNCTAD, based on OECD ODA/OA database.

investment cannot be expected to flow without decent transportation systems, a stable policy climate, human capital and reliable utilities.

The report underlines concrete priorities for the use of additional aid in areas that could encourage investment in the region. It calls for

/...

in the first phase of an infrastructure project to rehabilitate the Inga hydroelectric power station in the Democratic Republic of the Congo as part of the "Unified African Grid". In 2004, German investors had announced plans to build a computerized railway line from Rongai to Juba in Southern Sudan. Morocco might also receive increased FDI inflows in 2005 as a result of further privatization of public enterprises and the conclusion of an FTA with the United States.

Improving economic conditions in South Africa are encouraging FDI in the country's banking industry. The acquisition of 60% of ABSA (South Africa) by Barclays of the United Kingdom in 2005 may herald a wave of M&As and greenfield FDI in South Africa and in other countries in the region. Opportunities exist for FDI in key service industries in Africa,

particularly telecommunications, electricity and transport. FDI inflows to processing and other industries in the manufacturing sector are expected to be small, going mainly to the Libyan Arab Jamahiriya, Nigeria, South Africa and Uganda.

A 2005 survey of international FDI experts, TNCs and investment promotion agencies (IPAs) undertaken by UNCTAD (box I.3) revealed cautious optimism concerning the prospects for FDI in Africa. Among the TNCs, one out of four respondents expected FDI inflows to Africa to increase in 2005-2006 (figure II.6). An equal number of TNCs believed that inflows would decrease. FDI experts and IPAs were more optimistic: one out of three FDI experts and nine out of 10 African IPAs expected FDI inflows to grow in 2005-2006. Experts and TNCs judge FDI



### Box II.5. The Report of the Commission for Africa: recommendations to help boost investment (concluded)

donors to double their spending on infrastructure – from rural roads to regional highways, power projects and information and communications technologies (ICT) – and proposes a 100% external debt cancellation for African countries. The report recognizes the need to reverse years of chronic underinvestment in education (partly as a result of budget cuts made in order to comply with the IMF's structural adjustment programmes). It also calls on developed countries to support an Investment Climate Facility for Africa under the NEPAD initiative, and to insure foreign investors in post-conflict countries in Africa through a risk-bearing fund of the Multilateral Investment Guarantee Agency.

New ODA inflows into Africa, if allocated according to the priorities outlined in the report, could help improve the investment climate by providing opportunities for foreign firms to invest productively, creating jobs, and contributing to sustainable progress in reducing poverty while improving living standards in the region.

Source: UNCTAD, based on the United Kingdom, Commission for Africa 2005.

- <sup>a</sup> At the end of the summit of the G-8 countries in Gleneagles, United Kingdom, in July 2005, the countries and other donors made substantial commitments to increase aid by a variety of means, including through traditional development assistance, debt relief and innovative financing mechanisms, which would lead to an increase in ODA to Africa of \$25 billion a year by 2010.

Box table II.5.1. Top 10 ODA donors to Africa, 2000-2003<sup>a</sup>  
(Millions of dollars)

Donor country	2000	2001	2002	2003
United States	2 107	1 975	3 189	5 063
France	1 812	1 531	2 603	3 587
Germany	871	830	1 009	2 061
United Kingdom	1 151	1 204	1 048	1 508
Belgium	219	245	363	1 053
Netherlands	601	853	956	1 026
Italy	252	196	811	744
Japan	1 226	1 091	700	704
Sweden	399	352	409	683
Norway	339	325	452	581
G7 <sup>b</sup> to Africa	7 638	7 044	9 748	14 184
All donors to Africa	15 732	16 691	21 261	26 318
<i>Memorandum</i>				
G7 <sup>b</sup> to all recipients	167 773	153 514	184 551	223 633
All donors to all recipients	314 378	320 487	368 712	426 330

Source: UNCTAD, based on OECD, ODA/OA database.

<sup>a</sup> Ranked according to 2003 figures.

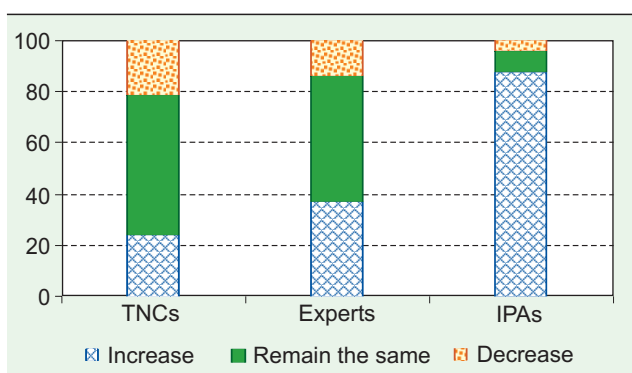
<sup>b</sup> Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

prospects for North African countries to be more positive than those for sub-Saharan African countries.

FDI outflows from Africa are also poised for a rapid expansion in 2005. The major home sources of this expansion are likely to be South

Figure II.6. Africa: prospects for FDI inflows, 2005-2006

(Per cent of responses from TNCs, experts and IPAs)



Source: UNCTAD ([www.unctad.org/fdiprosects](http://www.unctad.org/fdiprosects)).

Africa, Egypt and Nigeria. For instance, several South African TNCs are committed to large projects inside and outside Africa, particularly in the Democratic Republic of the Congo and Western Asian countries. Orascom Telecom Holding of Egypt has offered to buy the Wind SpA phone company of Italy in 2005.<sup>19</sup> Oriental Energy Resources of Nigeria is seeking to acquire petroleum exploration rights in Angola.

## 2. Asia and Oceania: inflows at a record high

FDI inflows to Asia and Oceania reached a new high at \$148 billion in 2004, registering the largest increase ever. The region's share of FDI inflows worldwide also increased from 16% in 2003 to 23% in 2004. Almost all parts of Asia and Oceania received higher flows than in 2003. FDI inflows also rose as a percentage of gross fixed capital formation (figure II.7). Outward flows from the region quadrupled to \$69 billion,



the second highest level ever, driven by FDI from most major economies, and particularly from Hong Kong (China). The policy environment for FDI continued to improve, and the prospects for FDI in and from the region remain promising.

### a. Trends: strong growth in FDI flows

FDI flows to Asia and Oceania<sup>20</sup> increased by 46% in 2004; 34 out of 54 economies received higher flows than in 2003. However, they remain concentrated: the top 10 host economies (figure II.8) accounted for 92% of FDI inflows to the region.

The distribution of inflows by size changed significantly compared with 2003: a few large FDI-recipient economies saw an increase in the level of FDI flows, and the number of economies that received less than \$100 million decreased (table II.3). Bangladesh, China, India, the Republic of Korea, Macao (China), Mongolia, Pakistan, Qatar, Singapore, the Syrian Arab Republic and Viet Nam received record levels of flows (annex table B.1).

While greenfield investment remains the most important mode of FDI in the region, cross-border M&As increased from \$22 billion in 2003 to \$25 billion in 2004 largely due to transactions in East Asia (annex table B.4). The top three targets in terms of the value of cross-border M&A sales in 2004 were China, the Republic of Korea

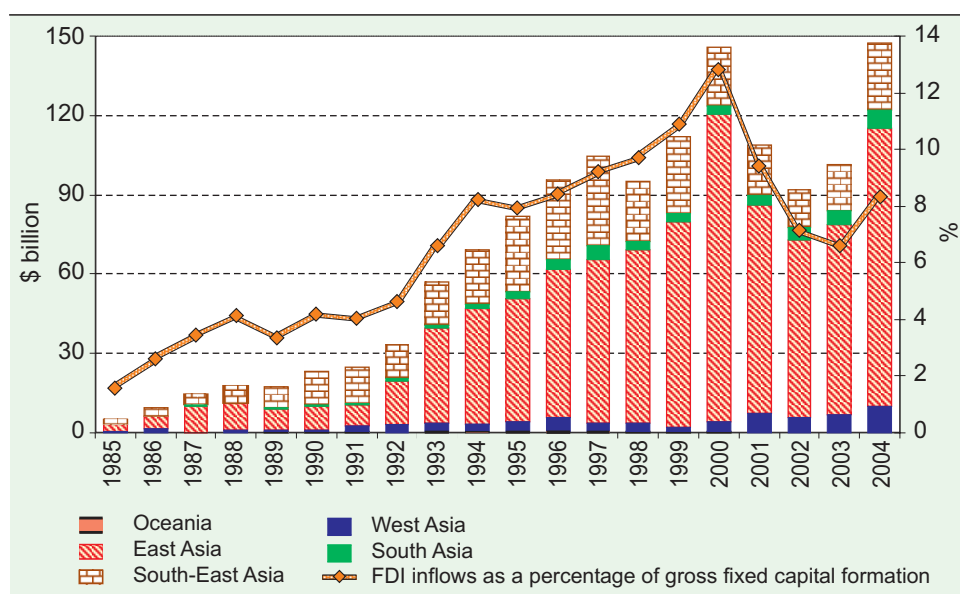
and Hong Kong (China) (figure II.9). The most significant increase took place in China, making the value of its cross-border M&A sales the largest in the region in 2004. The surge of M&As in China was driven largely by policy changes in that country.<sup>21</sup>

Cross-border M&As in Asia and Oceania primarily targeted service industries (and in particular financial services), which accounted for two-thirds of total cross-border M&A sales in 2004 (table II.4). Cross-border M&A sales almost doubled in the chemical industry, making it the largest recipient industry of cross-border M&As in manufacturing in the region.

In contrast to cross-border M&As, greenfield investment by TNCs concentrated on manufacturing followed by sales and marketing, retail and business services (annex table A.I.3). FDI in R&D, a relatively new area for TNC expansion in developing countries, has gained importance in recent years, accounting for 11% of all greenfield projects in Asia and in Oceania in 2004 (annex table A.I.3).

With a 46% increase in FDI inflows, East Asia remains the most important subregion for FDI inflows. However in terms of increase in inflows, the performance of West Asia (with a 51% increase) and South-East Asia (48%) was more impressive. FDI inflows to South Asia also increased, by 31%, to reach a record high. In contrast, Oceania witnessed a 54% decrease in flows.

Figure II.7. Asia and Oceania: FDI inflows and their share in gross fixed capital formation, 1985-2004



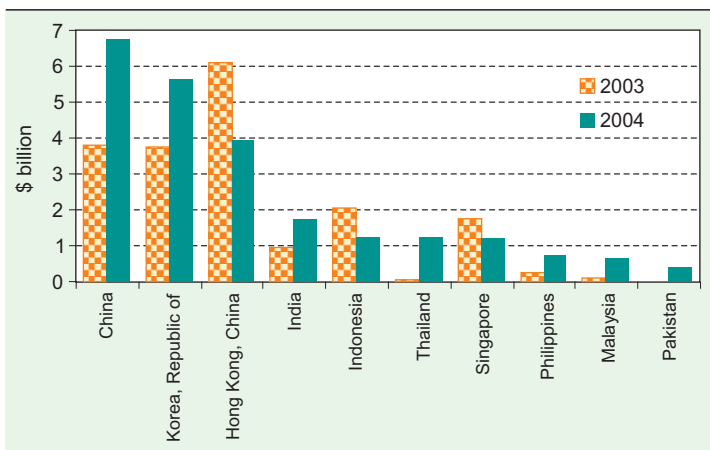
Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex tables B.1 and B.3.

- *East Asia*<sup>22</sup> accounted for the lion's share (71%) of FDI flows to Asia and Oceania. These rose from \$72 billion in 2003 to \$105 billion in 2004, mainly on account of higher FDI flows to Hong Kong (China), China and the Republic of Korea. FDI flows to Hong Kong (China) increased by 150%, to \$34 billion, led by flows to the services sector. An increase in cross-border M&A transactions in the Republic of Korea, especially large-value ones, helped push that country's inflows to \$8 billion.

China was again the largest recipient of FDI, not only in the region but also among all developing countries worldwide, with flows reaching the highest level (\$61 billion).<sup>23</sup> Strong economic growth, an improved policy environment and further opening up to FDI in certain industries – such as banking and other financial services – contributed to the increase. In 2004, five Chinese banks attracted \$2.7 billion in FDI<sup>24</sup> and total FDI flows to the banking sector reached \$3.8 billion. Investments by private equity and venture capital funds, especially from the United States, have become important sources of foreign investment in China.<sup>25</sup> The implementation of large-scale FDI projects also led to a significant increase in FDI in the automotive industry<sup>26</sup> and the semiconductor industry.

**Figure II.9. Top 10 economies in terms of cross-border M&A sales in Asia and Oceania: 2003, 2004**

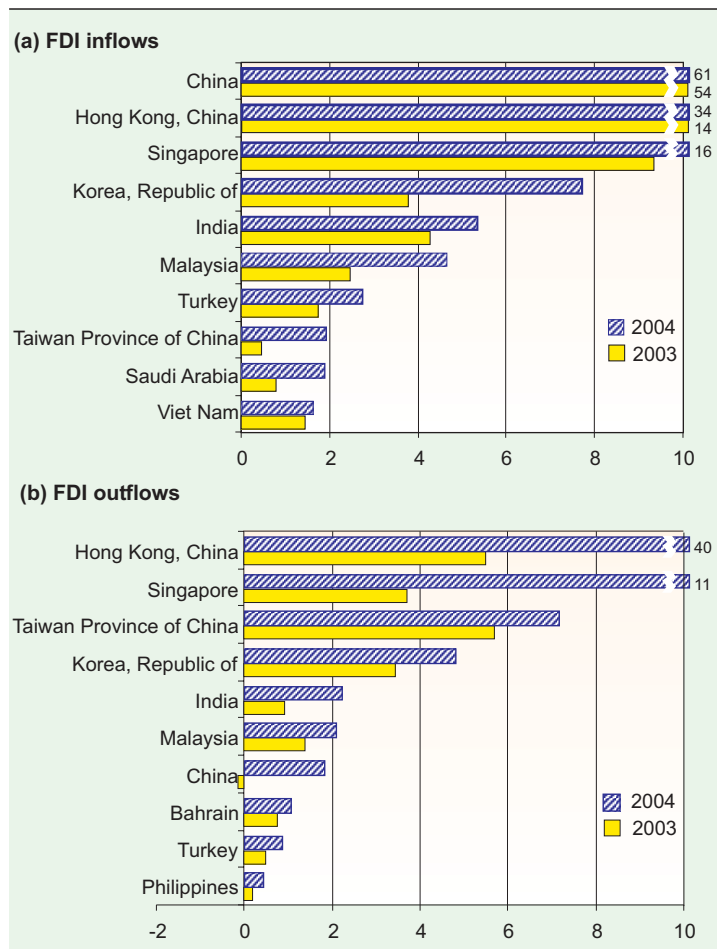
(Billions of dollars)



Source: UNCTAD, cross-border M&As database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.4.

**Figure II.8. Asia and Oceania: FDI flows, top 10 economies,<sup>a</sup> 2003, 2004**

(Billions of dollars)



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Ranked on the basis of the magnitude of FDI flows in 2004.

- *South-East Asia*<sup>27</sup> witnessed a further rise in flows from \$17 billion in 2003 to \$26 billion in 2004. The decline in repayments of intra-company loans by foreign affiliates in the subregion to parent firms helped, as did the increase in the level of cross-border M&As in the region (annex table B.4). Higher flows to Singapore, Malaysia, Indonesia, Myanmar, Viet Nam, the Philippines and Cambodia contributed to the subregion's increased FDI receipts. In Indonesia, the successful privatization of State assets and foreign acquisitions of private firms helped putting an end to the continuous period of negative FDI inflows that began in 1998. Acquisition by an investor group (led by Standard Chartered of the United

**Table II.3. Asia and Oceania: country distribution of FDI inflows, by range, 2003, 2004**

Range	2003		2004	
	Economy <sup>a</sup>		Economy <sup>a</sup>	
More than \$5 billion	China, Hong Kong (China) and Singapore		China, Hong Kong (China), Singapore, Republic of Korea and India	
\$2.0-4.9 billion	India, Republic of Korea, Malaysia, and Brunei Darussalam		Malaysia and Turkey	
\$1.0-1.9 billion	Thailand, Turkey, Viet Nam, and Syrian Arab Republic		Taiwan Province of China, Saudi Arabia, Viet Nam, Syrian Arab Republic, Thailand and Indonesia	
\$0.1-0.9 billion	Saudi Arabia, Qatar, Pakistan, Oman, Bahrain, Islamic Republic of Iran, Taiwan Province of China, Jordan, Macao (China), Lebanon, Philippines, Myanmar, Bangladesh, Sri Lanka, Democratic People's Republic of Korea, Mongolia and Papua New Guinea		Pakistan, Bahrain, United Arab Emirates, Qatar, Jordan, Macao (China), Myanmar, Islamic Republic of Iran, Philippines, Bangladesh, Iraq, Lebanon, Sri Lanka, Mongolia, Cambodia and Brunei Darussalam	
Less than \$0.1 billion	Cambodia, United Arab Emirates, Fiji, Lao People's Democratic Republic, Vanuatu, Nepal, Maldives, Tonga, Yemen, Iraq, Timor-Leste, Marshall Islands, Palau, Afghanistan, Nauru, Bhutan, Samoa, Tokelau, Tuvalu, New Caledonia, Solomon Islands, French Polynesia, Kuwait and Indonesia		Democratic People's Republic of Korea, Papua New Guinea, Vanuatu, Lao People's Democratic Republic, Maldives, Marshall Islands, Nepal, Tuvalu, New Caledonia, Palau, Tonga, Timor-Leste, Afghanistan, Bhutan, Samoa, Solomon Islands, Fiji, Oman, Kuwait and Yemen	

Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics) and annex table B.1.

<sup>a</sup> Listed in order of the magnitude of FDI inflows for each respective year.

**Table II.4. Asia and Oceania: distribution of cross-border M&A sales, by sector and industry, 2003, 2004**  
(Millions of dollars and per cent)

Sector/industry	2003		2004		Growth rate in 2004 (%)
	Value	%	Value	%	
<b>Primary</b>	<b>42</b>	<b>0.2</b>	<b>215</b>	<b>0.9</b>	<b>419</b>
<b>Manufacturing</b>	<b>7 401</b>	<b>34.2</b>	<b>8 125</b>	<b>32.7</b>	<b>10</b>
Chemicals and chemical products	1 248	5.8	2 392	9.6	92
Electrical and electronic equipment	943	4.4	1 691	6.8	79
Food, beverages and tobacco	1 276	5.9	1 652	6.7	30
Oil and gas; petroleum refining	1 757	8.1	614	2.5	-65
Motor vehicles and other transport equipment	1 312	6.1	516	2.1	-61
Other manufacturing	866	4.0	1 260	5.1	45
<b>Services</b>	<b>14 212</b>	<b>65.6</b>	<b>16 480</b>	<b>66.4</b>	<b>16</b>
Finance	6 052	27.9	10 947	44.1	81
Business activities	2 388	11.0	2 825	11.4	18
Electricity, gas, and water distribution	885	4.1	891	3.6	1
Transport, storage and communications	3 787	17.5	846	3.4	-78
Trade	481	2.2	426	1.7	-11
Other services	618	0.2	545	2.2	-12
<b>All industries</b>	<b>21 654</b>	<b>100.0</b>	<b>24 820</b>	<b>100.0</b>	<b>15</b>

Source: UNCTAD, cross-border M&As database (www.unctad.org/fdistatistics).

Kingdom) of a controlling interest in PT Bank Permata Tbk for \$305 million is an example of such privatization (annex table A.II.1). The

value of cross-border M&As in Malaysia, the Philippines and Thailand also rose significantly.

The rapid rise of FDI inflows to the subregion and the narrowing gap between flows to ASEAN members and China assuaged those concerned that China is crowding out FDI from its neighbouring countries. A recent study suggests that FDI in China did not crowd out FDI inflows to South-East Asian countries during 1992-2001 (Zhou and Lall 2005).<sup>28</sup> This was based on the fact that there is little competition between countries in market- and resource-seeking FDI and that efficiency-seeking, export-oriented FDI in China may have been so far complementary to that in South-East Asian countries.

- FDI inflows to *South Asia*<sup>29</sup> also climbed in 2004 for the fourth consecutive year. Inflows to India – at a record level of \$5 billion – were encouraged by an improving economic situation and a more open FDI climate. Cross-border M&As in India rose in 2004 as the telecommunications, business process outsourcing and pharmaceutical

industries saw an increase in large deals. Improved investment environments and the privatization of assets in Pakistan and Bangladesh contributed to higher FDI flows to those countries. Improvements in the regional political situation also played a role. In Afghanistan, investors from 25 countries have set up operations (Eedes 2005).<sup>30</sup>

- FDI inflows to *West Asia*<sup>31</sup> increased from \$6.5 billion in 2003 to \$9.8 billion in 2004.<sup>32</sup> Countries such as Bahrain, Jordan, Saudi Arabia, Turkey and the United Arab Emirates saw a sharp rise in inflows (box II.6). While high oil prices might have

influenced oil-related FDI, it is difficult to assess precisely their impact on FDI in the region. Efforts by a number of countries to promote non-oil investment in their economies contributed, to some extent, to the subregion's improved FDI flows (box II.6), as illustrated by developments in the Islamic Republic of Iran (box II.7).

- *Oceania*<sup>33</sup> witnessed a sharp fall in FDI inflows, from \$146 million in 2003 to \$67 million in 2004. This was mainly caused by the significant decline of flows to Papua New Guinea (from \$101 million to \$25 million) and Fiji (from \$23 million to -\$9 million). Flows to Vanuatu and Tuvalu rose to \$22 million and \$9 million respectively.

#### Box II.6. FDI flows to West Asia increased but remain concentrated

In 2004, FDI flows to West Asia rose by 51%. This increase was spread unevenly among the economies of the subregion, and FDI inflows were concentrated in particular in Turkey, Saudi Arabia and the Syrian Arab Republic in that order; the three countries together accounting for 59% of total inflows. The Triad was the main source of FDI flows to West Asian countries. South Africa was another relatively significant source of investment, while intraregional investment from within Asia also contributed to the upward trend. The growth in FDI inflows in 2004 largely reflected an increase in some large-scale greenfield investments by international oil and gas firms, as well as cross-border M&As in business and financial services, mining (including oil and gas) and manufacturing.

The relatively low importance of FDI in West Asian economies is reflected in the ratio of FDI flows to gross fixed capital formation: at 4.9%, it is below the developing-country average not to mention that of South, East and South-East Asia. This is partly due to the economic structure of the West Asian economies, the size of their markets, the importance of oil revenues to some of them and the overall level of political uncertainty affecting the subregion. Indeed, a difficult geopolitical situation in parts of the subregion heightens the risk perceptions of investors, while sanctions imposed on several countries in West Asia have impeded their integration into the world economy (Yousef 2005).

The primary sector remains dominant in terms of inward FDI stock, but FDI in manufacturing and services is rising in some countries such as Bahrain, the Islamic Republic of Iran, Saudi Arabia, Turkey and the United Arab Emirates. For instance, the number of cross-border M&As and greenfield FDI

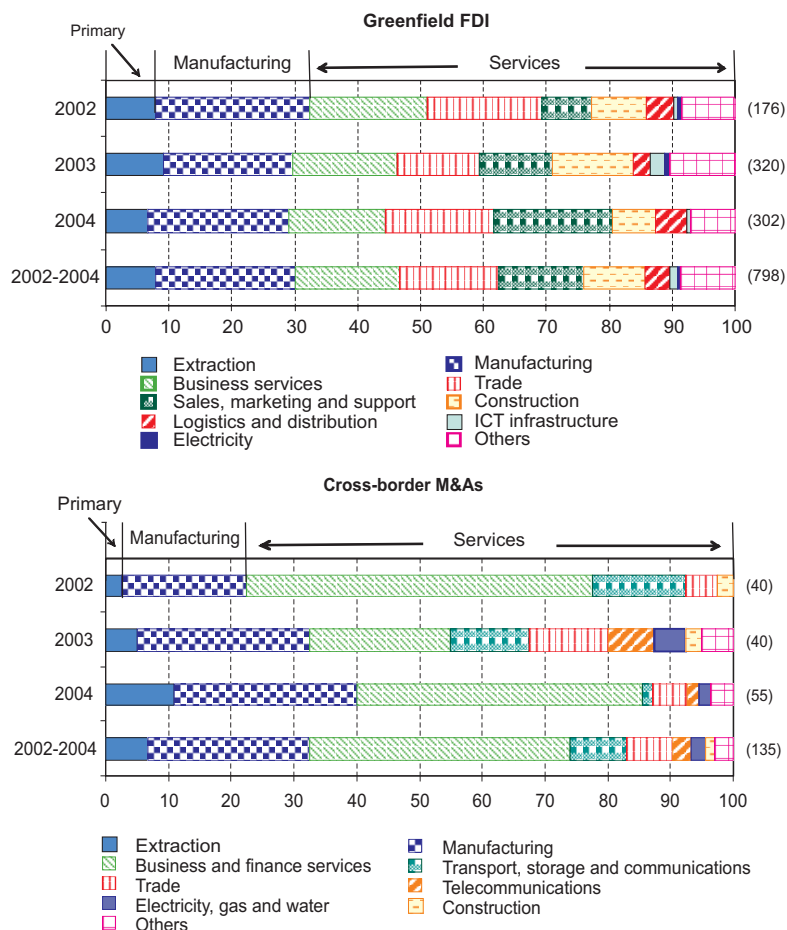
projects in the subregion between 2002 and 2004 were larger in business services and in manufacturing, including the oil refining industry, than in natural resource extraction (box figure II.6.1). Greenfield FDI projects in manufacturing were mainly in the chemical (28% of total manufacturing), automotive (28%) and food and drink (19%) industries. Large oil firms such as Chevron, ExxonMobil and Royal Dutch Shell Group announced large investments in the chemical and energy industries, especially in liquefied natural gas-related projects. Finally, spurred by the liberalization of regulatory restrictions on real estate investment, FDI in real estate and construction also increased, particularly in Bahrain, Jordan, Lebanon and the Syrian Arab Republic (UNDESA and UNCTAD 2005). This has been bolstered by the robust oil prices of the last few years and significant developments in the tourism sector. Bahrain, Dubai (part of the United Arab Emirates), and Qatar are the leading markets for intraregional FDI in real estate and tourism-related construction.<sup>a</sup>

The ICT industries have also attracted FDI following, in particular, efforts by some countries, in the context of their "e-Government Strategy", to attract FDI flows to such industries. For example Dubai Internet City, a free trade zone, has attracted a large number of companies such as Canon, Cisco Systems, Compaq, Dell, IBM, Microsoft, Oracle, Siemens and Sony Ericsson. In 2004, the Dubai International Financial Centre, a financial free zone allowing full foreign ownership, a zero tax rate and freedom to repatriate capital and profits without restrictions, was established as an onshore capital market.

/...

### Box II.6. FDI flows to West Asia increased but remain concentrated (concluded)

**Box figure II.6.1. Industry distribution of numbers of greenfield investment projects and cross-border M&A deals in West Asia, 2002-2004**  
(Per cent)



*Source:* UNCTAD, cross-border M&A database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) as well as data from OCO Consulting, LOCOMonitor website ([www.locomonitor.com](http://www.locomonitor.com)).

*Note:* With regard to greenfield investments the industry refers to the key business function or the primary activity of each project. Figures in parentheses show the number of projects/deals.

Countries in West Asia continue to pursue economic and regulatory reforms to improve their investment environment. However, despite a series of liberalization efforts, the past decade has not seen large increases in the activities of the private sector in West Asia. The subregion is partly affected by a low “level of freedom” (UNDP 2002, p. 27) and by weaknesses in competitiveness, in particular as regards the countries’ ability to absorb new

technologies (Lopez-Claros 2004, Blanke and Lopez-Claros 2005). Significant efforts to implement financial, administrative and judicial reforms would be necessary for the subregion to enhance its attractiveness to investors and increase FDI inflows, in keeping with its size and economic significance. In this process, regional initiatives and international cooperation and assistance could play an important role.<sup>b</sup>

*Source:* UNCTAD.

<sup>a</sup> “How long can the Middle East real estate boom last?”, *AME Info*, 4 December 2004, [www.ameinfo.com](http://www.ameinfo.com), “Desire for diversity drives building boom”, *FDI Financial Times Business*, 10 December 2004 ([www.fdimagazine.com](http://www.fdimagazine.com)).

<sup>b</sup> For instance, international institutions like OECD, the United Nations Development Programme (UNDP) and the World Bank are already involved in assisting the reform process in the West Asia’s and North Africa’s 19 economies. This includes an initiative developed by the governments of these countries on “Governance and Investment for Development”, which was approved by the OECD Council on 10 November 2004 ([www.oecd.org](http://www.oecd.org)).



Intraregional FDI flows in Asia and Oceania have grown over the years, encouraged by regional integration efforts, the expansion of production networks and the relocation of production to lower cost areas within the region. Intraregional FDI accounted for an estimated 46% of total flows to the region in 2002.<sup>34</sup> Significant intraregional FDI flows took place between East and South-East Asia, in particular from Hong

Kong (China) to the more developed South-East Asian countries such as Singapore and Malaysia, from Taiwan Province of China and the Republic of Korea to less developed countries such as the Philippines and Viet Nam, and from Singapore to China and Hong Kong (China). These flows are also important within East Asia – originating largely from Hong Kong (China), Taiwan Province of China and the Republic of Korea and

### Box II.7. Recent trends in FDI inflows in the Islamic Republic of Iran

Although there were large increases in FDI flows to the Islamic Republic of Iran following the adoption of its new FDI law of 2002, such flows remain modest, amounting to \$0.5 billion on average over the period 2002-2004 (box figure II.7.1). Although the presence of foreign investors in the country is indeed on the rise, it is not fully captured by data on FDI inflows. This is because a large number of projects with foreign participation are not covered by FDI statistics compiled on a balance-of-payments basis as they involve low levels of equity or non-equity arrangements.<sup>a</sup>

In the past few years, the Islamic Republic of Iran has enjoyed strong GDP growth due in part to high oil prices and to the implementation of regulatory reforms under the country's third Five-year Development Plan, 2000-2005 (IMF 2004). The main goal of the reforms is to diversify the country's economic structure. Efforts have been directed towards fostering private sector development and growth, including through

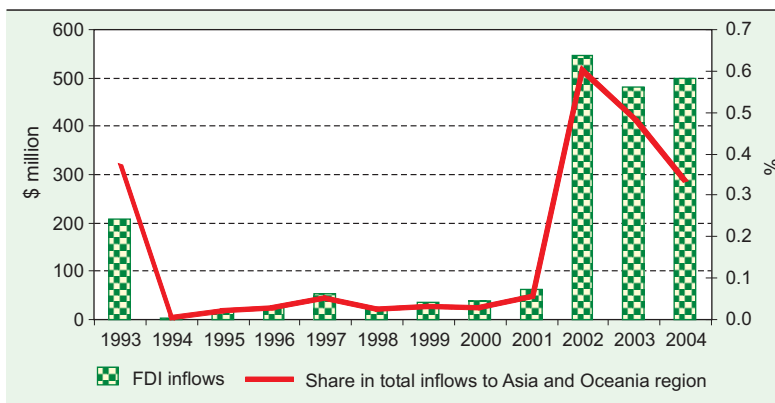
financial sector reform, privatization, further trade liberalization and improvements in the business climate (box II.8). In 2002, the country enacted a foreign investment law, the Foreign Investment Promotion and Protection Act, which is more liberal than the former law of 1955 (Law on the Attraction and Protection of Foreign Investment).

In the non-oil and gas sector, FDI inflows went into a wider range of industries (including service industries, chemicals and machinery) in 2002-2004 than in previous years. For example, no FDI was recorded in the tourism, telecommunications and electricity generation and distribution industries in 1999-2001, while these industries accounted for over 60% of flows in non-oil and gas industries in 2002-2004.<sup>b</sup>

Approved data, however, show a different picture of foreign presence in the country from that based on actual data (box figures II.7.1 and II.7.2). The value of foreign investment approved by the Organization for Investment, Economic and

Technical Assistance of Iran (OIETAI)<sup>c</sup> increased significantly after 2002 (box figure II.7.2). Data from OIETAI include FDI as well as various types of non-equity arrangements, referred to as "indirect" investments.<sup>d</sup> Foreign participation in projects in the oil and gas upstream activities and in national projects that are normally closed to FDI can be implemented only through contractual schemes, including buy-back arrangements (Islamic Republic of Iran, OIETAI 2004). Under the buy-back arrangements, as applied especially to the oil and gas industries, investors receive payments over a fixed period of time, rather than

**Box figure II.7.1. FDI inflows to the Islamic Republic of Iran and its share in total inflows to Asia and Oceania, 1993-2004**



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

/...

targeting particularly China. FDI flows within South-East Asia are also significant, with Singapore and Malaysia as the main sources of intraregional investment in that subregion. Although intra- and inter-regional FDI flows are much smaller in other subregions including South Asia, India is emerging as a key investor from that subregion.

Outward FDI flows from Asia and Oceania grew to \$69 billion (annex table B.1), driven by stronger outflows from most major economies in the region (figure II.8). Supportive government

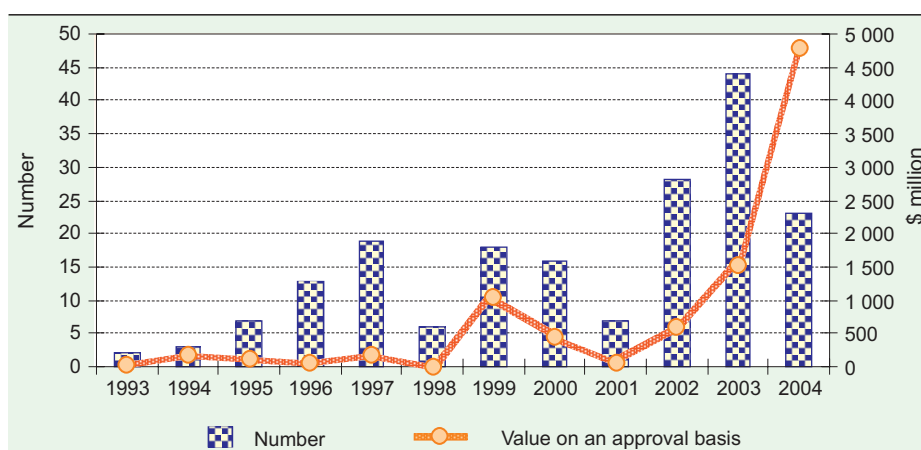
policies have played a role.<sup>35</sup> Outward FDI from Hong Kong (China) witnessed the most significant increase, jumping from \$5 billion in 2003 to \$40 billion in 2004. FDI from Singapore and the Republic of Korea also rose sharply, as did flows from China and India. For most developing Asian economies, FDI outflows are directed primarily at locations within the region. However, FDI outflows from Asia to other developing regions are increasing. For instance, in 2004, Latin America became the largest destination for Chinese investment, accounting for half of the total outflows from China due to

### Box II.7. Recent trends in FDI inflows in the Islamic Republic of Iran (concluded)

equity shares, in return for their outlay on the goods and services required for the execution of the projects.<sup>e</sup> As the Iranian Constitution currently prohibits the granting of petroleum rights on a concessionary or equity ownership basis, the Government supports buy-back arrangements as a way of attracting foreign capital and services in oil and gas industries (Islamic Republic of Iran, Chamber of Commerce, Industries and Mines, undated).

Political uncertainty in the region, however, is casting a shadow over the country's foreign investment climate and future growth. The escalation of international political tensions is an additional obstacle to attracting foreign investments to the Islamic Republic of Iran. This may affect FDI flows to the country for the next few years.

**Box figure II.7.2. Number and value of foreign investments<sup>a</sup> approved under the foreign investment laws of 1955 and 2002 in the Islamic Republic of Iran, 1993-2004**



Source: UNCTAD, based on Islamic Republic of Iran, OIETAI 2004.

<sup>a</sup> Includes, under the FDI law of 2002, FDI and foreign indirect (non-equity) investments (such as buy-back financing arrangements and build-operate-transfer schemes).

Source: UNCTAD.

<sup>a</sup> For example, FDI is not allowed in upstream activities in the oil and gas industries.

<sup>b</sup> Based on information provided by OIETAI.

<sup>c</sup> OIETAI was established in 1975 as an affiliate of the Ministry of Economic Affairs and Finance, and is legally empowered to serve as an IPA of the country under the 2002 FDI law.

<sup>d</sup> The investment law of 2002 defines two types of foreign investments, FDI and foreign "indirect" investment.

<sup>e</sup> See [www.petroleumiran.com](http://www.petroleumiran.com).

massive investments in natural resources. The largest FDI transactions by Indian companies were also in the natural resource sector in other regions: in 2004, the Oil and Natural Gas Corporation decided to invest \$1.1 billion in the Russian Federation and \$660 million in Angola. Asian investments in developed countries are also on the rise as illustrated by the acquisition of IBM's personal computers division by Lenovo (China), and by investment in FLAG Telecom (United States) and Tyco Global Network (United States) by India's Reliance and VSNL industrial groups respectively, in 2004.

### **b. Policy developments: favourable measures continue**

The policy environment for FDI in the region improved further over the past year (box II.8) as more countries introduced favourable policy measures with a view to increasing their economies' attractiveness for FDI. Countries also

cooperated in promoting investment: the ASEAN Finance Ministers conducted investment road shows in the United States in September 2004 and the First Asia Summit is scheduled to take place in December 2005 in Malaysia to strengthen economic cooperation and encourage intra-regional trade and FDI flows.

At the international level, countries of Asia and Oceania signed 33 new BITs in 2004 (figure II.10), accounting for 45% of the world total and bringing that region's total to 956. Afghanistan concluded its first BIT in that year (with Turkey), while China and the Republic of Korea added six and four new treaties, respectively, to their already long BIT lists. In West Asia, Lebanon concluded eight BITs, of which six were with African countries. Asian countries also signed 26 DTTs in 2004, bringing the total number of DTTs involving countries of this region to 870. The Islamic Republic of Iran was the most active in that respect, concluding four new DTTs.

#### **Box II.8. Some changes in national policies on inward FDI in Asia and Oceania in 2004-2005**

In *China* in 2004, several important policy changes took place. The Catalogue for the Industrial Guidance of FDI was revised in November to take into account commitments made by China in the context of its accession to the WTO. A number of industries have been added to the "encouraged" category, while some have been re-categorized from "encouraged" to "permitted" in order to control overheating investment of the domestic economy. China is further opening its services sector to foreign investment, for example by liberalizing rules on FDI in financial services, distribution services, media and education. In particular, stringent qualifications, ownership restrictions and geographical limitations previously imposed on FDI in distribution services (such as wholesale, retail and franchising) have been removed. Meanwhile, the National Economy and Social Development Plan 2005 emphasized the need to improve the quality of FDI by encouraging it in high-technology industries, advanced manufacturing, modern services and agriculture, and environmental protection. The plan encourages the establishment of R&D centres, regional headquarters and bases of advanced

manufacturing. It also welcomes the participation of foreign investors in the reform of State-owned enterprises.

In *India*, the Indian Investment Commission was charged with the responsibility of wooing private investors, both domestic and foreign. The Foreign Investment Promotion Board will become a one-stop service centre and facilitator for FDI. In 2004, foreign-equity ceilings in aviation services, private banks, non-news print publications and the petroleum industry were adjusted upwards.

In early 2005, the Government of *Indonesia* adopted the Jakarta Declaration outlining the Government's vision for infrastructure development, and underscoring its commitment to removing bureaucratic impediments to private investment. It also introduced a one-stop investment service.<sup>3</sup> A number of other measures are contemplated such as abolishing the requirement for foreign affiliates to sell part of their shares to local investors after a certain number of years of operation and removal of the 30-year limit on the validity of business licences for foreign investors.

/...

### Box II.8. Some changes in national policies on inward FDI in Asia and Oceania in 2004-2005 (concluded)

In the *Republic of Korea*, the Korea Trade-Investment Promotion Agency and its investment arm, Invest Korea, began to construct the Invest Korea Plaza in 2004, which will provide incubating facilities during initial investment stages and offer easy settlement services for foreign investors, in addition to existing one-stop services. Newly initiated corporate town projects as well as more free trade zones were launched in 2005. There has also been growing attention in recent years to attracting FDI in R&D (see Chapter VII).

In December 2004, the *Philippines* adopted a measure allowing the establishment of wholly-owned foreign affiliates in natural-resource-related activities.

In *Thailand* in 2004, the Board of Investment launched new investment packages for specific industries including the agro-industry, the high-end clothing (fashion) industry, the automotive industry, the ICT industry (in particular the hard disk drive industry) and high value-added services. The Skills, Technology, and Innovation tax privilege scheme was introduced to raise the technology levels and innovative capabilities of firms, while introducing special privileges to promote investment in the four northeastern provinces.

Source: UNCTAD.

<sup>a</sup> It takes 151 days in Indonesia to start a business due to the long process of obtaining a licence, compared with 33 days in Thailand, 30 days in Malaysia, 56 days in Viet Nam, 50 days in the Philippines and 41 days in China (World Bank 2005d).

In *West Asia*, most of the economies are making efforts to liberalize their FDI regimes and improve their investment climate (annex table A.II.2). All countries in the region (except for Qatar) have already established IPAs. In *Saudi Arabia's* negotiations for membership in the WTO have accelerated the country's liberalization of its FDI regulatory framework. Since 2003, *Turkey* has been implementing a series of investment-related reforms as well as a privatization programme in line with its planned negotiations on accession to the EU. In *Bahrain* and the *United Arab Emirates*, a noteworthy development is the liberalization of the real estate sector, a sector that is driving an intraregional investment boom both in construction and tourism development projects. Further liberalization in the financial sector in *Lebanon* may encourage large capital inflows, including from the Lebanese diaspora.

In *Oceania*, the amendment to the Foreign Investment Act in *Fiji* in 2004 applied the principles of the Convention on the Settlement of Investment Disputes, to which Fiji is a party. This amendment also provides for non-discrimination on grounds of nationality among foreign investors.

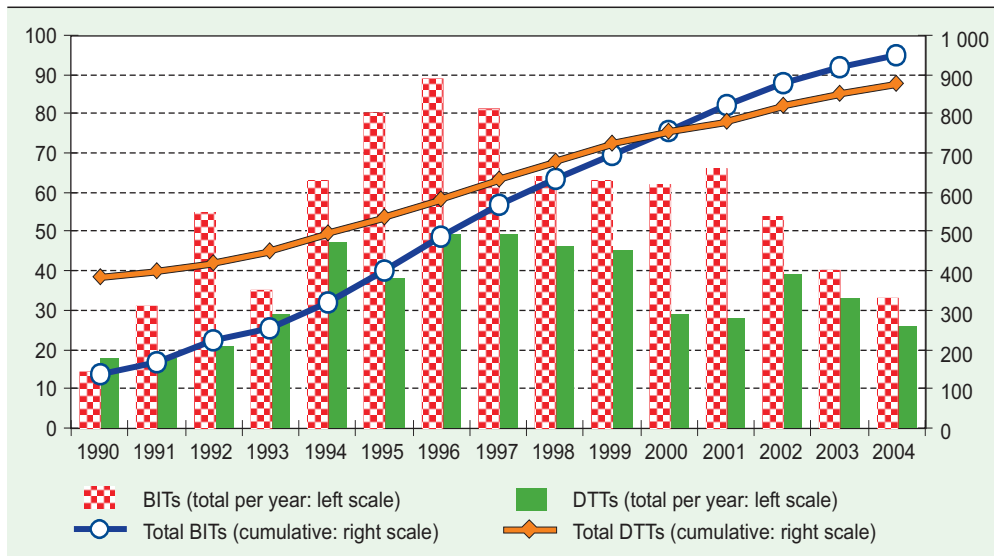
An increasing number of countries in 2003-2004 also signed or negotiated bilateral and regional FTAs that include investment provisions. ASEAN and China signed an agreement paving the way for establishing the world's largest free trade zone by 2010. ASEAN also concluded a Framework Agreement with India in October 2003 and a similar process is underway with Japan (box II.9). Members of the South Asian Association for Regional Cooperation (SAARC) are considering signing a regional agreement for the promotion and protection of FDI within the SAARC region.

In West Asia, a number of FTAs with FDI provisions at both bilateral and regional levels were signed or are under negotiation. Bahrain

and Jordan each signed an FTA with Singapore in 2004; Bahrain (2004) signed an FTA with the United States with a view to preparing for the United States-Middle East Free Trade Area by 2013. At the regional level, the Gulf Cooperation Council (GCC) signed a Framework Agreement on Economic Cooperation with India in August 2004 to pave the way for a future FTA with India. The GCC is also in negotiations with China for a similar agreement. Lebanon signed an FTA with EFTA in 2004 and a draft agreement to establish a free trade area with the GCC. The GCC may also sign an FTA with the EU before the end of 2005. Finally, the Aghadir Agreement signed in February 2004 by Egypt, Jordan, Morocco and Tunisia is a crucial step towards the creation of a subregional free trade zone.

**Figure II.10. Asia and Oceania: number of BITs and DTTs concluded, cumulative and annual, 1990-2004**

(Number)



Source: UNCTAD, BIT/DTT database ([www.unctad.org/iia](http://www.unctad.org/iia)).

### c. Prospects: increasingly bright

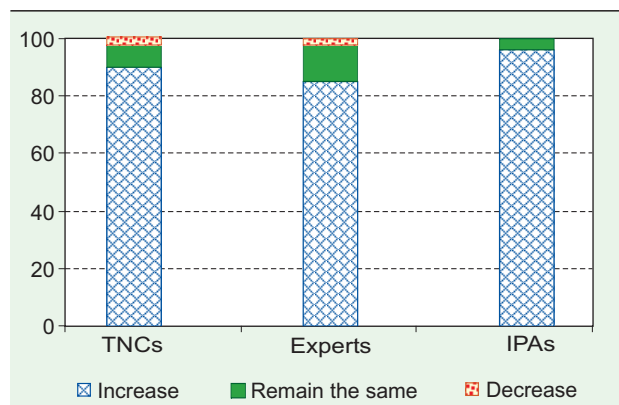
In view of the improved economic situation in the region, a better policy environment, and significant regional integration efforts, the prospects for FDI flows to Asia and Oceania in 2005 are highly positive: 85% of international experts, 90% of TNCs and 96% of IPAs responding to UNCTAD's 2005 survey (box I.3) anticipated increased FDI flows to Asia (figure II.11). This is even more optimistic than in the past, and is corroborated by a number of other surveys and reports (A.T. Kearney 2004, IIF 2005, PriceWaterhouseCoopers 2005, JBIC 2005). The recent increase in cross-border M&As in countries such as China, India and the Republic of Korea supports this optimistic assessment of FDI prospects in the region. However, flows are likely to remain concentrated in a few economies.

In 2003-2004 the increase in global demand for electronics and textiles augurs well for FDI in the region. FDI in ICT, as well as offshoring and outsourcing activities will continue to rise as services TNCs are driven by pressures to keep costs down. Many countries in the region will benefit because of their skills, cost and infrastructure advantages for such activities. Services FDI, encouraged by liberalization policies in industries such as finance, will continue to rise, thereby increasing the share of this sector in FDI flows to the region.

- East Asia is expected to receive the largest share of inflows, led by a further increase in flows to China. In this country, for instance, FDI will continue to rise in services, in particular in the banking industry. Large-scale foreign investments are expected in China's four largest State-owned banks before their initial public offerings.<sup>36</sup> Cross-border M&As are expected to rise in service industries in other countries. For example in finance in the Republic of Korea, Standard Chartered (United Kingdom) acquired Korea First Bank in 2005.

**Figure II.11. Asia and Oceania: prospects for FDI inflows, 2005-2006**

(Per cent of responses from TNCs, experts and IPAs)



Source: UNCTAD ([www.unctad.org/fdiprospects](http://www.unctad.org/fdiprospects)).



- FDI flows to South-East Asia should increase in 2005 for the third consecutive year. Japanese companies foresee that demand in their host country markets in ASEAN will expand, leading to higher profits in 2005.<sup>37</sup> Japanese manufacturers view Viet Nam in particular as a promising location for production. Agreements between Japan and ASEAN as a group, or its member countries individually, are expected to strengthen FDI relationships between Japan and countries in the subregion (box II.9). Intra-regional investment will also continue to rise as the region integrates further. FDI in natural resource-related activities is expected to rise significantly in the Philippines.
- In South Asia, flows to India should continue to increase, especially in steel, telecommunications, infrastructure and finance. In India, the Government aims to attract \$150 billion in the next decade by setting up special economic zones, science parks and free trade and warehousing zones.<sup>38</sup> Bangladesh will receive increased inflows as compared to 2004 primarily because of an increase in FDI from India. Flows to Pakistan are expected to increase partly as a result of privatization, especially in the telecommunications industry. Finally, the end of the textiles and clothing quotas should benefit countries such as Bangladesh, India and Pakistan in attracting more textiles-related FDI (UNCTAD 2005b).
- The global oil markets will largely determine the West Asia's economic outlook in 2005. Although oil production and prices may not remain at their present high levels (UNDESA and UNCTAD 2005), FDI in the subregion should rise in 2005, notably in the production and distribution of petroleum and liquefied natural gas. While FDI growth per se will be modest, foreign presence could rise as a result of non-equity contractual arrangements. Significant efforts by Turkey in the investment area will continue, including privatization in oil refining and telecommunications in the next few years.
- In the Oceania subregion 2005 is likely to be a year of recovery in FDI flows. Countries such as Samoa will experience higher FDI flows as a result of relatively large M&A deals including the acquisition by Virgin Blue (Australia) of a stake in the country's State airline in 2005.

**Box II.9. FTAs and economic partnership agreements between ASEAN or ASEAN member countries and Japan: implications for FDI**

Following the 2002 Agreement between Japan and Singapore for a New Age Economic Partnership, recent negotiations between other ASEAN member countries (in particular, Malaysia, the Philippines and Thailand) and Japan also cover a broad range of provisions on investment, movement of personnel, intellectual property rights (IPRs) and competition policies. According to the Japan External Trade Organization (JETRO) survey released in April 2005, on Japanese-affiliated manufacturers operating in six ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam) and India, some 60% of the companies surveyed expect that FTAs or economic partnership agreements (EPAs) between Japan and the region where they operate will benefit their

business activities.<sup>a</sup> On a country basis, more firms operating in Indonesia and Thailand than in other countries expect that such agreements will have favourable effects. Few respondents, however, expect improvements in their business activities as a result of FTAs or EPAs between China and Japan or between China and ASEAN: only 22%, for instance, foresee favourable effects from the EPA between China and ASEAN.

In another survey – the 2004 survey on overseas business operations of Japanese manufacturing companies by the Japan Bank for International Cooperation (JBIC) – 72% of all respondents expect to benefit from the conclusion of FTAs with Japan (JBIC 2005).

Source: UNCTAD.

<sup>a</sup> Information from JETRO, "Japanese business sentiment in Asia improved in April", press release of 21 April 2005 ([www.jetro.go.jp](http://www.jetro.go.jp)).

Prospects for FDI outflows from Asia and Oceania are also promising and should lead to increased intraregional FDI. An increasing proportion of the growth in outward FDI will be from Chinese, Indian and Korean firms, including through large-scale overseas M&As. The internationalization of Chinese enterprises will continue, including through investments outside Asia. In particular, significant Chinese investments are planned in natural resources (mainly in Latin America), steel (in Brazil in particular)<sup>39</sup> and real estate (for example, in the Russian Federation).<sup>40</sup> China is set to become a major foreign investor in Latin America (box II.13). Chinese investments in developed countries will also increase, as suggested by the recent bid made by CNOOC to acquire the United States oil firm, Unocal Corp.<sup>41</sup> Recent appreciation of the Chinese currency may contribute further to the increase in Chinese outward FDI.

### 3. Latin America and the Caribbean: FDI inflows rebound

Following four years of continuous decline, FDI flows to Latin America and the Caribbean registered a significant upsurge in 2004. Economic recovery in Latin America – after half a decade of economic stagnation – and stronger growth of the world economy were the main reasons for the rebound. High prices of primary commodities also played a role. At the same time the sectoral composition of inward FDI is showing signs of change in some parts of the region. In the MERCOSUR subregion, the manufacturing sector has re-emerged as the leading recipient of FDI inflows. Policy changes, particularly those related to extraction activities, could also affect FDI in some countries. Overall, FDI inflows in Latin America are projected to strengthen further in 2005.

#### a. Trends: a resurgence of FDI inflows in many countries

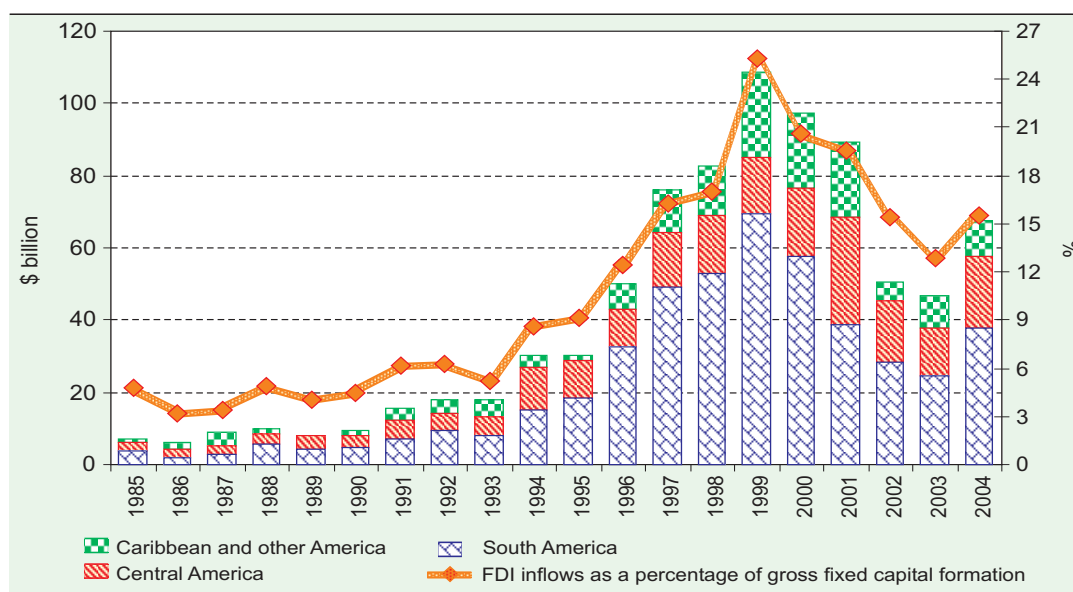
In 2004, FDI inflows into Latin America and the Caribbean rose for the first time in five years (figure II.12). They reached \$68 billion, 44% more than in 2003. However, they were still far below their average of the second half of the 1990s when large-scale privatizations and cross-border acquisitions of private firms triggered an

FDI boom. FDI as a percentage of gross fixed capital formation increased from 13% in 2003 to 15.5% in 2004 (figure II.12). Brazil and Mexico consolidated their positions as the largest recipients of FDI in the region (figure II.13 and table II.5). The steepest rises were seen in Argentina (125%), Brazil (79%) and Chile (73%). In Central America and the Caribbean, FDI inflows rose by 32%, to \$30 billion, owing mainly to a sharp increase in flows to Mexico. The situation was different in the Andean Community where total inflows remained unchanged from 2003, although the trend varied for different countries: FDI inflows rose in Colombia and Peru by 53% and 37%, respectively, while they fell in Venezuela, Ecuador and Bolivia.

A combination of internal and external factors contributed to the strong increase in FDI inflows to Latin America and the Caribbean in 2004:

- Strong economic growth in most of the countries in the region resulted in a significant increase in domestic demand, which attracted market-seeking FDI.
- Exchange rates remained at levels that favour competitiveness, although some currencies appreciated during 2004.<sup>42</sup> This stimulated FDI in export activities and in market-seeking activities in manufacturing.
- The boom in demand for commodities, especially in China, helped fuel FDI in minerals in Argentina, Brazil, Chile and Peru, as well as in oil and gas in Colombia, Peru and Trinidad & Tobago. It also had an indirect impact on FDI in other related activities such as the manufacture of trucks, farm machinery and extraction and exploration machinery, mainly located in MERCOSUR and dominated by TNCs.
- Windfall profits from higher commodity prices have increased reinvested earnings of resource-seeking TNCs in countries like Chile where undistributed corporate profits are subject to a lower tax rate than distributed dividends (17% instead of 35-42%). In Chile, reinvested earnings of foreign affiliates amounted to \$6.2 billion in 2004, corresponding to 82% of total inward FDI. These earnings were mainly generated by foreign affiliates in the mining sector, a sector that benefited from higher mineral prices.

**Figure II.12. Latin America and the Caribbean: FDI inflows and their share in gross fixed capital formation, 1985-2004**



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex tables B.1 and B.3.

- The continued recovery of the United States economy had positive effects on export-oriented FDI in the manufacturing sector in Mexico and Central America.
- Cross-border M&As made a strong comeback in the region with an increase of 109% in total value, their first upturn since 2000 (table II.6).

The decline in FDI inflows to Bolivia, Ecuador and Venezuela, most of which target hydrocarbon activities, is due to changes in oil and gas contracts in Venezuela, delays in adopting a new hydrocarbon law in Bolivia, and to the completion of the Crude Oil Pipeline (OCP) construction in Ecuador in 2003 that had previously been associated with significant amounts of FDI.

*FDI outflows* from Latin America grew at a modest 3.6% in 2004, their first increase since 2000, reaching \$11 billion, most of which came from Brazil (\$9.5 billion). The \$4 billion acquisition of the controlling shares of the brewer, Ambev (Brazil), by Interbrew (Belgium),<sup>43</sup> as well as unusual amounts of intra-company loans by Brazilian companies explains this high level of FDI from Brazil. Among the other 10 largest outward-investor countries in the region, only Mexico and Costa Rica increased their FDI outflows in 2004 (figure II.13).

The sectoral distribution of FDI in Latin America varies by subregion and country, and

is changing. The services sector has lost importance as a recipient of FDI in Argentina and Brazil since 2001. In Brazil, it was overtaken by the manufacturing sector in 2004, for the first time since 1996 (figure II.14). In Argentina, FDI inflows to services reached negative values in 2002 (figure II.15). In Mexico, FDI flows to the manufacturing sector recovered in 2004 and surpassed those in services for the first time since 2000. Conversely, in Central America and the Caribbean, the recent privatizations of public utility services in a number of countries contributed to the growing importance of services as recipients of FDI. In the Andean Community, high oil and mineral prices sustained the position of the primary sector as the main recipient of FDI inflows.

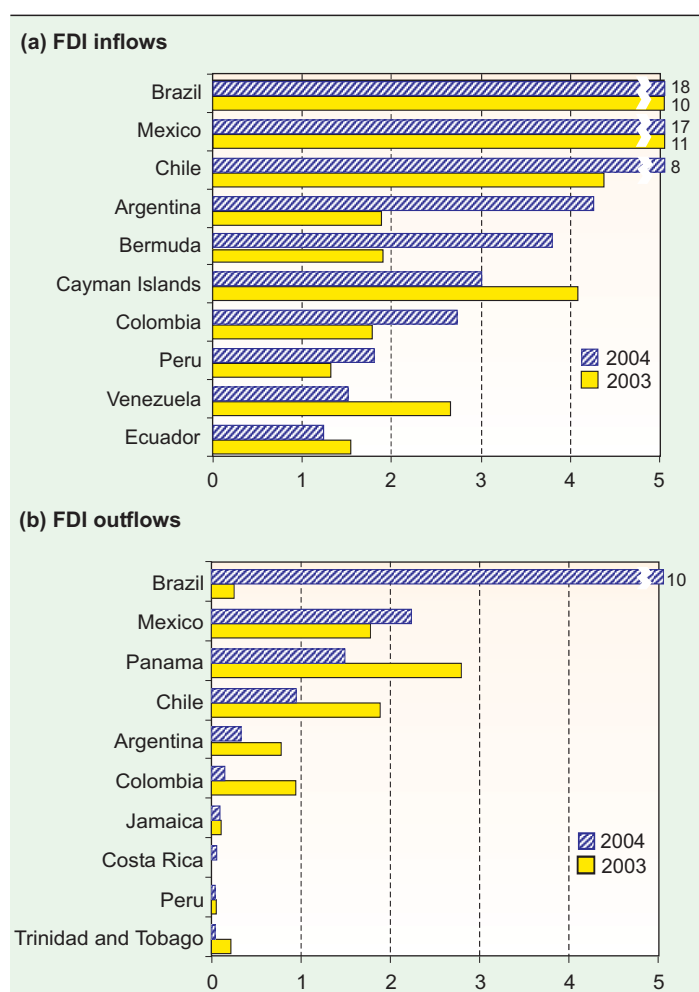
Several factors are behind the declining flows of FDI into services in Argentina and Brazil:

- the completion of most of the privatization programmes;
- strategic changes of some parent companies facing financial difficulties; and
- economic stagnation (1999-2003), devaluations and the rise of regulatory conflicts, which have made this sector less attractive to FDI since the early 2000s.

These factors provoked a number of divestments by foreign companies in the services sector, particularly in the telecoms, electricity,

**Figure II.13. Latin America and the Caribbean: FDI flows, top 10 economies,<sup>a</sup> 2003, 2004**

(Billions of dollars)



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Ranked on the basis of the magnitude of 2004 FDI flows.

banking and retailing industries (ECLAC 2003, 2004b). The service firms suffered most from the impact of the economic crisis. They faced serious difficulties in reducing their large foreign-currency liabilities incurred during their expansion phase. Because of the non-tradability of their activities they were often unable to refocus their strategy towards export-oriented production to take advantage of devalued currencies as some TNCs in manufacturing did.

In the case of Mexico, manufacturing began losing importance as a recipient of FDI in the early 2000s (figure II.16) for two main reasons: first, the emergence of the financial sector as an increasingly attractive area for FDI owing to the removal of all remaining market-share limitations on foreign ownership of national banks in December 1998; and second, the significant drop in FDI flows to the *maquila* industry during 2001-2003 due to a downturn in demand from the United States and rising competition from China. The strong recovery of FDI in the manufacturing sector in 2004 (by 64%), exceeding that in services, reflected new investments in the *maquiladora* industry, some large-scale M&A transactions<sup>44</sup> and improved domestic demand.

As in other regions, resource-seeking FDI into Latin America and the Caribbean was stimulated in 2004 by the high prices

**Table II.5. Latin America and the Caribbean: country distribution of FDI inflows, by range, 2003, 2004**

Range	2003		2004	
	Economy <sup>a</sup>		Economy <sup>a</sup>	
More than \$10 billion	Mexico, and Brazil		Brazil and Mexico	
\$5.0-9.9 billion	..		Chile	
\$1.0-4.9 billion	Chile, Cayman Islands, Venezuela, Bermuda, Argentina, Colombia, Ecuador and Peru		Argentina, Bermuda, Cayman Islands, Colombia, Peru, Venezuela, Ecuador, Panama and Trinidad and Tobago	
Less than \$1 billion	Trinidad and Tobago, Panama, Jamaica, Dominican Republic, Costa Rica, Uruguay, Honduras, Nicaragua, Bolivia, Aruba, Antigua and Barbuda, El Salvador, Bahamas, Guatemala and Saint Lucia, Grenada, Saint Kitts and Nevis, Barbados, Belize, Saint Vincent and the Grenadines, Paraguay, Anguilla, Guyana, Dominica British Virgin Islands, Haiti, Montserrat, Turks and Caicos Islands, Cuba, Suriname and Netherlands Antilles		Jamaica, Dominican Republic, Costa Rica, El Salvador, Uruguay, Honduras, Nicaragua, Bahamas, Belize, Guatemala, Aruba, Paraguay, Bolivia, Saint Lucia, Antigua and Barbuda, Anguilla and British Virgin Islands, Saint Kitts and Nevis, Saint Vincent and the Grenadines, Barbados, Guyana, Grenada, Puerto Rico, Dominica, Haiti, Montserrat, Cuba, Netherlands Antilles and Suriname	

Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

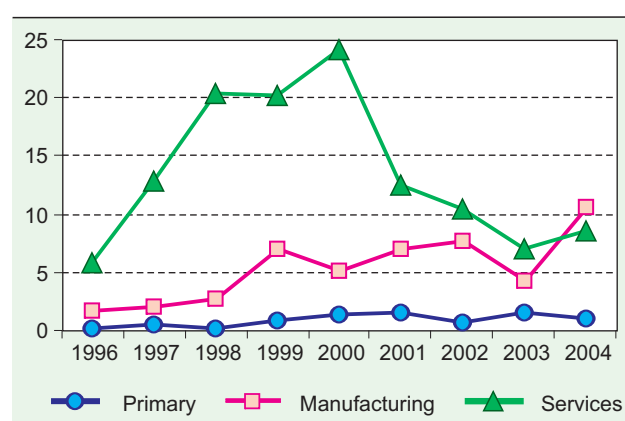
<sup>a</sup> Listed in order of the magnitude of FDI inflows for each respective year.

**Table II.6. Latin America and the Caribbean: distribution of cross-border M&A sales, by sector and industry, 2003, 2004**  
(Millions of dollars and per cent)

Sector/industry	2003		2004		Growth rate in 2004 (%)
	Value	%	Value	%	
<b>Primary</b>	<b>518</b>	<b>4.3</b>	<b>1 022</b>	<b>4.0</b>	<b>97</b>
Agriculture, forestry and fishing	45	0.4	26	0.1	-42
Mining	473	3.9	996	3.9	111
<b>Manufacturing</b>	<b>4 294</b>	<b>35.5</b>	<b>7 718</b>	<b>30.5</b>	<b>80</b>
Food, beverages and tobacco	1 175	9.7	4 182	16.5	256
Wood and wood products	220	1.8	348	1.4	58
Oil and gas; petroleum refining	1 490	12.3	1 070	4.2	-28
Chemicals and chemical products	192	1.6	631	2.5	229
Stone, clay, glass and concrete products	-	-	634	2.5	-
Metals and metal products	964	8.0	195	0.8	-80
Electrical and electronic equipment	113	0.9	565	2.2	403
Other manufacturing	141	1.2	93	0.4	-35
<b>Services</b>	<b>7 273</b>	<b>60.2</b>	<b>16 544</b>	<b>65.4</b>	<b>127</b>
Electricity, gas, and water distribution	334	2.8	190	0.8	-43
Hotels and restaurants	97	0.8	387	1.5	297
Trade	-	-	489	1.9	..
Transport, storage and communications	2 731	22.6	8 209	32.5	201
Finance	4 003	33.1	6 275	24.8	57
Business activities	62	0.5	744	2.9	1 099
Other services	46	0.4	250	1.0	444
<b>All industries</b>	<b>12 085</b>	<b>100.0</b>	<b>25 284</b>	<b>100.0</b>	<b>109</b>

Source: UNCTAD, cross-border M&As database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

**Figure II.14. FDI inflows by sector in Brazil, 1996-2004**  
(Billions of dollars)



Source: UNCTAD, based on data from Banco Central do Brazil.

of commodities. As discussed below, some countries have changed their taxes and legislation concerning non-renewable natural resource activities, specifically in the non-oil mining industry in Chile and Peru, and in the oil industry in Argentina, Bolivia and Venezuela, in order to increase the State's share in natural resource revenues. So far these changes do not seem to have had a major effect on FDI in non-oil mining. In 2004, \$774 million – more than one-fifth of

global exploration resources in non-oil mining – was invested in Latin American countries (Chaparro 2005). Moreover, significant non-oil mining projects in Argentina, Brazil, Chile and Peru have been announced since 2004 (annex table A.II.3).

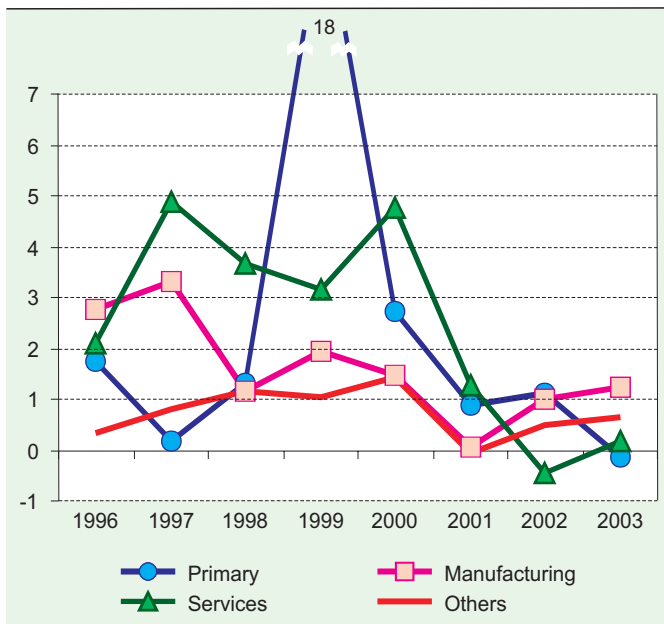
In oil and gas, TNCs have held back investing in Argentina, Bolivia and Venezuela pending the adoption of new regulations. However, high oil prices and the need for TNCs to maintain their reserve levels in a context of dwindling exploration opportunities elsewhere, are likely to sustain their interest in the region. As in the case of non-oil mining, significant projects and investment plans have been announced by TNCs in the hydrocarbons industry in Latin America since 2004 (annex table A.II.3).

Agricultural exports from Latin America and the Caribbean countries also enjoyed unusually strong growth in 2004. Overseas sales – particularly of soya beans but also of meats – were at record levels in Argentina and Brazil, notably as a result of strong demand from China. Some TNCs (e.g. Cargill (United States) and Bunge (United States)), have been positioning themselves to profit from this export boom.<sup>45</sup>

In manufacturing, TNCs registered higher sales than in 2003 in South America due to the region's economic recovery and the growth of



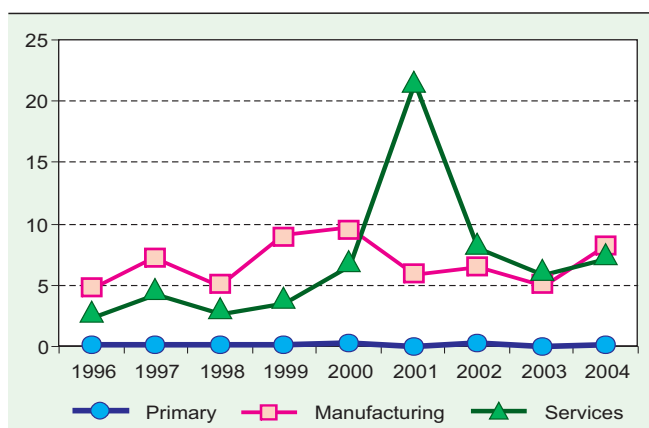
**Figure II.15. FDI inflows by sector in Argentina, 1996-2003**  
(Billions of dollars)



Source: UNCTAD, based on data from Instituto Nacional de Estadística y Censos (INDEC), Argentina.

Note: The steep rise in FDI inflows to the primary sector in Argentina in 1999 is due to the acquisition of the State-owned petroleum company, YPF (Argentina), by Repsol (Spain) for \$15.2 billion.

**Figure II.16. FDI inflows by sector in Mexico, 1996-2004**  
(Billions of dollars)



Source: UNCTAD, based on Secretaría de Economía de México, *Informe Estadístico Trimestral Sobre el Comportamiento de la Inversión Extranjera Directa en México*, Comisión Nacional de Inversiones Extranjeras, [www.economia.gob.mx](http://www.economia.gob.mx).

Note: The marked increase in FDI inflows to the services sector in 2001 was due to the acquisition of the Mexican bank Banamex-Accival by Citigroup (United States) for \$12.5 billion.

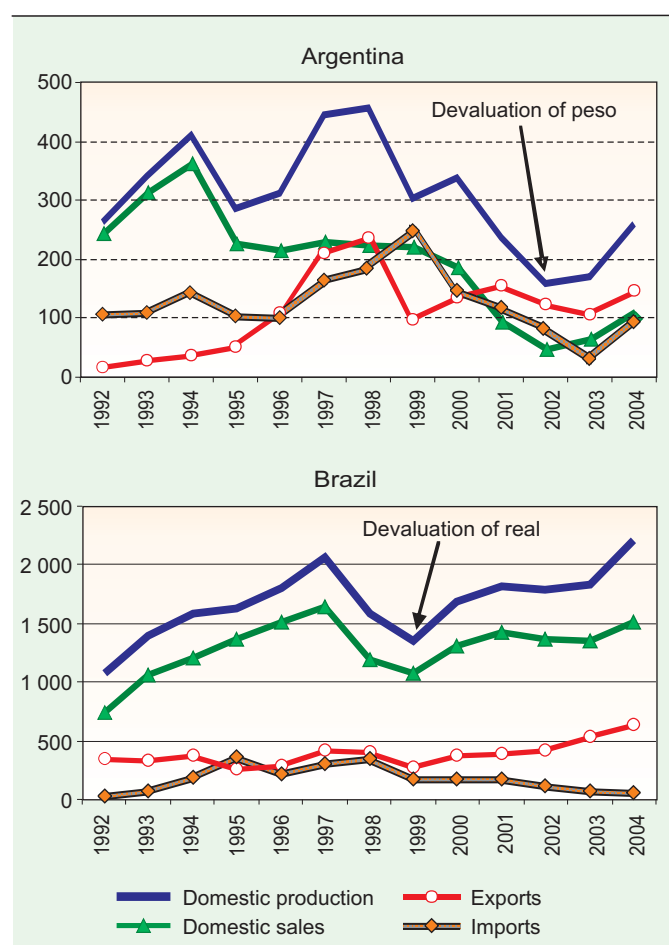
external demand. Investments by foreign companies were the most buoyant in the automotive, steel, food and beverage, and sugar refining industries. It was a boom year for the car industry in MERCOSUR: in Argentina – where the automobile industry had experienced poor performance since 1999 – production and export of vehicles jumped by 54% and 35% respectively (in units) in 2004, while domestic sales doubled. In Brazil, where the scale of automobile production is much larger than in Argentina, production, exports and domestic sales rose by 21%, 20% and 11% respectively (figure II.17). Car manufacturers announced important investment projects in 2004, mainly in Brazil, but also in Argentina, notably export-oriented projects in compact cars (annex table A.II.4). In Brazil, however, the industry's expectations have subsequently been adjusted downwards, mainly because of the continued strength of the country's currency, relatively high interest rates and declining sales abroad during the first few months of 2005.<sup>46</sup> FDI in the automobile industry that targeted the MERCOSUR market during the 1990s is shifting towards export-oriented production for markets outside MERCOSUR (box II.10).

The recovery of United States demand and the devaluation of the currencies in the dollar zone (i.e. currencies which move more or less in conjunction with the dollar) have also increased the interest of carmakers in investing in Mexico. According to the Mexican automotive industry association, carmakers are planning to invest some \$5.5 billion in the country between 2004 and 2007.<sup>47</sup> In fact several TNCs have already started, or have announced, new projects in the country (annex table A.II.4). The conclusion of an FTA with Japan is also likely to improve Mexico's position as a recipient of FDI in the automotive industry. This agreement, scheduled for implementation in spring 2005, is part of Mexico's strategy of reducing its heavy dependence on the United States market. It is expected to raise Japanese FDI in the automotive industry to an estimated \$1.3 billion per year up to 2015.<sup>48</sup>

Strong global demand is encouraging investment in Brazil's steel industry. The Brazilian Steel Industry (IBS) predicts investment (foreign and domestic) of \$13 billion in 2005-2010, most of it in the form of new outlays.<sup>49</sup>

**Figure II.17. Automotive industry in Argentina and Brazil: production, domestic sales, exports and imports, 1992-2004**

(Thousands of units)



Source: UNCTAD, based on Asociación de Fábricas de Automotores (ADEFA), [www.adefa.com.ar/](http://www.adefa.com.ar/); Associação Nacional dos Fabricantes de Veículos Automotores (Anfavea), [www.anfavea.com.br/](http://www.anfavea.com.br/).

TNCs in the food and beverages industry of Latin America have benefited from growing exports and higher purchasing power in domestic markets, with consumers increasingly basing their buying decisions on brands, rather than prices, and returning to premium brands. This behaviour has boosted business for producers of well-known branded foods – where TNCs have a strong presence. Some firms have announced new investments,<sup>50</sup> while others have been engaged in acquisitions in search of stronger market position. In beverages, for instance, the most notable deal is the merger between AmBev (Brazil) and Interbrew (Belgium) (mentioned earlier), and in foods it is the acquisition by Arcor (Argentina) of a majority stake (51%) in Danone's (France) cookie and biscuit activities in South America.

Sugar refining in Brazil is becoming attractive to investors mainly because of the shift of car manufacturers in that country towards flex-fuel vehicles that run on sugar-cane-based alcohol as well as petrol.<sup>51</sup> Foreign and local companies are reported to be planning investments of some \$3 billion in Brazil's sugar-cane-based ethanol industry.<sup>52</sup>

FDI in the *maquiladora* industry in Mexico surged in 2004, with a 26% increase, after three consecutive years of decline, as United States demand picked up. *Maquila* exports were 13% higher than in 2003 and employment levels rose for the first time since 2000, registering a 5% increase. However, there is still some way to go to recover the 300,000 jobs that were lost between end 2000 and end 2003 (figure II.18). Employment trends were uneven across industries. Labour-intensive industries such as textiles and clothing, footwear and toys continued to witness a decrease in employment, while the electrical and electronic products industry registered the biggest rise (8% growth).<sup>53</sup> Some attribute the upsurge in the electrical and electronics industry to the return of some enterprises that had moved to China after that country entered the WTO in 2001. Motorola, for example, inaugurated its new plant in Nogales in April 2005. Others point to the relocation of some United States firms to Mexico in response to the challenge posed by Asian competitors.

In Central America and the Caribbean, FDI in manufacturing is concentrated in labour-intensive activities, mainly in the apparel industry, where TNCs have set up assembly operations for exports almost exclusively to the United States. Six countries are important export platforms in this respect: Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras and Nicaragua. The removal of textiles and clothing quotas in January 2005 has raised concerns about the future of the apparel industry in the six countries.<sup>54</sup> Some fear that the impact could be similar to that of the entry of China into the WTO in 2001, which, combined with the slowdown in United States demand, led to the stagnation of United States apparel imports from Central America (figure II.19) (UNCTAD 2005b).<sup>55</sup> Competition exists not only with China, but with other Asian countries such as India, Bangladesh and Turkey. The industry could survive if Central American and Caribbean

### Box II.10. MERCOSUR: FDI in the automobile industry is targeting broader export markets

During the 1990s, TNCs made large market-seeking investments in the automotive industry in Brazil and Argentina. By the early 2000s, an estimated \$20-25 billion was invested – divided roughly four-to-one between Brazil and Argentina. The economic crises suffered by countries in the MERCOSUR subregion from the second half of the 1990s until 2003 severely affected the automotive industry and disrupted initial strategies aimed at the expanding MERCOSUR market.

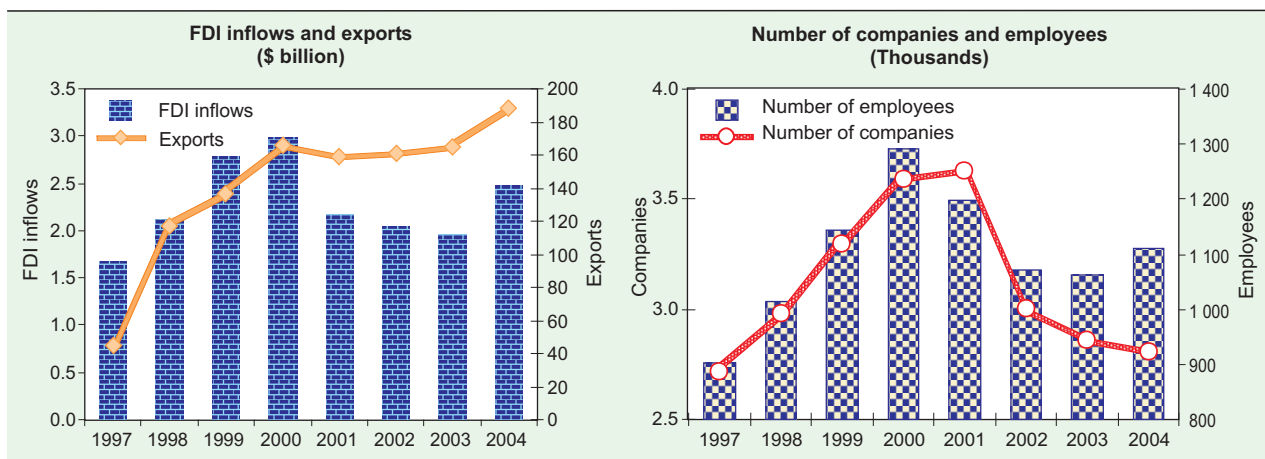
The devaluation of the Brazilian real in 1999 and of the Argentinean peso in 2002 improved the export competitiveness of the two countries and encouraged TNCs in the automobile industries to use their capacity increasingly to produce for export markets outside MERCOSUR. At the same time, TNC producers reorganized

their Latin American production networks: MERCOSUR affiliates specialized in small, low-cost vehicles with high fuel economy directed towards consumers with lower purchasing power, while Mexican affiliates focused on more expensive models, targeting consumers with high purchasing power, mainly in the United States (ECLAC 2004b).

Bilateral agreements between MERCOSUR member countries and Mexico, which entered into force in January 2003, supported this new export strategy through the reduction of tariffs and implementation of import quotas. Significant increases of automobile exports from Argentina and Brazil to Mexico have been registered since then, making Mexico the main destination of MERCOSUR countries' vehicle exports, followed by the United States and Chile.

*Source:* UNCTAD, based on ECLAC 2004b; "Latin America: Industry forecast: Getting up to speed", *Business Latin America*, 17 May 2004 (London: EIU); Asociación de Fábricas de Automotores (ADEFSA), [www.adeffa.com.ar/](http://www.adeffa.com.ar/); Associação Nacional dos Fabricantes de Veículos Automotores (Anfavea), [www.anfavea.com.br/](http://www.anfavea.com.br/); United Nations Comtrade database; La Razón, [www.larazon.com](http://www.larazon.com).

Figure II.18. *Maquila* industry in Mexico, 1997-2004



*Source:* UNCTAD, based on Instituto Nacional de Estadística, Geografía e Informática (INEGI) of Mexico.

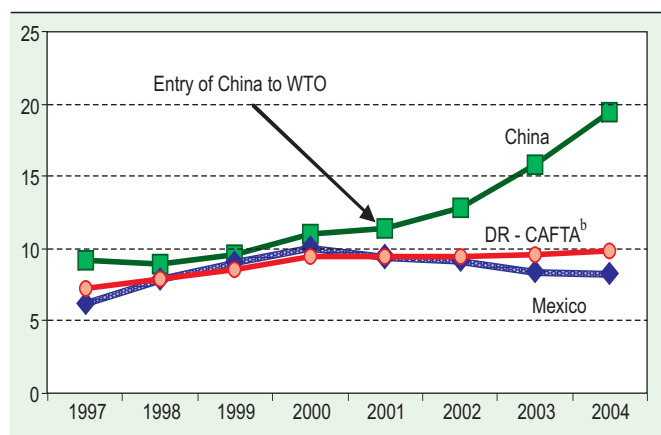
countries carefully evaluated their competitive advantages over the Asian countries (box.II.11) while building a strategy to go beyond the *maquila* model and diversify their export markets.

In service-related activities, asset divestments by foreign firms that had begun in the early 2000s are continuing, for example, Royal Ahold (Netherlands) and Carrefour

(France) in the retail industry as well as Bellsouth and AT&T in the telecom industry have sold part or all of their assets in the region. These withdrawals have given opportunities to competitors – including Latin American TNCs (e.g. Chilean retailer Cencosud, the Mexican telecom company Telmex)<sup>56</sup> – to expand. Other withdrawals are envisaged in telecom, electricity, gas and water activities.<sup>57</sup>

**Figure II.19. United States imports of apparel and textile products<sup>a</sup> from selected countries and regions, 1997-2004**

(Billions of dollars)



Source: UNCTAD, based on data from the United States International Trade Commission, [www.usitc.gov](http://www.usitc.gov).

<sup>a</sup> Includes textiles and fabrics (NAICS-313), textile mill products (NAICS-312) and apparel and accessories (NAICS-315).

<sup>b</sup> The signatory countries of DR-CAFTA with the United States comprise: Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras and Nicaragua.

### **b. Policy developments: some changes in the area of natural resources**

FDI has received favourable treatment in most Latin American countries as part of a broader free-market and liberalization policy put in place in the 1990s. This includes preferential treatment through, for instance, special tax regimes,<sup>58</sup> debt-to-equity swap mechanisms<sup>59</sup> and access to investor-State dispute settlement mechanisms.

To a large extent, policy-makers sought to target a large volume of FDI on the assumption that it would make a vital contribution to economic development. This led to the view, shared by a number of experts, that “in recent years the region’s FDI policies have focused almost exclusively on attracting FDI, with no concern for selecting or channelling it according to national developmental priorities. That is, FDI policies tended to reflect short-term macroeconomic priorities much more than the requirements for productive development”.<sup>60</sup>

The deterioration of the economic situation during the period 1999-2003, reflected by the stagnation of the regional economy and increase in unemployment and poverty, led to widespread disenchantment with the results of the economic reforms related to FDI promotion and

privatization.<sup>61</sup> The discontent has in some cases had repercussions at the policy level. In public utility services, several recent initiatives were either cancelled or suspended, such as in water services in Bolivia, telecommunications in Paraguay and electricity in the Dominican Republic, Ecuador and Peru. In Argentina, the relationship between the Government and the privatized enterprises – now foreign affiliates of TNCs – had deteriorated since the end of the “convertibility” regime in January 2002. The incentives used in that country to attract FDI during the 1990s turned out to be unsustainable when economic conditions changed. To address the deepest economic recession the country had ever known, the authorities implemented a series of measures that proved successful in restoring economic recovery and growth. However, some of these measures led a significant number of foreign firms – mainly public utilities – to resort to international arbitration (box II.12).

In natural resource activities, social and political pressures, fuelled by the strong rise in commodity prices, are pushing governments in some countries of Latin America and the Caribbean to modify their tax regimes and change existing legislation:

- In *Argentina*, taxes on oil exports were increased from 20% to a range of 25-45%, depending on the level of the international price of oil. Moreover, after an energy shortage attributable to insufficient investment in the oil industry – entirely privatized in the 1990s and mainly comprising foreign affiliates – the Congress approved a bill, introduced by the Government in October 2004, to create a State-owned petroleum company *Energía Argentina Sociedad Anónima (ENARSA)*.<sup>62</sup> The latter has formed joint ventures with *Petróleos de Venezuela (PDVSA)*, *Lukoil* (Russian Federation), *Sinopec* (China) and *Brazil’s Petrobrás* to explore offshore areas.
- In *Bolivia* – where petroleum activity was privatized in the 1990s – a new *Hydrocarbon Law* was approved in May 2005 by both the Parliament and the Senate. It increases taxes on oil production from 18% to 50% and requires producers to accept new contracts based on State ownership of well-head gas in line with the results of a referendum in July 2004.<sup>63</sup>



### Box II.11. Can the apparel industry in Central America and the Caribbean compete with Asia for the United States market?

The high level of competitiveness of Asia's apparel industry stems not only from lower wages, but also from the reorganization of that industry into an integrated system of production that encompasses all phases, from inputs to completed products. The integrated system of production in Asia has boosted the development of a strong regional cluster in textiles and apparel. It offers rapid and cheap access to a vast supply of specialized inputs for the industry (fibres, yarns and fabrics) as well as access to diversified export markets. The competitive advantage of the Central American and Caribbean countries in the industry has, by contrast, been derived from a combination of factors, including low wages,<sup>a</sup> export processing zones and preferential access to the North American market – characteristics that make them well suited to final product assembly (ECLAC 2004b). The apparel industry in Central America is specialized in catering to a single export market – that of the United States. Exports are, moreover, strongly dependent on a production-sharing mechanism.<sup>b</sup> This mechanism has led foreign apparel firms operating in these countries to use expensive United States inputs, while keeping domestic value added low (ECLAC 2004b).

Central American countries have two advantages over Asia: geographic proximity to

the United States, which offers the opportunity to deliver goods faster than China or other Asian countries can do, and to respond quickly to changes in United States market conditions and special demands; and duty-free access to the United States market for textile and apparel exports under the United States-Caribbean Basin Trade Partnership Act (CBTPA), provided the yarns, fabrics and threads are imported from the United States.

In 2004, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua and the United States signed the United States-Dominican Republic-Central America Free Trade Agreement (DR-CAFTA).<sup>c</sup> The commercial part of this agreement transforms the unilateral United States concessions of the CBTPA into preferential treatment by each party for goods imported from any other party. It relaxes the rules of origin by extending the agreement to regional inputs and making it more flexible for some specific products; but, generally, it fails to secure tariff preferences for exports within the DR-CAFTA region that use cloth and materials from third countries outside the region. The latter would have allowed the region to import competitive inputs, including from Asia, and to compete better with Asian final producers no longer restricted by quotas.

*Source:* UNCTAD, based on IADB 2004, ECLAC 2004b, Quinteros 2004, UNCTAD 2005b.

- <sup>a</sup> There are some exceptions: for example, the Costa Rican apparel industry uses a qualified workforce and is specialized in niche markets.
- <sup>b</sup> The production-sharing mechanism allows imports incorporating United States-made components to enter the United States either free of duty or at reduced duties.
- <sup>c</sup> At the time of writing this report, DR-CAFTA had been ratified by Guatemala and El Salvador and still needs to be ratified by each of the other parties before it can enter into force.

### Box II.12. The need to weigh the costs and benefits of incentives to FDI: the experience of Argentina

Argentina's privatization of public utility firms is an example of the need for policy-makers to weigh carefully the costs and benefits of incentives for FDI. At the beginning of the 1990s, a programme to privatize public utility firms was launched, which set bidding conditions that made it necessary for interested local firms to associate with foreign ones and offered incentives such as a debt-to-equity swap mechanism. Further incentives were added shortly after privatization:

some taxes were reduced or eliminated and new clauses were introduced to the contracts in which utility rates were denominated in dollars and indexed to the United States' inflation index. During the same decade, Argentina signed 54 BITs to provide security and guarantees for investors.

Problems began to surface when economic conditions in the country deteriorated. Economic contraction, massive withdrawals of banking

/...



### Box II.12. The need to weigh the costs and benefits of incentives to FDI: the experience of Argentina (concluded)

deposits and a rapid decline in international reserves forced the Government in January 2002 to abrogate the convertibility law that fixed the peso's exchange rate at par with the United States dollar. The trebling of the value of the dollar in local currency that resulted, in the context of deep economic recession, led the Government to transform all the dollar-denominated contracts into national-currency-denominated contracts, including those signed with public utility firms. The periodic adjustments of public utility tariffs based on foreign inflation indices were also eliminated.

In the following months a number of foreign investors resorted to arbitration by the International Centre for Settlement of Investment Disputes (ICSID) and other fora. Indeed, 37 out of the 40 arbitration cases to which the Argentine Government is party (as of June 2005) were registered after the 2002 emergency measures were introduced, and are related, at least in part, to the financial crisis. A majority of these cases were launched by public utility firms claiming breach of contract and violation of treaty guarantees provided under BITs, such as fair and equitable treatment or guarantee against (indirect) expropriation.

Argentina has stated that “it has not offered any guarantee concerning the maintenance of the convertibility system and in case of devaluation of its currency, because the Government could not have assumed an obligation to follow any specific economic or exchange policy since it can freely modify those policies.”<sup>a</sup> In Argentina's view, its actions had been rendered necessary by an imminent economic, financial and social crisis in the country, and it thus referred to a state of necessity. Argentina has also contended that “the emergency measures adopted by the Government are to be considered as economic policy regulatory

measures that do not give right to compensation. They were instrumented through legislative acts of general scope, non-discriminatory, and therefore applicable to both Argentine and foreign nationals without any distinction. They are temporary in nature and oriented at the protection of public welfare interests, with a view to normalize the life of the country, to guarantee the continuity of public utilities and to keep rates for customers at an affordable level.”<sup>a</sup>

At the same time, the Government has been negotiating gradual tariff increases with privately-owned public utilities provided that international claims are withdrawn. At least one complainant – the energy company Pioneer Natural Resources (United States) – withdrew its complaint in April 2005, and negotiations with other energy firms such as AES (United States), Gas natural BAN (Spain) and Edesur (Spain) are reported to be at an advanced stage.

An ICSID tribunal rendered a first award in the long list of pending cases on 12 May 2005. The tribunal ordered Argentina to pay \$133.5 million plus interest in compensation to CMS<sup>b</sup> on the grounds of breach of contract and violation of the BIT between Argentina and the United States. The tribunal rejected Argentina's arguments based on a state of necessity as well as the investor's contention that it had suffered an indirect or regulatory expropriation of its investment.

At the time of writing this report, it is not known whether Argentina or CMS will initiate any of the procedures established in Chapter IV, Section 5 of the ICSID Convention<sup>c</sup> in relation to this award. Some officials have mentioned, however, that considering the scope of ICSID arbitration awards, their validity could be challenged in Argentina's Supreme Court.

*Source:* UNCTAD, based on ICSID 2005, IISD 2005, Azpiazú 2004, Bouzas and Chudnovsky 2004, Alfaro 2004, “La española Gas Natural Ban retira su demanda contra la Argentina”, *Clarín*, 15 March 2005; “AES retiró su demanda en el Ciadi y se acelera el acuerdo”, *La Nación*, 15 April 2005, “Acuerdo del Gobierno y Edesur para subir tarifas”, *La Nación*, 12 June 2005, and communication from the Mission of Argentina to the United Nations office in Geneva.

<sup>a</sup> Official communications from the Government of Argentina.

<sup>b</sup> The tribunal also decided that after the payment of the compensation CMS will transfer its assets in its Argentinean affiliate to the Argentinean State, provided the latter makes the payment of an additional \$1.1 million. The tribunal gives Argentina a period of one year in which to accept such a transfer (ICSID 2005).

<sup>c</sup> Section 5 of Chapter IV deals with the “interpretation, revision and annulment of the award”.

- In *Chile*, the Congress approved a law in May 2005 creating a tax of 5% on the operating profits of non-oil mining groups with an aggregate annual output of 50,000 tonnes or more of fine copper equivalent. The new tax, effective in January 2006, will be deposited in a fund to finance innovation and R&D activities generally so as to prepare for the time when mining resources are exhausted.
- In *Peru* the Congress approved a bill to charge royalties ranging between 1 and 3% on non-oil mining outputs.
- In *Venezuela*, the Government increased royalties on extra-heavy oil from 1% to 16.67% in October 2004. Later, in April 2005, it announced that 32 oilfield operating contracts with foreign oil companies, which account for almost one-quarter of total oil production, would be cancelled by the end of the year and renegotiated under new terms. Income taxes and royalty levels will be higher, and Venezuela's State-owned oil company, *Petróleos de Venezuela (PDVSA)*, will hold a majority share in the ventures. To be allowed even to enter into talks for new deals, operators may have to pay compensation for underpaying their income tax, which the Government is claiming they have been doing since 2000.<sup>64</sup>

These policy changes show growing concern in Latin America and the Caribbean countries regarding the impact of FDI on their economies, in particular in the area of natural

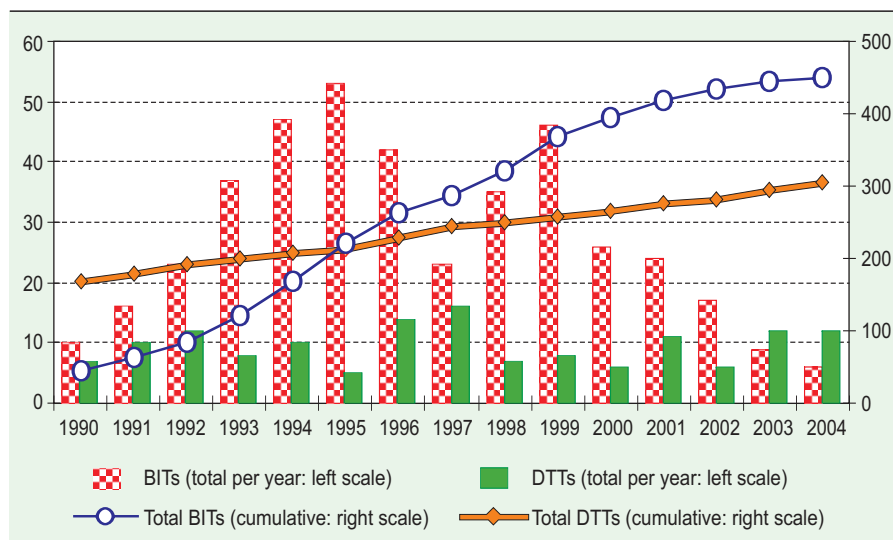
resources. It does not mean, however, that openness to FDI in the region is being reversed. For instance, a number of policy changes that can have a favourable impact on FDI also took place in these countries in 2004, including a new investment promotion regime in Argentina for investments in capital goods in manufactures and infrastructure;<sup>65</sup> a new industrial and innovation policy in Brazil that gives incentives to investments in targeted sectors (ECLAC 2005); measures to end monopolies in mobile telecommunications in Barbados and in the telecom sector in Cayman Islands; removal of limitations to foreign ownership in the transport industry in Guatemala; and a reduction of the corporate income tax rate (for both foreign and local firms) in Barbados, Mexico and Uruguay.

At the bilateral level, Latin American countries signed 12 DTTs and 6 BITs during 2004 (figure II.20). Among the latter, the BIT signed between Uruguay and the United States was the first agreement based on the new United States model BITs text. The total number of BITs and DTTs involving Latin American countries reached 451 and 306 respectively at the end of 2004.

At the regional level, an FTA between Central America, the Dominican Republic and the United States of America (DR-CAFTA), the Free Trade Agreement between the Caribbean Community (CARICOM) and Costa Rica as well as one between Mexico and Japan for the Strengthening of Economic Partnership (all three

**Figure II.20. Latin America and the Caribbean: number of BITs and DTTs concluded, cumulative and annual, 1990-2004**

(Number)



Source: UNCTAD, BIT/DTT database ([www.unctad.org/ia](http://www.unctad.org/ia)).

with substantive investment disciplines) were concluded. Other agreements with investment provisions signed in 2004 include the Partial Reach Agreement for Economic, Trade and Investment Promotion between Argentina and Bolivia as well as the Comprehensive Economic Cooperation Agreement between Chile and India.

### c. Prospects: growing opportunities

FDI flows to Latin America and the Caribbean are expected to rise further in 2005-2006 as most of the driving forces behind FDI growth in 2004 still exist. The macroeconomic environment in the region has improved, and economic growth is expected to remain robust in 2005 (around 4%) (IMF 2005, UNCTAD 2005c). After a prolonged period of economic stagnation (1999-2003), investments are required that will help modernize and expand production capacity and to remove infrastructure bottlenecks mainly in energy roads and ports to meet growing internal and external demand. In addition, the economic recovery in Argentina and the successful restructuring of its external debt have removed a source of macroeconomic instability in the Southern Cone region.

UNCTAD's 2005 survey (box I.3) also shows positive prospects for FDI in Latin America and the Caribbean, though the outlook is less optimistic than for countries in Asia and Oceania or South-East Europe and the CIS. The majority of IPAs in Latin America and the Caribbean, along with two out of five FDI experts and one out of three TNCs, expect FDI to the region to increase, while about half the FDI experts and two out of three TNCs expect it to remain at the same level (figure II.21).

FDI is likely to grow unevenly across sectors and subregions. In the *primary* sector, where projects are concentrated in the South American countries, FDI inflows should continue to be attracted by relatively high levels of commodity prices driven by strong world demand. Taxes and legislative changes aimed at increasing the State's share in natural resource revenues have not prevented TNCs from announcing important projects in 2004 and 2005. Higher prices and the entry of new investors seem to be improving the bargaining position of governments. Growing demand for resources such as oil, copper, iron ore and soybeans is increasing developing-country firm's interest as well in investing in Latin America (as noted in the

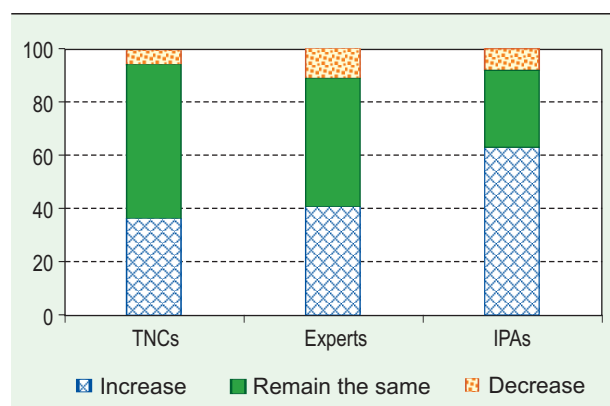
previous section on Asia and Oceania). For example, high profile visits with public statements of large investment plans, and the signature of several cooperation agreements, accompanied by the actual launching of new projects, have raised expectations of a substantial increase in Chinese investments in the region in coming years (box.II.13).

In *manufacturing*, the Governments of Argentina and Brazil have shown interest in developing supportive policies, with incentives directed to specific areas identified as priorities. At the same time, there is risk of a slowdown in investment projects in Brazil due to the continued strength of the currency and high interest rates.<sup>66</sup> In the case of FDI in the *maquiladora* industries of Mexico, Central America and the Caribbean, prospects are mixed. Economic growth in the United States is expected to register a moderate slowdown, but should nonetheless remain at 3-3.5% in 2005 (IMF 2005, UNCTAD 2005c). Of greatest concern to those industries is increasing competition from Asian countries. However, as far as the automobile industry is concerned, investment projects launched or announced in 2004 and 2005 in Mexico would guarantee significant FDI flows into the industry (and hence into the manufacturing sector as a whole) in the short term.<sup>67</sup>

In *services*, DR-CAFTA is expected to facilitate FDI in Central America, mainly by United States and Mexican firms, although the ratification of the agreement is still uncertain.<sup>68</sup>

**Figure II.21. Latin America and the Caribbean: prospects for FDI inflows, 2005-2006**

(Per cent of responses from TNCs, experts and IPAs)



Source: UNCTAD ([www.unctad.org/fdiprospects](http://www.unctad.org/fdiprospects)).

### Box.II.13. China's new investment interest in Latin America

China's interest in Latin America is a fairly new phenomenon that has developed along with the steady increase of its imports – mostly of natural resource products – from the region. China's imports from Latin America rose more than fivefold between 2000 and 2004, reaching \$20.2 billion; this increased the region's share in total Chinese imports from 2.1% to 3.6%.<sup>a</sup>

The visit of the President of China to Brazil, Argentina, Cuba and Chile in November 2004, accompanied by some 200 Chinese business people, demonstrates the growing interest of Chinese TNCs in Latin America. In a speech to the Brazilian Congress during this visit, it was announced that China would invest \$100 billion in Latin America over the next 10 years,

particularly in railways, oil exploration and construction projects in Argentina; a nickel plant in Cuba; copper mining projects in Chile; along with steel mill, railway and oil exploration projects in Brazil. This reflects the new Chinese strategy in Latin America of securing access to natural resources through FDI.

While Chinese companies already own stakes in minerals operations in Ecuador, Peru and Venezuela, among others, China intends to expand its trade and investment activities in the region. Moreover, the country has signed 14 cooperation protocols with Brazil and 19 with Venezuela. In addition, China and Chile announced in 2004 that they would be negotiating a bilateral free trade agreement.

*Source:* UNCTAD, based on “Abren la puerta para negocios con China por US\$ 20.000 millones”, *Clarín*, 16 November 2004, “Brazil/Argentina: China's long-term commitments”, *Business Latin America* (London: EIU), 15 November 2004; “Brazil: Lula's China commitments”, *Business Latin America* (London: EIU), 7 June 2004, “Brazil: China appeal”, *Business Latin America* (London: EIU), 17 May 2004, Dumbaugh and Sullivan 2005.

<sup>a</sup> Data from United Nations COMTRADE database.

In the Southern Cone countries, privatizations are likely to be modest due to the near-completion of the process. However, the consolidation of the subregion's economic growth is likely to revive the interest of foreign investors, particularly leading Latin American TNCs that would like to continue expanding regionally.

As regards FDI outflows from the region, a further increase can be expected in the coming years. Leading Latin American TNCs are expected to continue to expand, principally to neighbouring countries and regionally, though global expansion is also likely to increase. This is in line with the growing transnationalization of firms from developing countries in recent years.

In conclusion, the recovery of economic growth in Latin America, higher demand for commodities and policy support to manufacturing activities in some countries are opening up new business opportunities for foreign investment in the region. These opportunities are somewhat different from those that prevailed during the peak period for FDI in the 1990s; they are likely to be more in manufacturing, construction and natural resources, than in the services sector, and to involve the creation of new assets more than

the acquisition of existing ones. Moreover, they are expected to engage new actors, such as Chinese firms, and to give more prominence to Latin American TNCs. Finally, as most of the drivers behind the resurgence of FDI in the region relate to developments in the Southern Cone, FDI is expected to be more buoyant in South America than in Mexico, Central America and the Caribbean in 2005 and beyond.

## B. South-East Europe and the CIS: FDI rises for the fourth year in a row

### 1. Trends: FDI inflows sharply up

FDI *inflows* to South-East Europe and the CIS, a new regional grouping of economies introduced in this *WIR* (box I.2), recorded their fourth year of growth in 2004, reaching an all-time high of \$35 billion (figure II.22). Trends in inward FDI to the two subregions differ somewhat, however, reflecting the influence of divergent factors. In South-East Europe, FDI inflows started to grow only in 2003, and within two years, led by large privatization deals, they

nearly tripled, to \$11 billion. In the CIS, inflows grew from \$5 billion in 2000 to \$24 billion in 2004, driven largely by high prices of petroleum and natural gas. FDI inflows into the region are expected to grow further over the next few years.

Of the 19 countries in the group, 16 received higher flows than in 2003. Inflows remain concentrated in a few economies. In 2004, the top 10 destinations accounted for 95% of flows to the region (figure II.23). The Russian Federation alone, with its large natural and human resources, accounted for more than one-third of the group's total inflows. The oil economies of Azerbaijan and Kazakhstan accounted for another quarter. The two South-East European countries (Bulgaria and Romania) expected to join the EU in 2007 together accounted for more than one-fifth of the regional total and for more than 70% of the South-East European subtotal.

The distribution of FDI inflows by size among the region's economies remained stable in comparison with that in 2003: only Romania moved to a higher bracket of FDI inflows and Serbia and Montenegro to a lower one as compared with 2003 (table II.7).

In South-East Europe, as in previous years, the EU candidate countries, Bulgaria and Romania, were the main recipients of inward FDI

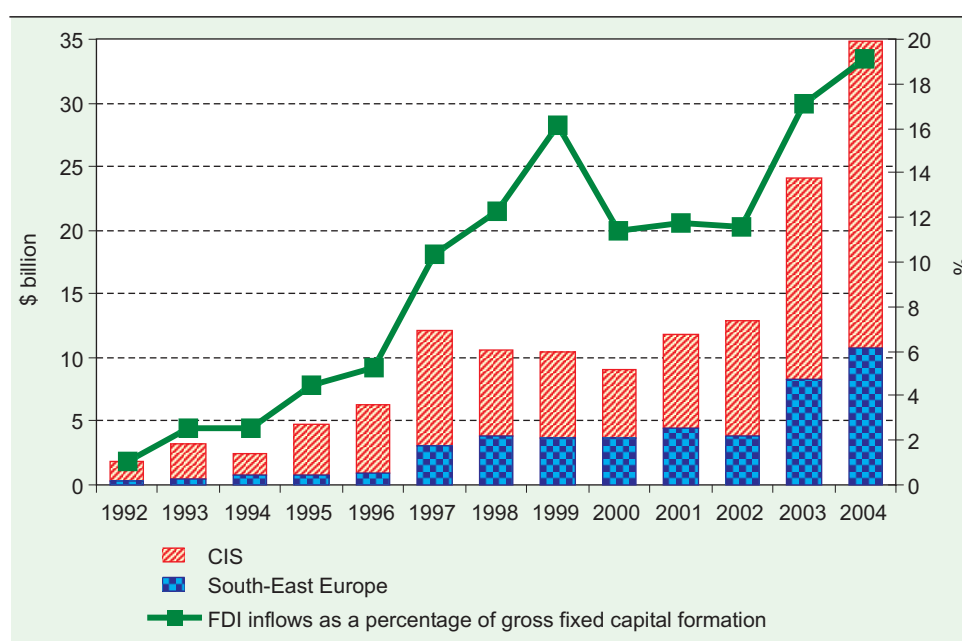
in 2004. Romania alone attracted more FDI than the five countries on the western side of the subregion (Albania, Bosnia and Herzegovina, Croatia, TFYR Macedonia, Serbia and Montenegro) together. With the exception of Croatia – the only upper middle-income economy of South-East Europe and the CIS – the low levels of inward FDI reflect GDP per capita levels that are even lower than in Bulgaria and Romania, combined with a post-conflict situation that has had a negative impact on infrastructure and has made potential investors cautious.

In *Romania*, the record level of inflows (\$5 billion) was partly a result of the privatization sale of the oil company, Petrom, to OMV (Austria). Inflows were also important in greenfield and expansion projects, particularly in the automotive industry and in services. In *Bulgaria* in 2004, Telekom Austria acquired the telecom operator MobilTel, while Viva Ventures (United States) took majority control of the Bulgarian Telecommunications Company (BTC). The power industry also received major investments in 2004 from Austria, the Czech Republic and Germany.

The industry composition of FDI inflows in South-East Europe is affected by these major transactions (annex table A.II.5). The

**Figure II.22. South-East Europe and CIS: FDI inflows and their share in gross fixed capital formation, 1992-2004**

(Billions of dollars and per cent)

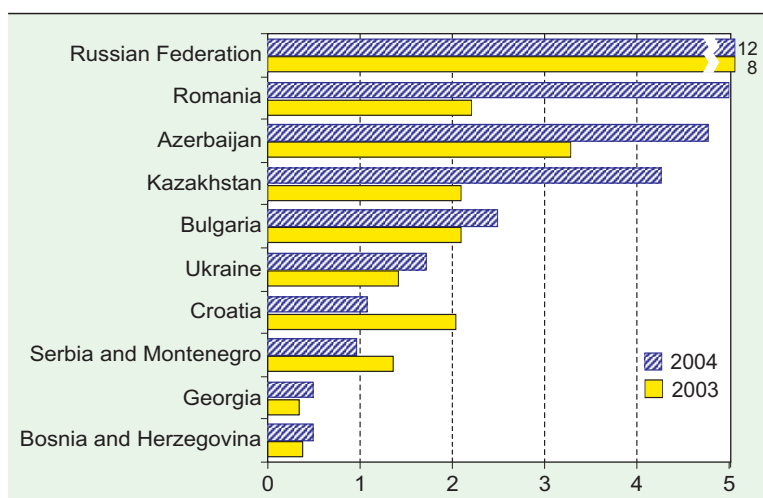


Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex tables B.1 and B.3.



**Figure II.23. South-East Europe and CIS: FDI inflows, top 10 recipients,<sup>a</sup> 2003, 2004**

(Billions of dollars)



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Ranked on the basis of the magnitude of 2004 FDI inflows.

manufacturing sector dominated inflows only in Romania in 2003 and 2004.<sup>69</sup> The sector also took a sizeable share of FDI in Bulgaria, although the share declined in 2004. Within services, trade and telecommunications played particularly important roles as a result of recent privatization deals.

In the CIS, four countries, the Russian Federation, Azerbaijan, Kazakhstan and Ukraine, in that order, together accounted for 93% of the subregional total of FDI inflows in 2004. In the first three countries, FDI was driven by projects in natural resources (especially petroleum and natural gas) and related activities,<sup>70</sup> while in Ukraine (the second largest country in area on the European continent after the Russian

Federation) it was more broad-based: besides oil companies such as Lukoil (Russian Federation) and Regal Petroleum (United Kingdom), the list of companies with major FDI projects in 2004 in Ukraine included manufacturers of consumer goods, construction materials, retailing and telecommunications firms (annex table A.II.5).

In the *Russian Federation*, petroleum and natural gas extraction attracted large investments from TNCs in 2004, especially in the Russian Far East island of Sakhalin. Inflows also rose as some round-tripped Russian capital returned from Cyprus and Luxembourg.<sup>71</sup> In *Azerbaijan*, a combination of high oil prices and prospects of an imminent opening of the pipeline linking the Azeri capital, Baku, to the Turkish Mediterranean port, Ceyhan, prompted a rise in FDI in petroleum in 2004.<sup>72</sup> In *Kazakhstan*, a surge in FDI led to a 16% rise in oil and gas output in 2004. The country attracted both global petroleum firms and independent oil companies.<sup>73</sup> It also attracted large FDI projects in other natural resources such as aluminium in 2004.

The industry composition of cross-border M&As has changed from year to year. In 2003, petroleum refining (part of coke, petroleum and nuclear fuel) alone accounted for 82% of cross-border M&A sales receipts (table II.8). This is mainly due to the acquisition of the Tyumen Oil Company (TNK) of the Russian Federation by BP (reported in *WIR03*, p. 62). In 2004, services accounted for close to two-thirds of the M&A

**Table II.7. South-East Europe and CIS: country distribution of FDI inflows, by range, 2003, 2004**

Range	2003	2004
	Economy <sup>a</sup>	Economy <sup>a</sup>
Above \$5.0 billion	Russian Federation	Russian Federation and Romania
\$1.0-4.9 billion	Azerbaijan, Romania, Bulgaria, Kazakhstan, Croatia, Ukraine and Serbia and Montenegro	Azerbaijan, Kazakhstan, Bulgaria, Ukraine and Croatia
Less than \$1.0 billion	Bosnia and Herzegovina, Georgia, Albania, Belarus, Armenia, Turkmenistan, TFYR Macedonia, Republic of Moldova, Uzbekistan, Kyrgyzstan and Tajikistan	Serbia and Montenegro, Georgia, Bosnia and Herzegovina, Albania, Tajikistan, Armenia, Belarus, TFYR Macedonia, Republic of Moldova, Turkmenistan, Uzbekistan and Kyrgyzstan

Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Listed in order of the magnitude of FDI inflows for each respective year.

**Table II.8. South-East Europe and CIS: distribution of cross-border M&A sales, by sector and industry, 2003, 2004**  
(Millions of dollars and per cent)

Sector/industry	2003		2004		Growth rate in 2004 (%)
	Value	%	Value	%	
<b>Primary</b>	<b>94</b>	<b>0.8</b>	<b>32</b>	<b>0.3</b>	<b>-66.3</b>
Agriculture, hunting, forestry and fishing	10	0.1	4	0.04	-57.8
Mining, quarrying and petroleum	83	0.7	27	0.3	-67.3
<b>Manufacturing</b>	<b>10 997</b>	<b>88.7</b>	<b>3 827</b>	<b>38.1</b>	<b>-65.2</b>
Food, beverages and tobacco	743	6.0	241	2.4	-67.5
Textiles, clothing and leather	1	0.01	-	-	-
Wood and wood products	0.2	-	-	-	-
Publishing and printing	24	0.2	-	-	-
Coke, petroleum and nuclear fuel	10 177	82.1	3 238	32.2	-68.2
Chemicals and chemical products	1	0.01	23	0.2	2228
Non-metallic mineral products	-	-	167	1.7	-
Metals and metal products	48	0.4	156	1.6	228.7
Machinery and equipment	3	0.03	-	-	-
Motor vehicles and other transport equipment	0.2	-	1	0.01	419.5
<b>Services</b>	<b>1 304</b>	<b>10.5</b>	<b>6 188</b>	<b>61.6</b>	<b>374.6</b>
Electricity, gas and water	26	0.2	851	-	3164
Trade	128	1.0	9	0.1	-92.8
Hotels and restaurants	4	0.03	-	-	-
Transport, storage and communications	677	5.5	4 919	49.0	626.3
Finance	423	3.4	347	3.5	-18.0
Business services	46	0.4	30	0.3	-34.0
Health and social services	-	-	2	0.02	-
Community, social and personal service activities	-	-	31	0.3	-
<b>All industries</b>	<b>12 395</b>	<b>100.0</b>	<b>10 047</b>	<b>100.0</b>	<b>-18.9</b>

Source: UNCTAD, cross-border M&As database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

sales, with telecommunications accounting for the largest deals.

After two years of growth (2002-2003), FDI *outflows* from South-East Europe and the CIS declined slightly in 2004. This was due to the slowdown of outward FDI by Russian TNCs, which alone represent about 99% of the regional total. This slowdown, in turn, is mostly the result of a changing relationship between the Government and the business sector that has prompted firms to slow down their expansion abroad.

Projects abroad by Russian firms often target other CIS countries: for example, Lukoil Oil Company signed a \$1 billion natural gas deal in Uzbekistan in 2004 to be financed over 35 years. Lukoil will own 90% of the joint venture formed for this purpose.<sup>74</sup> Outside the CIS, Norilsk Nickel completed in 2004 the acquisition of its stake in South Africa's Gold Fields (*WIR04*, p. 74). While traditionally Russian outward FDI has been driven by firms based in natural resources (chapter I and annex table A.I.11), the industry base for outward FDI is broadening to include other activities such as telecommunications.

## 2. Policy developments: diversity in policy approaches

FDI patterns in individual South-East European and CIS countries reflect not only natural-resource endowments and other location-specific economic factors, but also diversity in policy approaches to inward FDI. In Bulgaria and Romania, the prospect of joining the EU in 2007 is prompting rapid adoption of the EU's *acquis communautaire*, increased efforts towards improving the business environment and the completion of large privatization deals. Other South-East European countries are following these two in varying degrees.

In the CIS, policies relating to FDI and privatization are diverse. So is the approach towards the treatment of FDI in natural resources. In the area of privatization, for example, the Russian Federation and Ukraine follow divergent strategies, despite the fact that in both countries the main challenge is to tackle the consequences of earlier deals, which led to insider ownership of key resources (Bevan and Fennema 2003, Nureev and Runov 2003, Puffer and McCarthy 2003, Shlapentokh 2004).

In the Russian Federation, authorities have adopted a two-pronged approach towards firms privatized in the early 1990s. This strategy has important implications not only for inward but also for outward FDI. The Russian strategy on post-privatization has, on the one hand, tried to increase de facto the Government's influence over these firms. On the other hand, the authorities have used, or are planning to use, direct measures to take back State control of some key companies. For instance, in June 2005 the Government increased its stake in Gazprom, the country's largest natural gas producer, from 39.27% to 50.01%. In the oil industry, following an audit that identified \$28 billion in unpaid taxes, authorities took back control of the core extraction company of the second largest Russian corporation – and a large outward investor – Yukos.<sup>75</sup>

There is a danger that these actions could send contradictory signals to foreign investors. On the one hand, the weakening of opposition to foreign shareholding in local companies (mostly informally) and the direct acceptance of foreign minority shareholding (e.g. BP-TNK) are signs of opening up. The evolution of the tax system towards flat and lower taxes could also encourage foreign investors. In 2002, corporate income tax ("profits tax") was set at a flat 24%, while the Government eliminated the previously widespread use of tax concessions and special favourable tax regimes (OECD 2004a, p. 33). On the other hand, there are measures that could discourage inward FDI. Liberalization of foreign equity investment in key companies is advancing slowly. Limitations on foreign ownership in Gazprom and United Energy Systems had been originally set at 20% and 25%, respectively, in the late 1990s. These limits are to be raised gradually. Moreover, foreign ownership could be de facto limited to 49% by domestic regulations on natural resources, such as the decision in February 2005 of the Ministry for Natural Resources of the Russian Federation to restrict new tenders for oil and metal deposits to companies that are at least 51% Russian-owned. This prevents not just foreign affiliates but also joint ventures from exploiting new oil reserves in the country. This rule could also potentially affect Russian oil firms in which the combined foreign portfolio and direct ownership might reach 50%.

In the fiscal area, "...although the new Tax Code significantly clarifies the roles and powers of tax inspectors and tax bodies, and grants

greatly expanded rights to taxpayers, tax enforcement remains political and often arbitrary" (OECD 2004a, pp. 34-35). In this context, the extension of tax audits from Yukos to the BP-TNK joint venture<sup>76</sup> has been interpreted as a negative sign by foreign investors (IIF 2004). In the latest investment climate survey of the country, as many as 75% of the firms surveyed considered the interpretation of regulations by authorities as unpredictable (World Bank 2005e, pp. 23 and 246).

In Ukraine, the new Government that came to power at the end of 2004 seems to be opening its doors wider to foreign investors. In February 2005, the authorities decided to revise earlier privatizations by annulling the results of unlawful insider deals and putting the shares of the companies concerned on sale again. The list of firms that could be re-privatized this way includes key companies such as the steelmaker Kryvozyhstal, the metallurgical conglomerate Ukrudrrom, the Petrovsky Steel Plant, the Nikopol Ferroalloys Plant, the Dzerzhinsky Metal Plant, the chemical factory Azot Severodonetsk and the Nikolaev aluminium plant.<sup>77</sup>

The Russian Federation and other CIS countries also diverge with regard to the regulation and treatment of FDI in natural-resource extraction. Azerbaijan, Kazakhstan and Turkmenistan not only apply fewer limits on the foreign ownership of oil and gas, but also levy lower taxes and royalties on oil than does the Russian Federation. For instance, in 2004, firms in Kazakhstan paid \$1.5-\$2 of royalties per barrel of oil compared with \$6-\$7 in the Russian Federation, and investors were offered tax stability clauses (Dashevsky and Loukashov 2004, p. 13).

With respect to the international framework for investment, South-East European and CIS countries signed 17 new BITs in 2004 (figure II.24) bringing the total number of BITs involving this group of countries to 642. This increase was the lowest level registered since 1991. In 2004, 29 new DITs were concluded bringing the total to 494.

### 3. Prospects: continuing growth

FDI inflows to South-East Europe and the CIS are expected to grow further in the near future based on the expectation that, with their competitive wages, South-East Europe (especially the two countries in the subregion that are

expected to join the EU in 2007), and Ukraine from the CIS will attract an increasing number of efficiency-seeking or export-oriented projects. At the same time, high oil and gas prices will continue to encourage FDI in the natural-resource-rich CIS countries. In both groups, FDI inflows may be affected positively by improvements in the business environment.

In South-East Europe (and partly also in Belarus, western Russia and Ukraine in the CIS), the eastward expansion of the EU in 2004 created major transportation and logistical advantages, as these countries became immediate neighbours of the EU. This “new frontier” (UNCTAD 2003a, p. 17) could potentially become a magnet for efficiency-seeking investment. It is not yet certain, however, if new greenfield projects could compensate for the drop in privatization-related inflows once the current wave of large privatization deals is completed.

Adding to the “new frontier” status of the countries mentioned are the advantages offered by low labour costs, which are even lower than those of the new EU members that joined the EU in 2004 (figure II.25). Gross wages in Bulgaria and Romania are comparable with those of India and China. However, to exploit this advantage these South-East European countries would also need to offer similar levels of labour productivity. The forecast that their textile, garment and footwear industries in 2005 would be negatively affected by competition from China (Hunya 2005) suggests that currently this is not the case.

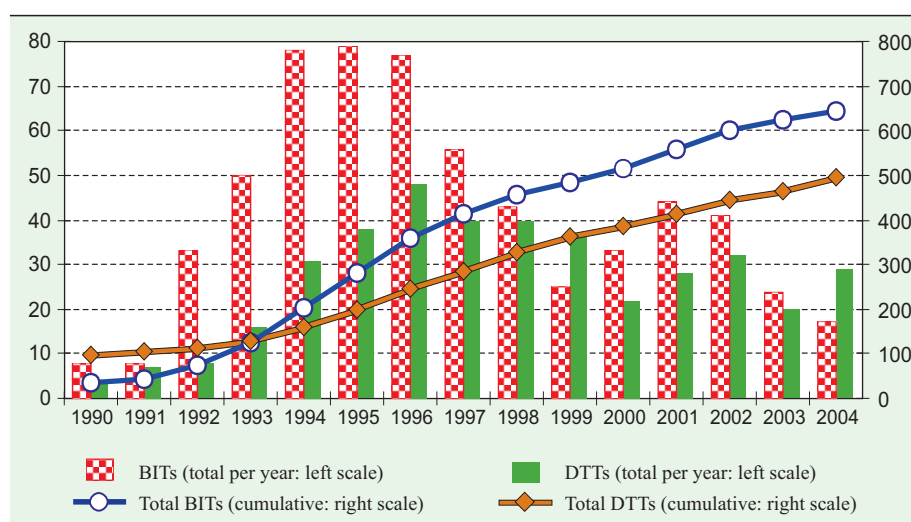
In the natural-resource-rich economies of the CIS it is not simply the volume of inward FDI that will matter in the future, but rather, their success with diversification into new activities. In this respect, Kazakhstan and the Russian Federation have slightly broader natural resource bases and downstream activities than do Azerbaijan or Turkmenistan. Prospects for diversifying FDI inflows away from natural resources are not necessarily promising, however. What makes diversification difficult is the adverse impact of the “Dutch disease”<sup>78</sup> on production costs in other industries: as large oil and gas exports lead to a real appreciation of the local currency, production costs in manufacturing, expressed in dollars, increase to internationally uncompetitive levels.

The CIS also includes countries, such as Kyrgyzstan, the Republic of Moldova, Tajikistan and Uzbekistan, where GDP per capita is comparable with that of the poorest countries of the world. Some of these countries suffer from conflict situations and other political uncertainties. These conditions make it difficult to overcome marginalization through various strategies, including attracting and leveraging inward FDI.

On balance, the prospects for FDI inflows to South-East Europe and the CIS in 2005 and 2006 are deemed positive by FDI experts, TNCs and IPAs alike (box I.3). In all three groups nine out of ten respondents believe that FDI flows to

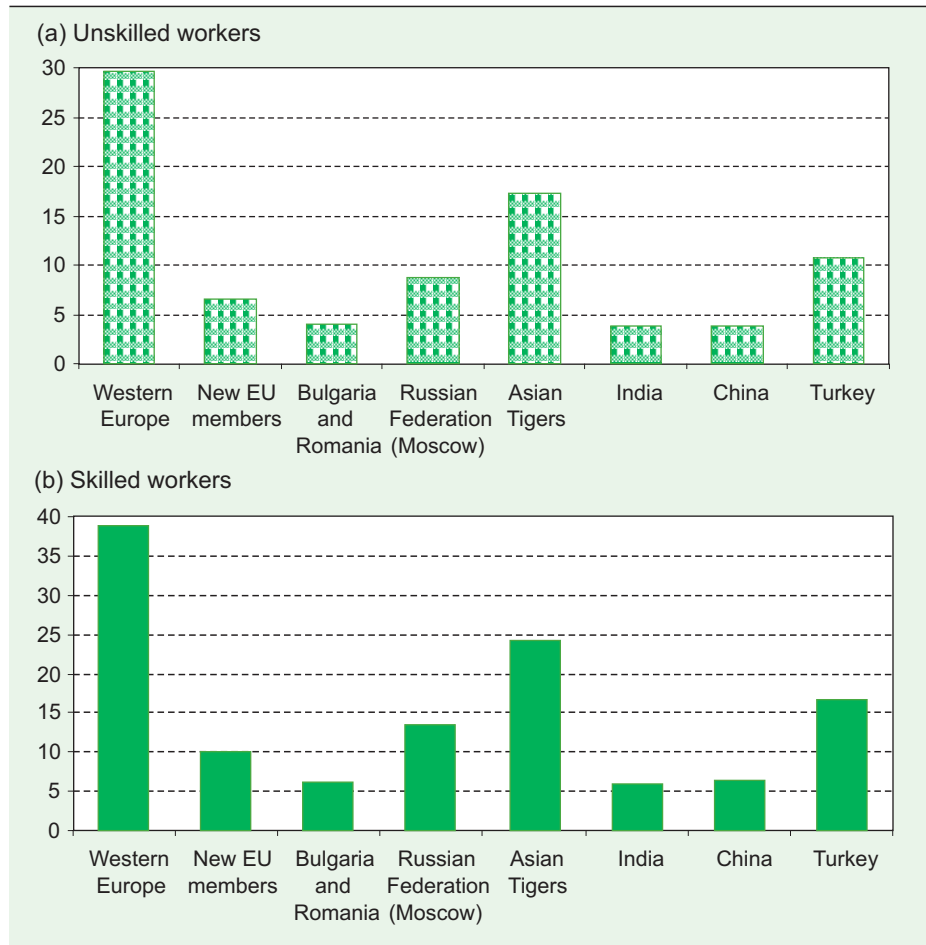
**Figure II.24. South-East Europe and CIS: number of BITs and DTTs concluded, cumulative and annual, 1990-2004**

(Number)



Source: UNCTAD, BIT/DTT database ([www.unctad.org/iaa](http://www.unctad.org/iaa)).

**Figure II.25. The wage ladder: gross pay per annum in selected economies, 2004**  
(Median, thousands of dollars)



Source: UNCTAD, based on Mercer Human Resource Consulting, "2005 international geographic salary differential report", [www.mercerhr.com](http://www.mercerhr.com).

Note: Asian Tigers include Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China.

the region will increase in 2005-2006 (figure II.26).

A comparison with other surveys is not straightforward because, with the exception of the Russian Federation, other surveys do not monitor South-East Europe and the CIS. Moreover, surveys looking at the Russian Federation from different angles present contradictory results. For instance, on the one hand the A.T. Kearney *FDI Confidence Index* (A.T. Kearney 2004) noted a decline in confidence in the Russian Federation in the aftermath of the Yukos case, although consumer-related industries (retail trade and food and beverages) still seemed to have a positive outlook; on the other hand, the latest survey of Japanese manufacturing TNCs (JBIC 2005) raised the ranking of the Russian Federation to the 6th most promising location for TNCs in the next

three years compared to its 10th position in the previous survey.

Outward FDI in South-East Europe and the CIS is expected to recover, as the fundamental reason for Russian firms (the principal outward investors in the region) going abroad – to control the value chain of their resources – remains unchanged, and the State is expected to give the green light to foreign expansion once again.

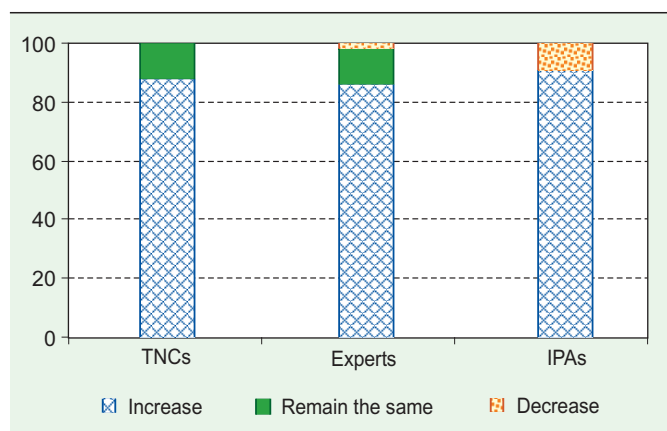
## C. Developed countries: uneven performance

Total FDI inflows to developed countries declined by 14%, to \$380 billion, in 2004. Since their peak in 2000, inflows to those economies as a group have plummeted by two-thirds, falling in some major recipient countries. On the one



**Figure II.26. South-East Europe and CIS: prospects for FDI inflows, 2005-2006**

(Per cent of responses from TNCs, experts and IPAs)



Source: UNCTAD ([www.unctad.org/fdiprosects](http://www.unctad.org/fdiprosects)).

hand, such flows rose significantly in Australia, the United Kingdom and the United States, as well as in all of the ten new EU-accession countries now classified as developed countries (box I.2). On the other hand, total flows to the EU-15 countries declined by 40% from their 2003 level, due mainly to relatively low economic growth rates in that region and to large-scale repayments of intra-firm credits by foreign affiliates to their parent firms abroad in some major host countries (e.g. Germany, the Netherlands, Sweden). Other developed countries, such as Israel, Norway and Switzerland, also recorded lower FDI inflows. Outflows of FDI from the developed countries increased modestly in 2004.

## 1. Trends: a turnaround in many countries

FDI inflows to developed countries declined from \$442 billion in 2003 to \$380 billion in 2004. The decline (14%) was less pronounced than in 2003 (19%). Eight countries reported FDI inflows of more than \$10 billion (table II.9), and inflows into more than half of the developed countries – including the 10 EU-accession countries – increased. This, together with a number of factors discussed below, suggests that FDI inflows to developed countries may be bottoming out and that a gradual recovery is finally under way.

There was a significant rebound in FDI inflows to *North America*: these nearly doubled in 2004 (figure II.27). This was due to an increase

in inflows to the United States, from \$57 billion in 2003 to \$96 billion in 2004 (figure II.28), making that country the largest FDI recipient worldwide for the first time since 2001, ahead of the United Kingdom, China and Luxembourg. Reinvested earnings accounted for most of the increase, rising from \$1.5 billion in 2003 to \$45 billion in 2004. Net repayments abroad of intra-company debt by foreign affiliates in the United States decreased by 44%, so that the inflows due to this component stood at -\$17.8 billion in 2004 as compared with -\$31.7 billion in 2003. Favourable economic growth prospects and high corporate profits contributed to the increase in FDI flows to the United States. In the finance and insurance services industry, FDI inflows increased to \$31.8 billion in 2004 due to consolidation in the industry and to the expansion of European banks into the United States market. Spurred by financial deregulation and globalization, European financial firms have been looking to new markets; the three largest cross-border M&A deals in 2004 took place in this industry (annex table A.I.1). Besides market-seeking FDI in services and in manufacturing, the United States attracted FDI in chemicals and electrical equipment,<sup>79</sup> industries that are typically export-oriented, and benefited from the decline in the value of the United States dollar. Overall FDI inflows to the United States manufacturing sector reached \$19.4 billion in 2004, a substantial increase compared with the \$0.3 billion of the year before. The main home countries for FDI in the United States in 2004 were the EU countries (\$41.4 billion), Canada (\$31.8 billion) and Japan (\$16.1 billion). In contrast to the FDI upswing in the United States, FDI inflows to Canada in 2004 stagnated (at nearly \$7 billion).

FDI inflows to the United States amounted to 0.8% of its (nominal) GDP in 2004. Inflows, however, remained smaller than outflows. The deficit in the current account was again mostly financed by portfolio capital inflows. Since 2002, the net balance of FDI inflows and the current-account balance have moved together into the red (figure II.29).

FDI flows into the *EU* fell by 36% to \$216 billion. However there were large differences between trends in FDI inflows to the EU-15 and to the ten new EU member countries:

- In the EU-15, total FDI inflows declined by 40%, to \$196 billion in 2004, the lowest

**Table II.9. Developed countries: country distribution of FDI inflows, by range, 2003, 2004**

Range	2003		2004	
	Economy <sup>a</sup>		Economy <sup>a</sup>	
More than \$50 billion	Luxembourg and the United States		the United States, the United Kingdom and Luxembourg	
\$10-49 billion	France, Belgium, Spain, Germany, Ireland, the United Kingdom, the Netherlands, Switzerland and Italy		Australia, Belgium, France, Spain and Italy	
\$1-9 billion	Austria, Australia, Portugal, Canada, Japan, Poland, Israel, Norway, Finland, Denmark, New Zealand, Hungary, the Czech Republic, Sweden and Cyprus		Ireland, Japan, Canada, Poland, Austria, Finland, Switzerland, the Czech Republic, Hungary, New Zealand, Norway, Israel, Greece, Cyprus, Slovakia and Portugal	
Less than \$1 billion	Estonia, Slovakia, Greece, Slovenia, Iceland, Latvia, Malta, Lithuania and Gibraltar		Estonia, Lithuania, Latvia, Slovenia, Malta, Iceland, Gibraltar, Sweden, the Netherlands, Denmark and Germany	

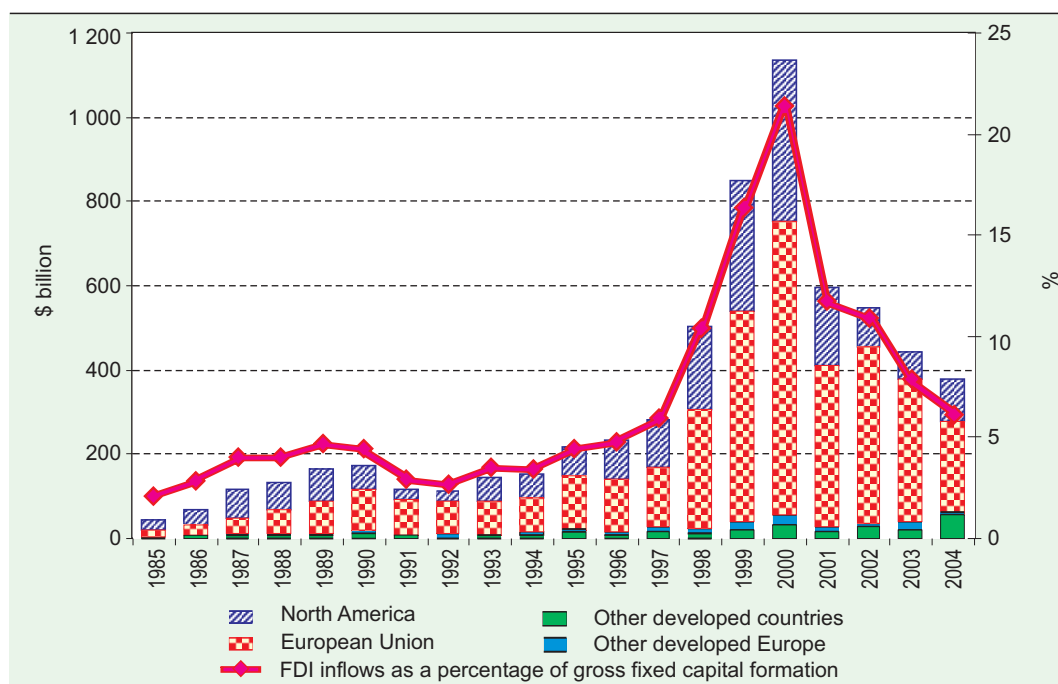
Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Listed in order of the magnitude of FDI inflows for each respective year.

level since 1998.<sup>80</sup> A sharp fall in flows to three EU-15 countries, Germany, Luxembourg and the Netherlands, alone accounted for 95% of the total decline. FDI inflows turned negative in the Netherlands where foreign investors reduced their FDI stock by \$4.6 billion (compared to inflows of \$19.3 billion in 2003). The downturn was primarily due to intra-company debt repayments<sup>81</sup> and to a change in the system

of compilation of balance-of-payments statistics introduced in April 2003 (see annex B, "Definitions and sources"). Low economic growth also contributed to the decline. FDI inflows into Luxembourg fell by 37%, to \$57 billion (less than half its average inflows in 2002-2003), primarily because fewer special purpose entities were established.

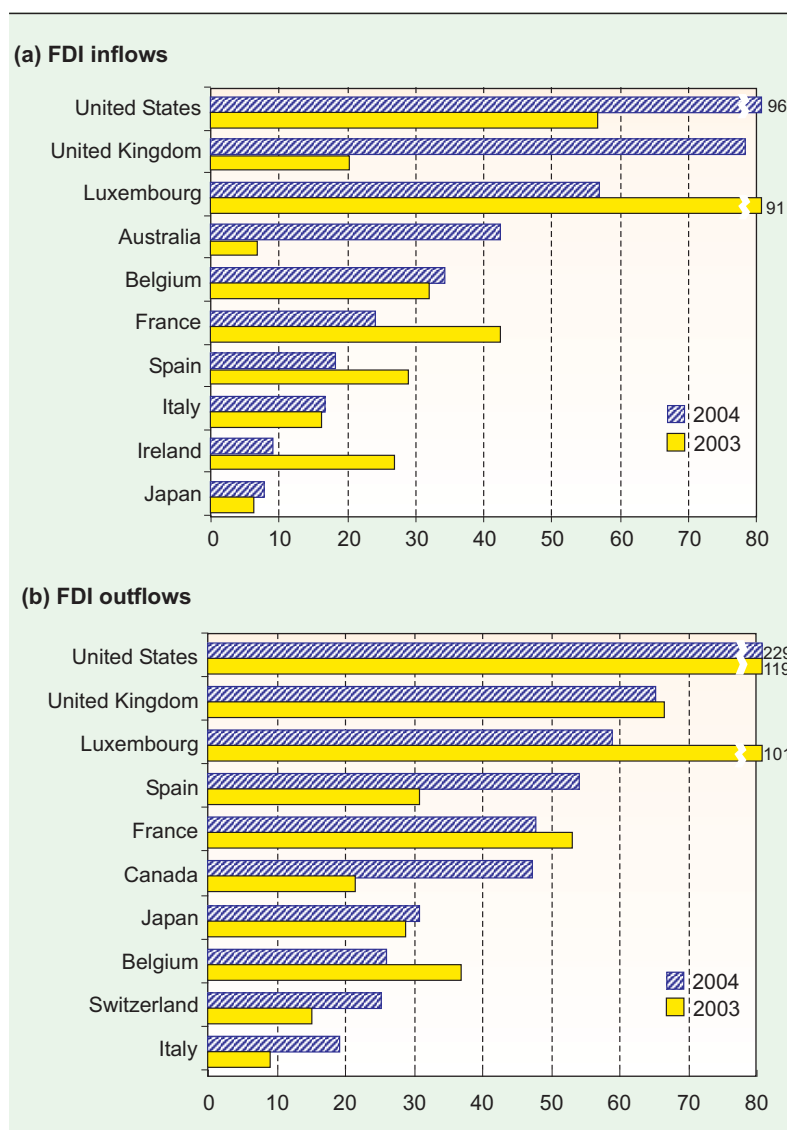
**Figure II.27. Developed countries: FDI inflows and their share in gross fixed capital formation, 1985-2004**



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex tables B.1 and B.3.

**Figure II.28. Developed countries: FDI flows, top 10 economies,<sup>a</sup> 2003, 2004**

(Billions of dollars)



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and annex table B.1.

<sup>a</sup> Listed on the basis of the magnitude of 2004 FDI flows.

In Germany, negative FDI inflows of \$39 billion were recorded as a result of lower inflows of equity capital and large repatriations of intra-company loans resulting from tax changes (box II.14). Investment by private equity funds played a growing role in FDI inflows to Germany,<sup>82</sup> in particular in the chemicals industry. As in Germany and the Netherlands, FDI inflows to Denmark also turned negative, largely as a result of repatriations of equity capital caused by the economic slowdown and repayment of cross-border intra-company loans by foreign affiliates of

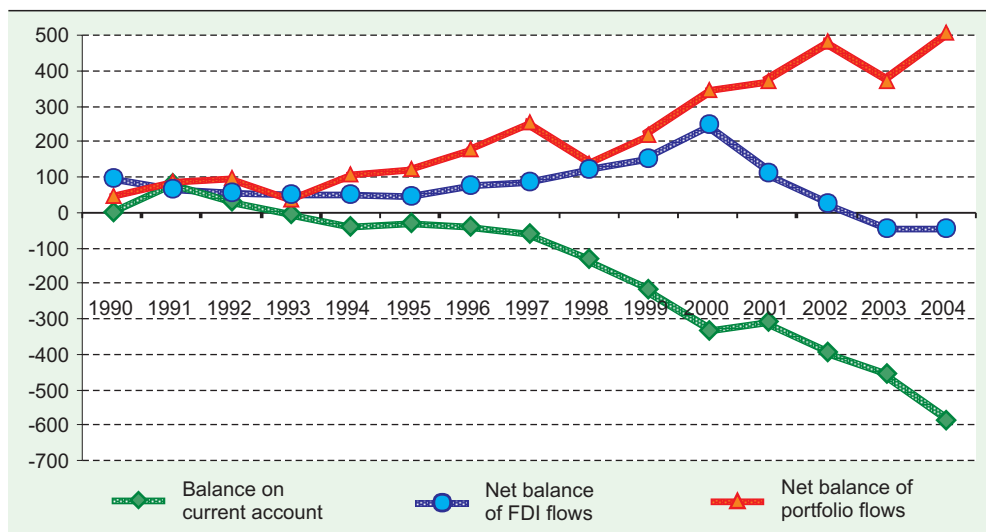
Danish TNCs. France,<sup>83</sup> Ireland<sup>84</sup> and Spain,<sup>85</sup> countries with relatively large FDI inflows in the recent past, also experienced a substantial decline (ranging between 37% and 66%) in inflows in 2004. Similarly FDI inflows into Sweden and Austria fell, but to a lesser extent.

Whereas the great majority of EU-15 countries attracted less FDI, the United Kingdom became the second largest recipient of FDI worldwide in 2004, as inflows surged from \$20 billion to \$78 billion. This was the third largest FDI inflow ever to that country, exceeded only by that registered in the peak years of 1999 (\$88 billion) and 2000 (\$119 billion). Increased flows from the United States partly explain this rise. As a result, the position of the United States – which already accounted for 39% of the total inward FDI stock of the United Kingdom in 2003 – as a leading source of FDI in the United Kingdom strengthened further.<sup>86</sup> Both cross-border M&As and greenfield investments contributed to the increase. The value of some cross-border M&A deals was extremely high. For instance, Santander Central Hispano, Spain's largest bank, bought Abbey National at a price of \$16 billion, Europe's biggest ever cross-border merger in banking (annex table A.I.1).

Quarterly and even annual FDI figures are very volatile. They are often influenced by a single large transaction or random movements of individual components of FDI flows that are not necessarily related to changes in the fundamental determinants of FDI. A medium-term examination of the 2002-2004 period, for instance, provides a better picture of the FDI performance of the EU-15 countries. France and the United Kingdom received relatively high FDI inflows during that period (on average \$38.6 billion and \$41 billion per year respectively). The United Kingdom experienced relatively strong economic growth during these years of 3%, which is higher than that in the euro area (IMF 2005). In France, the Government

Figure II.29. Current-account balance, net balance of FDI flows<sup>a</sup> and net balance of portfolio flows<sup>b</sup> in the United States, 1990-2004

(Billions of dollars)



Source: UNCTAD, based on data from FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and United States Bureau of Economic Analysis ([www.bea.doc.gov](http://www.bea.doc.gov)).

<sup>a</sup> FDI inflows less FDI outflows.

<sup>b</sup> Foreign securities of United States-owned assets abroad, less United States Treasury securities, and securities other than Treasury securities of foreign-owned assets in the United States.

has been actively promoting FDI inflows in recent years (*WIR04*, p. 87). In contrast, Italy and Germany, due to weak economic growth and relatively rigid labour markets, attracted considerably less FDI (\$16 billion and \$13 billion, respectively, on average). Part of Italy's weak performance may be attributed to structural problems such as high labour and energy costs. Other economies that performed well over the 2002-2004 period were Belgium (\$27 billion per year in FDI inflows on average), Spain (\$30 billion) and Ireland (\$22 billion), although FDI flows have been decreasing for the latter two countries.

- FDI inflows into the 10 *EU-accession countries* (which were previously classified under Central and Eastern Europe (see box I.2)) rose by 69% in 2004, to \$20 billion, with Poland, the Czech Republic and Hungary, in that order, receiving the largest FDI inflows. Reinvested earnings accounted for more than half of the FDI flows to these countries, whereas equity investments in new projects and privatization sales were the dominant forms of FDI in Slovakia, Latvia and Lithuania (Hunya 2005). With the rising FDI inflows, the share of inward FDI in gross fixed capital formation in the 10 new EU countries grew from 11% in

2003 to 16% in 2004 (annex table B.3), which is higher than the EU-15 average. FDI stock in relation to economic size, as measured by stock as a percentage of GDP, is also higher for these countries (39%) than for the EU-15 (31%) (annex table B.3).

As in the past, the EU-15 countries were the major investors in the 10 new EU countries. A recent study shows that the largest investors in these countries were Germany and the Netherlands, which together accounted for 40% of the inward stock, followed by Austria and France (Hunya 2005). It should also be noted that a significant share of FDI flows to the new countries is undertaken by foreign affiliates operating in the EU-15.

Lithuania, Latvia and the Czech Republic experienced the largest increase in inward FDI flows in 2004 among the 10 new EU members. Flows to Lithuania more than quadrupled (to \$773 million); they more than doubled in Latvia (\$647 million), the Czech Republic (\$4.5 billion) and Hungary (\$4.2 billion); and Slovakia (\$1.2 billion) received 68% higher inflows than in 2003, mainly due to the privatization of three electricity distributors.<sup>87</sup> Inflows to Cyprus increased marginally (\$1.1 billion) in 2004.

The 10 new EU countries accounted for only 9.4% of FDI inflows to the EU-25 in 2004. Whether their share in EU-25 inward FDI flows will increase in the future remains an open question. But a number of structural characteristics make them attractive locations for further FDI (box II.15).

FDI inflows into the *other developed countries* shrank by 66% in 2004. Israel, Norway and Switzerland in particular received less investment. Japan, on the other hand, recorded 24% higher FDI inflows in 2004 (\$7.8 billion). In January 2003, Japan announced its goal of doubling inward FDI within five years. This would require average inflows of more than \$15

billion per year, considerably higher than what Japan has received over the past two years. In order to achieve this goal, a large number of measures in five priority areas were proposed in 2004 (*WIR04*, p. 82); one of the most important ones was the introduction of a measure to allow cross-border equity swaps. However, in 2005, there was a move to delay the legislation that would allow this scheme after a controversial deal took place between Livedoor (Japan) and Nippon Broadcasting System. It should also be noted that much of recent FDI in Japan has been in the form of distress funds (funds used to purchase companies experiencing substantial financial difficulties) from foreign institutional investors,

#### Box II.14. What lies behind the negative FDI inflows to Germany in 2004?

In 2004, Germany experienced negative FDI inflows (-\$38.6 billion) for the first time since 1992. This was caused mainly by a large drop in the equity capital component of FDI and by a net repayment of cross-border intra-company loans by foreign affiliates in Germany for the second year in a row (box table II.14.1).

Intra-company loans have played a substantial role in financing FDI in Germany, accounting for an average of about 47% of FDI flows over the past 30 years.<sup>a</sup> Such loans are relatively volatile. Their movements depend on a variety of factors related to the financial

management of individual companies. In 2003, the repayment of loans by foreign investors was partly due to a revision of the German Corporation Tax Act (*Körperschaftssteuergesetz*) that was intended to encourage foreign companies to transform corporate loans to their German affiliates into equity capital. It should have been no more than a change in the mode of FDI financing, but according to the Deutsche Bundesbank, the addition to equity was much lower than the repayment of credits, which resulted in a net reduction in FDI flows to Germany (Deutsche Bundesbank 2005, p.42). Increased repayment of intra-company loans by German affiliates of foreign firms in 2004 (46 billion euro) can also largely be explained by a single transaction (of an estimated 20 billion euro) where the German affiliate of a foreign enterprise in the telecoms industry used the sales proceeds from its reduced participation in an affiliate abroad to repay loans to a non-German affiliate of the group (Deutsche Bundesbank 2005, p. 41). Furthermore, the improved profitability of companies located in Germany may have motivated repayment of loans by German affiliates to their parent companies abroad.<sup>b</sup> The low value of the United States dollar may also have played a role by facilitating the repayment of dollar-denominated debt.

**Box table II.14.1. FDI inflows to Germany by financing component, 2002-2004**  
(Billions of euros)

Year	Equity capital	Reinvested earnings	Intra-company loans	Total
2002	35.9	-7.1	25.1	53.7
2003	40.5	-7.4	-8.8	24.2
2004	21.6	-6.4	-46.2	-31.1

Source: UNCTAD, based on data from Deutsche Bundesbank, *Balance of Payments Statistics*.

Source: UNCTAD.

<sup>a</sup> In the same period, the share of equity capital in financing FDI inflows in Germany was 70% and the share of reinvested earnings -17%. The continued losses (after dividend payments) registered by foreign affiliates, that led to negative reinvested earnings, can be explained in part by relatively high German taxes on such earnings.

<sup>b</sup> A recent study of the financing patterns of foreign FDI in Germany found statistically significant effects of the profitability of foreign affiliates on the volume of intra-company loans (Ramb and Weichenrieder 2005).



### Box II.15. EU accession and its impact on FDI in the new member countries

Inward FDI stock in the 10 new EU member countries at the end of 2004 reached \$230 billion. Within the ten years 1995-2004, this stock grew fivefold, nearly twice as fast as world FDI stock. Heading the list of top host countries in the group are relatively large countries such as Poland (\$61 billion in FDI stock), Hungary (\$60 billion) and the Czech Republic (\$56 billion). Together they accounted for more than three-quarters of the total inward FDI stock of the new EU member countries. Inward FDI stock per capita in the 10 new EU countries amounted to \$3,079 at the end of 2004, and inward FDI stock in relation to nominal GDP reached nearly 39%, as compared with \$9,790 and 31% for the EU-15 average (box figure II.15.1). On a per capita basis, the small

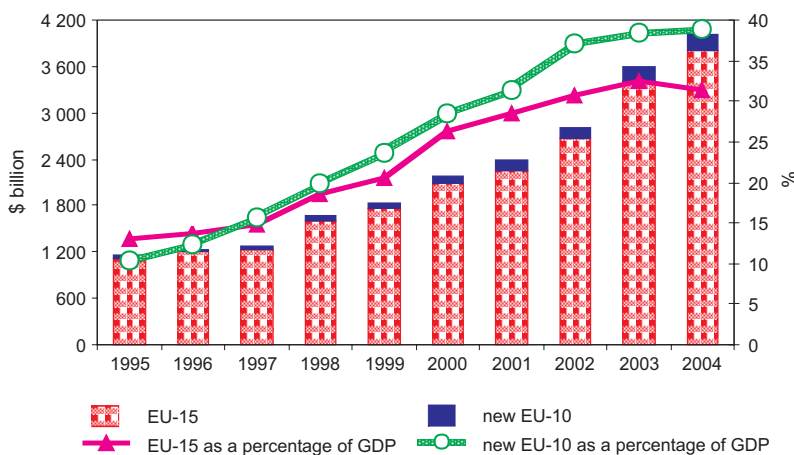
States. Prior to 2004, these companies were discouraged from investing in these countries because of the political and economic risks, and because stringent border controls made just-in-time delivery impossible. These obstacles have diminished since May 2004.<sup>b</sup> Third, consolidation of some industries and restructuring of certain TNC operations are taking place in the new EU member countries.

The main motives of foreign investors to invest in the 10 new EU members remain similar to those of the pre-accession phase (*WIR03*, pp. 64-66, *WIR04*, pp. 75-78). For market-seeking investors it is the strong economic growth of new EU member countries in 2004: their real GDP grew by 5.5%, more than double the EU-15 average (IMF 2005); and their favourable growth prospects continue to be very attractive. For efficiency-seeking investors, competitive unit labour costs are particularly important. In 2000, wages in the then-accession countries reached one-fifth of the level of the EU-15, while in productivity there was only a one-to-three difference (*WIR04*, p. 77). According to one estimate, average wages in new EU members in 2020 will still be 60% lower than the EU-15 average (box table II.15.1).<sup>c</sup> In the new EU member States, corporate taxes are lower than in the EU-15: rates were 20%, on average, for the former compared to 31% for the latter. However, a simple comparison of tax rates is not sufficient for assessing the relative

tax burdens in each country (*WIR04*, p.77). Other elements (such as the tax base, or specific tax regimes) need to be taken into account.

Additionally, full membership of the EU in May 2004 implied the adoption of the full body of EU laws (the *acquis communautaire*) that should reduce risk premiums for investors (*WIR04*, p.77), while accession to the customs union has lowered transaction costs. Access to EU Structural Funds (that are intended for basic infrastructure development, human resource development, competitiveness and enterprise development, rural development and environmental protection) can contribute to an improvement of the business environment

**Box figure II.15.1. Inward FDI stock as a percentage of GDP in the EU-15 and EU-10 accession countries**



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

Mediterranean countries, Cyprus and Malta, lead the country rankings. Both countries have followed market-oriented economic policies for a long time and have reached relatively high income levels.

There are three main trends emerging in FDI inflows to the new EU countries: first, new EU member States are increasingly attracting FDI into activities that require higher skills such as precision engineering, design and R&D (chapter IV). This quite often involves upgrading existing facilities and focusing on export-oriented manufacturing, particularly in the automotive and machinery industries (Hunya 2005).<sup>a</sup> Second, small and medium-sized enterprises from the EU-15 are beginning to invest in the new EU member

a somewhat peculiar feature of inward FDI into Japan.<sup>88</sup> FDI inflows into some smaller economies outside the North American and EU regions – such as New Zealand and Iceland – remained stable.

FDI flows to Australia increased to a record \$43 billion in 2004, resulting from a growth of equity investment, from \$2.3 billion in 2003 to \$35.5 billion in 2004, and a significant (56%) rise in M&A deals. These were driven by strong demand for Australia's natural resources, the privatization of State-owned assets and liberalization of the media industry.

There was an impressive surge in FDI inflows from developing countries to the United Kingdom and Japan – rising by 120% and 56% respectively during the period 2002-2003. In the United Kingdom, investment from Latin America accounted for the bulk of the increase in FDI originating from developing countries. In Japan, investment from developing Asia more than quadrupled during this period. For developed countries as a group, flows from developing countries remain volatile, rising and falling sharply from year to year.

### Box II.15. EU accession and its impact on FDI in the new member countries (concluded)

(WIR04, p.77). In addition, the full membership in the European Monetary Union envisaged by the end of this decade is expected to lead to falling interest rates in the coming years, which would improve financing conditions in these countries.<sup>d</sup>

However, despite entry into the EU and the expected burst of investor interest, risks persist in the new EU member countries. A recent survey has shown that corporate investors perceive poor infrastructure, corruption and the gradual erosion of low-cost advantage as leading threats to the competitiveness of the ten new EU members (A.T. Kearney 2004, p.21). EU reforms are expected to bring infrastructure investments and give regulatory stability to the EU single market, but the economic and social costs of adjustment are also expected to be high. Rising incomes may erode wage competitiveness. EU law will likely add a new layer of regulations and may undermine new members' relative FDI advantages in areas such as taxes and labour costs. These factors could also push investors further East and South outside the new EU.

Source: UNCTAD.

- <sup>a</sup> According to one study, foreign affiliates generated 70% of manufactured exports in the Czech Republic, Hungary, Poland and Slovakia in 2001 (Hunya 2004, WIR02). On the other hand, the importance of services in inward FDI overall continues to rise (annex tables I.4 and I.6).
- <sup>b</sup> Ernst & Young's *European Investment Monitor* shows a substantial increase in the number of projects in the new member States after accession, both in absolute terms and relative to Western Europe.
- <sup>c</sup> It is assumed that the convergence rate, the rate at which the wage gap between the EU-15 and the ten EU accession countries declines, is 1.5% per year. The convergence rate between rich and poor countries in Western Europe in the period 1963-2000 was 1.1% (Sinn and Ochel 2003).
- <sup>d</sup> In order to join the European Monetary Union new EU member countries have to fulfil several convergence criteria such as low inflation rates, low long-term interest rates that reflect low inflation expectations, stable exchange rates and two fiscal criteria (a current deficit lower than 3% of GDP and an outstanding deficit smaller than 60% of GDP). This convergence process should lead to falling interest rates in these countries.

#### Box table II.15.1. Convergence of wage levels in the EU: a projection, 2004, 2020

(Average of EU-15=100)

Country	2004	2020
Poland	29	40
Czech Republic	25	38
Hungary	31	38
Slovakia	18	36
Slovenia	44 <sup>a</sup>	55
Cyprus	48 <sup>b</sup>	61
Estonia	20	36
Lithuania	23	34
Latvia	19	33
EU-15 average	100	100

Source: UNCTAD, based on Rottmann and Jost 2004, and Mercer Human Resource Consulting, 2005 *Inter-National Geographic Salary Differential Report* (www.mercerhr.com).

Note: Under the assumption of a convergence rate of 1.5% per year.

<sup>a</sup> 2002.

<sup>b</sup> 2001.

There are some notable changes in the sectoral pattern of FDI in the developed countries. Overall, the importance of services in inward FDI continues to rise (annex tables A.I.4 and A.I.6). The industries in developed countries with the largest cross-border M&A deals in terms of value were construction, health and social services, and business activities, followed closely by electrical and electronic equipment, and textiles and clothing (table II.10 and annex table A.I.1). Furthermore, the real estate industry has recently witnessed an impressive surge in M&As.

FDI *outflows* from developed countries increased by 10% in 2004 to \$637 billion, stimulated by high economic growth rates and rising corporate profits in many parts of the world. Such outflows exceeded inflows of developed countries by \$148 billion per annum, on average, during the period 2002-2004, thus maintaining the dominant position of developed countries as net providers of FDI. As in the past, the largest share of outflows from developed

countries was directed towards other developed countries.

In 2004, the United States was by far the largest source of FDI worldwide, recording its largest outflows ever (\$229 billion), followed by the United Kingdom (\$65 billion), Luxembourg (\$59 billion) and France (\$48 billion) (figure II.28). In addition there was a marked increase in FDI outflows from the new EU member countries such as Poland (311%), Lithuania (606%) and Latvia (201%). For most developed countries, FDI outflows exceeded inflows. The countries in which FDI outflows exceeded FDI inflows the most were: the United States (\$133 billion), Canada (\$41 billion), Germany (\$31 billion), Japan (\$23 billion), Spain (\$36 billion) and Switzerland (\$21 billion). The 10 new EU countries were all net importers of FDI capital in 2004, as in previous years.

Until the 1970s the vast majority of developed-country FDI abroad was resource- or market-seeking in nature. In the 1980s and 1990s,

**Table II.10. Developed countries: distribution of cross-border M&A sales, by sector and industry, 2003, 2004**  
(Millions of dollars and per cent)

Sector/industry	2003		2004		Growth rate in 2004 (%)
	Value	%	Value	%	
<b>Primary</b>	<b>6 232</b>	<b>2.5</b>	<b>2 791</b>	<b>0.9</b>	<b>-55</b>
Agriculture, forestry and fishing	1 287	0.5	1 205	0.4	-6
Mining	4 945	2.0	1 587	0.5	-68
<b>Manufacturing</b>	<b>101 954</b>	<b>41.7</b>	<b>114 187</b>	<b>36.2</b>	<b>12</b>
Food, beverages and tobacco	24 746	10.1	17 774	5.6	-28
Textiles, clothing and leather	648	0.3	1 511	0.5	133
Wood and wood products	2 528	1.0	3 101	1.0	23
Printing, publishing and allied services	11 812	4.8	8 853	2.8	-25
Oil and gas; petroleum refining	7 713	3.2	9 110	2.9	18
Chemicals and chemical products	21 377	8.7	38 741	12.3	81
Rubber and miscellaneous plastic products	1 319	0.5	557	0.2	-58
Stone, clay, glass and concrete products	2 652	1.1	4 161	1.3	57
Metals and metal products	6 862	2.8	3 947	1.2	-42
Machinery	3 829	1.6	6 491	2.1	70
Electrical and electronic equipment	4 354	1.8	10 741	3.4	147
Motor vehicles and other transport equipment	4 417	1.8	3 082	1.0	-30
Measuring, medical and photo equipment; clocks	8 018	3.3	5 815	1.8	-27
Miscellaneous manufacturing	1 681	0.7	303	0.1	-82
<b>Services</b>	<b>136 240</b>	<b>55.7</b>	<b>198 872</b>	<b>63.0</b>	<b>46</b>
Electricity, gas and water distribution	14 336	5.9	22 848	7.2	59
Construction firms	911	0.4	3 138	1.0	245
Hotels and restaurants	3 946	1.6	4 103	1.3	4
Trade	12 572	5.1	25 476	8.1	103
Transport, storage and communications	27 527	11.3	21 909	6.9	-20
Finance	44 222	18.1	64 149	20.3	45
Business activities	20 961	8.6	51 636	16.3	146
Public administration	55	-	3	-	-95
Health and social services	1 085	0.4	2 722	0.9	151
Educational services	77	-	67	-	-12
Community, social and personal service activities	10 547	4.3	2 818	0.9	-73
<b>All industries</b>	<b>244 426</b>	<b>100.0</b>	<b>315 851</b>	<b>100.0</b>	<b>29</b>

Source: UNCTAD, cross-border M&A database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

developed-country firms increasingly sought to take advantage of cost differences in different production locations by building up global production networks to produce for regional and world markets (efficiency-seeking FDI). In recent years, another kind of trend in FDI from developed countries has emerged as companies also engage in R&D activities abroad (see Part Two). Most FDI in R&D by developed-country firms is targeted to other developed countries. The United States is the largest host country for FDI – both greenfield and M&A – in R&D, followed by the United Kingdom. In the case of greenfield FDI in R&D, Ireland and Spain also figure as large recipients in addition to Canada, France, Germany and Japan. But lately, developing countries like China and India are becoming increasingly important as hosts for R&D activities by developed-country TNCs (chapter IV.C).

## 2. Policy developments: diverging tendencies

Many developed countries have further liberalized their FDI rules and continue to conclude bilateral and regional agreements. The number of national regulatory changes in 2004 exceeded that in 2003 by 20%, rising from 48 to 60. Most of the changes were investor-friendly. The proliferation of BITs and DTTs continued, with 39 BITs and 53 DTTs involving a developed country (figure II.30) concluded in 2004. This brought the total number of BITs and DTTs involving developed countries to 2,014 and 1,464, respectively, at the end of 2004. Belgium-Luxembourg, Finland, Sweden and Switzerland were the most active with respect to BITs, concluding five new BITs each. Despite an overall attitude that is friendly towards FDI, fears of job losses and decreasing corporate tax payments have led to attempts and measures in some developed countries (e.g. the United States) to encourage companies to invest more at home. Others have undertaken a number of reforms. In Germany, for example, several measures were adopted to reform the labour market.<sup>89</sup> Furthermore, in 2004 France and Germany launched an initiative to set minimum corporate tax rates in Europe to avoid excessive tax competition among EU member States. However, this initiative requires unanimous approval by the EU members. The corporate income tax was reduced in a number of EU-15 and other

developed countries such as Austria, Canada, Denmark, Finland, Greece and Portugal (chapter I).

Further liberalization with respect to FDI in real estate was undertaken in a number of developed countries, including the 10 new EU countries. For example in Poland, permit requirements for investment in real estate were abolished through an amendment to the real estate law. This may partly explain the 10% increase in FDI inflows to the real estate industry in Poland in 2004.<sup>90</sup> In Germany, the regulation of real estate has been partly liberalized, which has led to the selling of property by public entities as a way of reducing the fiscal deficit. Similarly, in Italy the introduction of a new tax regime for real estate investment funds may have led to some large M&A deals in the real estate industry in 2004.<sup>91</sup> Further deregulation and privatization of State-owned assets were reported in Canada (petroleum industry),<sup>92</sup> Italy (electricity industry and media activities), the Netherlands and Hungary (electricity industry) as well as in Lithuania (stock exchange).

## 3. Prospects: positive overall

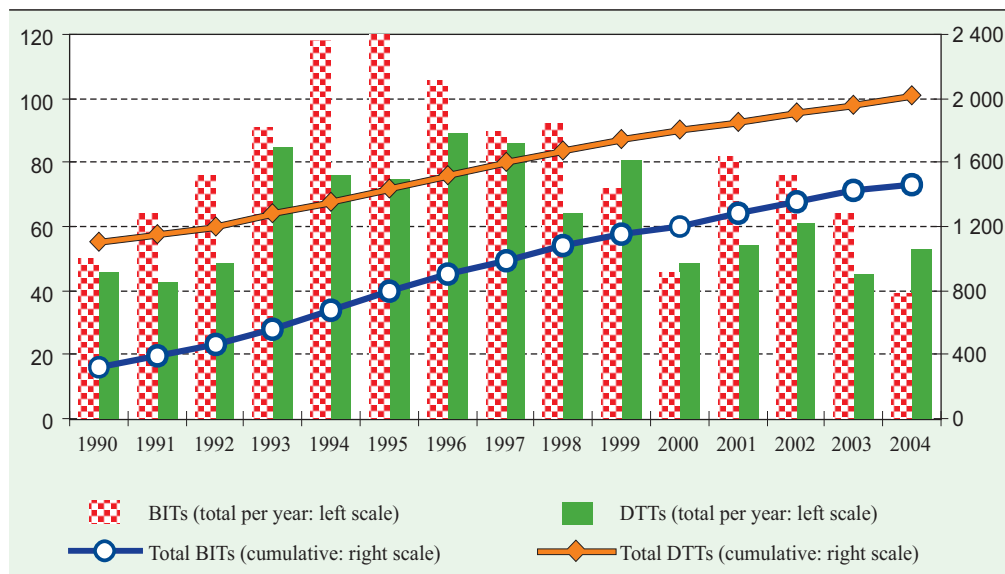
FDI prospects for *developed countries* in 2005 are favourable both for inward and outward flows, underpinned by the forecast of continuing relatively high GDP growth (2.6%), a strong pick-up in corporate profits and a renewed enthusiasm for cross-border M&As (IMF 2005, ECB 2004). The significant increase in cross-border M&As in the first half of the year in developed countries could signal higher FDI flows in 2005. The situation will, however, differ among countries and subregions according to different growth prospects and risk factors.

For the *United States*, economic growth prospects for 2005 are encouraging – although growth in 2005 may prove somewhat weaker than in 2004. Recent data releases suggest buoyant corporate profitability, an increase in export growth rates (ECB 2005), strong business and consumer confidence (IMF 2005), and an increase of 15% in cross-border M&As transactions in the first half of 2005. This may trigger further increases in inward FDI in the United States, although significant imbalances in the economy are a potential concern.

FDI outflows from the United States in 2005 may be held back by recent legislation (the Homeland Investment Act passed in November



Figure II.30. Developed countries: number of BITs and DTTs concluded, cumulative and annual, 1990-2004



Source: UNCTAD, BIT/DTT database ([www.unctad.org/ia](http://www.unctad.org/ia)).

2004) that lowers the tax on repatriated foreign earnings of United States firms.<sup>93</sup> This law, which provides a one-time tax break on corporate foreign profits, is likely to reduce FDI outflows from the United States significantly in 2005, given that over 60% of outward FDI flows (2001-2004) are in the form of reinvested earnings. United States holdings abroad worth approximately \$400-600 billion could potentially be eligible for this tax relief and \$100-150 billion of them are expected to flow back to the United States instead of being reinvested or held by foreign affiliates of United States TNCs.<sup>94</sup> Indeed, a number of United States TNCs have already planned to repatriate a significant amount of foreign profits (table II.11), which would finance some M&A deals within the United States. It would also help finance the United States trade deficit, estimated to be around \$600 billion in 2005, and may contribute to a strengthening of the United States dollar.<sup>95</sup>

For the EU-15, a marginal rise in FDI inflows is expected, partly as a result of an upswing in cross-border M&A activity in the first half of 2005 and healthy corporate profits (IMF 2005). For the euro area, there is a consensus among a number of forecasts that annual GDP growth will average 1.2-1.6% in 2005.<sup>96</sup> Some countries such as the United Kingdom and the new EU members should attract high market-seeking FDI inflows as robust economic growth is expected in 2005 (IMF 2005). Privatization

should also contribute to higher FDI inflows in some large economies.<sup>97</sup> On the other hand, some countries – notably Germany and Italy – are expected to suffer from low economic growth rates. Nevertheless, according to a recent survey (Ernst & Young 2005), Western Europe is the most attractive region for FDI.

Competitive pressures in some industries are driving firms, especially in the EU, to seek economies of scale and scope through cross-

Table II.11. Expected repatriation of profits from United States affiliates abroad to their parents, selected TNCs, 2005

TNCs	Profits to be repatriated to parent firms
3M	1.0
Bristol Myers Group	9.0
Coca-Cola	6.1
Dell	4.1
Eli Lilly and Company	8.0
ExxonMobil	-
General Electric	-
IBM	8.0
Intel	6.0
Johnson & Johnson	11.0
Kellogg	1.0
Oracle	3.1
Pepsico	7.5
Pfizer	29.0
Procter & Gamble	10.7
Schering-Plough	9.4

Source: UNCTAD, based on various newspaper accounts.



border M&As. Thus outflows from EU-15 countries in these industries are expected to increase. In addition, improved corporate profits are likely to encourage EU firms to expand into new markets, especially in Asia and in the new EU member countries. A survey of German firms by the Deutsche Industrie- und Handelskammertag, for instance, shows that 40% of respondent German companies plan to continue investing abroad (DIHK 2005a).

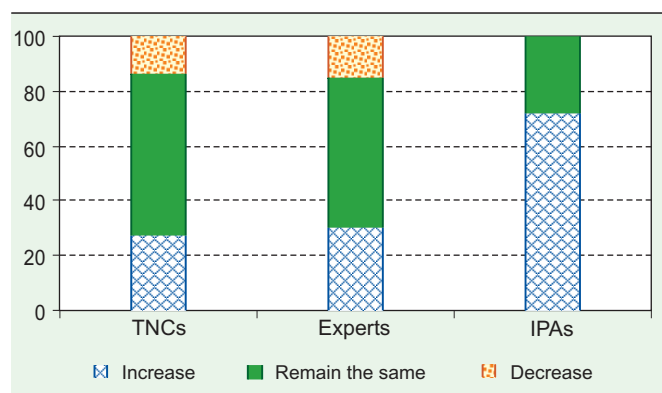
For the 10 new EU member States, FDI prospects look good. As of March-April 2005 these countries were considered to be, after Western Europe, the second most attractive locations for FDI. This is mainly due to the high priority accorded to them by European TNCs (Ernst & Young 2005, p. 9). Although new EU members continue to show solid growth, FDI in these countries is dependent on the health of the European economy as a whole. Consequently, deceleration of growth in the EU-15 might curtail investments at home and abroad (Hunya 2005).

For *Japan* the rise in FDI inflows is likely to continue, supported by economic growth and improving structural features of the Japanese economy. As far as outflows are concerned, a survey by JBIC in late 2004 indicated that 47% of Japanese manufacturing TNCs that responded to the survey plan to strengthen and expand their foreign activities, while another 46% expect to maintain their current level of activities over the following three years (JBIC 2005). In the services sector, for example, Japanese banks are returning gradually to foreign markets by establishing affiliates abroad for the first time, following a continuous three-year decline in FDI projects in banking since 2001. For *Australia*, privatization of State-owned assets is expected to boost FDI inflows further.

UNCTAD's 2005 survey of top TNCs, FDI locational experts and IPAs (box I.3) shows that 60% of TNCs and experts expect FDI inflows to remain the same in 2005-2006 while about one-third of them expect such flows to increase (figure II.31).<sup>98</sup> Looking ahead, FDI flows to major developed countries have risen in the first quarter of 2005, indicating favourable FDI prospects for developed countries as a whole. For example, FDI flows in the United States, the United Kingdom, France, Germany and Australia rose by 81%, 41%, 15%, 109% and 30% respectively.

**Figure II.31. Developed countries: prospects for FDI inflows, 2005-2006**

(Per cent of responses from TNCs, experts and IPAs)



Source: UNCTAD ([www.unctad.org/fdiprosects](http://www.unctad.org/fdiprosects)).

## Notes

- Major revisions have been made to the 2003 data on FDI inflows to the top host African countries, with the combined inflows to Angola and Nigeria in that year rising by up to \$6 billion after the revision. According to the revised data, total FDI inflows to Africa were \$18 billion in 2003 (annex table B.1).
- Oil prices, for instance, soared above \$50 a barrel, up from \$22 in 2003. Gold prices rose to above \$400 per ounce in 2004 as against \$280 in 2003, while copper prices rose by 90% (Kitco Bullion Dealers ([www.kitco.com](http://www.kitco.com))). Prices also rose for diamonds and platinum.
- The Royal Dutch /Shell Group of Companies in Nigeria, for instance, reported an annual net income for the year ending 31 December 2004 of \$18.2 billion, 38% higher than in the previous year ([www.allafrica.com](http://www.allafrica.com)).
- Algeria, Egypt, the Libyan Arab Jamahiriya, Morocco, Sudan and Tunisia.
- Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Reunion, Rwanda, Seychelles, Somalia, the United Republic of Tanzania, Uganda, Zambia and Zimbabwe.
- Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone and Togo.
- Angola, Cameroon, Central African Republic, Chad, Congo, Democratic Republic of the Congo, Equatorial Guinea, Gabon and Sao Tome and Principe.
- Botswana, Lesotho, Namibia, South Africa and Swaziland.
- Source: *Coca Cola Newsletter* ([www.inboxrobot.com/news/CocaCola](http://www.inboxrobot.com/news/CocaCola)).
- In 2001-2002 FDI flows to Nigeria were, on average, \$1.7 billion per year and to Angola \$1.9 billion ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).
- Egypt's Orascom is the major telecoms operator in Algeria (*WIR04*, pp. 46-47). Also, Kuwait's National

- mobile telecoms company (AlWatanya) invested \$400 million there in 2004 (*source: Economist Intelligence Unit, Algeria 2004 Country Report*).
- <sup>12</sup> Source: Economist Intelligence Unit, *Morocco 2004 Country Report*.
- <sup>13</sup> Information is from the EIU's country reports ([www.eiu.com](http://www.eiu.com)).
- <sup>14</sup> Source: MIGA ([www.miga.org](http://www.miga.org)).
- <sup>15</sup> ATI was established by the Common Market for Eastern and Southern Africa (COMESA) Summit of Heads of State in May 2000 and launched in August 2001.
- <sup>16</sup> In 2001, Japan established categories of products for which preference is granted to LDCs, as a result of which about 99% of individual products (some 360 items, including all the textile and clothing products) from LDCs are imported duty-free and quota-free.
- <sup>17</sup> Source: "Sub-Saharan oil growing "force" on world markets", *Mail & Guardian* ([www.mg.co.za](http://www.mg.co.za)), 6 July 2005.
- <sup>18</sup> Sources: *IPAWorld* ([www.ipaworld.com](http://www.ipaworld.com)), 24 June 2004; *Mining News* ([www.miningnews.net](http://www.miningnews.net)), 19 August 2004 and [www.numsa.org.za](http://www.numsa.org.za).
- <sup>19</sup> Source: "TLC: Egypt's Orascom plans new acquisitions in Italy", *Euro-Mediterranean Network for Culture and Social Dialogue*, 11 July 2005, [www.ansamed.info](http://www.ansamed.info).
- <sup>20</sup> Following a reclassification, Asia and Oceania (previously Asia and the Pacific) includes a total of 61 countries and territories. On the one hand, eight countries in Central Asia that were included as part of the region in previous *WIRs* are now reclassified under the CIS. Cyprus, formerly under West Asia, is now reclassified under the EU (box I.2). On the other hand, ten additional countries and territories in Oceania (formerly Pacific islands) and Timor-Leste are now classified under Asia and Oceania. Data are available for 54 countries and territories in the region.
- <sup>21</sup> Three regulations promulgated by the China Securities Regulatory Commission in 2002 provide procedural provisions for the acquisition of listed companies. In addition, the "Interim Provisions on the Utilisation of Foreign Investment to Restructure State-owned Enterprises" adopted in 2002 include provisions for foreign M&As of State-owned enterprises (excluding listed companies and financial institutions). The "Interim Provisions on Mergers and Acquisition of Domestic Enterprises by Foreign Investors" adopted in 2003 include more detailed provisions for the acquisition of domestic firms.
- <sup>22</sup> Includes China, Hong Kong (China), the Democratic People's Republic of Korea, the Republic of Korea, Macao (China), Mongolia and Taiwan Province of China.
- <sup>23</sup> The FDI flow data reported by China's Ministry of Commerce (MOFCOM), and used by UNCTAD in recent *WIRs*, are gathered on a gross basis (recording only credit transactions) rather than a net (credit less debit) or balance-of-payments basis. Thus divestments, capital withdrawals and repayment of debt to foreign parent firms are not included. Data on inward FDI stock are revised as reported by MOFCOM (see annex B, Definitions and sources, for details).
- <sup>24</sup> For example, HSBC (United Kingdom) invested \$1.7 billion for a 20% stake in the Bank of Communication. By the end of 2004, a total of 10 Chinese banks had foreign ownership (*Source: data from China Banking Regulatory Commission*).
- <sup>25</sup> Some recent large investment projects by private equity funds include: Texas Pacific Group, General Atlantic and New Bridge Capital's investment in Lenovo (\$350 million), Carlyle and Prudential Financial's investment in China Pacific Life Insurance (\$400 million) and New Bridge Capital's investment in Shenzhen Development Bank (\$160 million) (*Source: data from various newspaper accounts*).
- <sup>26</sup> This is illustrated by the FAW-Toyota (\$2.5 billion) and DMC-Nissan (\$2 billion) joint ventures.
- <sup>27</sup> Comprises ASEAN member countries (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam) and Timor-Leste.
- <sup>28</sup> Other, similar studies reached the same conclusion. See for instance Cheong 2000 and Chantasawat et al. 2003.
- <sup>29</sup> Includes Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.
- <sup>30</sup> In September 2002, the Afghan Government passed the Law on Domestic and Foreign Private Investment that includes investor-friendly incentives to attract foreign investment. Wholly owned foreign affiliates are also allowed to be established. Firms from China, France, Germany, the Islamic Republic of Iran, the Netherlands, Pakistan (Afghan expatriates), Turkey, the United Kingdom and the United States have already invested in Afghanistan. Major investments during 2004 and early 2005 include those by Universal Guardian (United States) in business services, Heidelberger (Germany) in business machines and equipment, Home Essentials (Hong Kong, China) in consumer products and a Coca-Cola bottling plant (\$40 million). In financial services, Standard Chartered Bank (United Kingdom), Habib Bank (Pakistan) and Arian Bank (Islamic Republic of Iran) are major foreign-owned banks (*BBC Morning South Asia*, 14 July 2004 and *Nihon Keizai Shimbun*, 21 March 2005).
- <sup>31</sup> Includes Bahrain, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, the Palestinian Territory, Qatar, Saudi Arabia, the Syrian Arab Republic, Turkey, the United Arab Emirates and Yemen.
- <sup>32</sup> Including the data from Bahrain, Oman, Saudi Arabia and the Syrian Arab Republic, where a survey on inward FDI was undertaken for the first time in 2004, with technical assistance from the Economic and Social Commission for West Asia (ESCWA) and UNCTAD. See, for example, the Saudi Arabian General Investment Authority (SAGIA), "SAGIA initiates first major FDI survey in Kingdom", 14 July 2004 ([www.sagia.gov.sa](http://www.sagia.gov.sa)). In June 2005 SAGIA released a report entitled "Foreign direct investment survey report", detailing information on inward FDI (both flows and stock).
- <sup>33</sup> American Samoa, Cook Islands, Fiji, French Polynesia, Guam, Kiribati, Marshall Islands, the Federated States of Micronesia, Nauru, New Caledonia, Niue, Northern Marina Islands, Palau, Papua New Guinea, Samoa, the Solomon Islands, Tokelau, Tonga, Tuvalu, Vanuatu, Wallis and the Futuna Islands.
- <sup>34</sup> Data from UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

- 35 In October 2004, for instance, the National Development and Reform Commission and the Export-Import Bank of China jointly promulgated a circular to encourage overseas investment projects in the following four areas: (i) resource exploration projects that can mitigate the domestic shortage of natural resources, (ii) projects that can promote the export of domestic technologies, products, equipment and labour, (iii) overseas R&D centres that can utilize internationally advanced technologies, managerial skills and professionals, and (iv) M&As that can enhance the international competitiveness of Chinese enterprises and accelerate their entry into foreign markets. A preferential credit policy encourages investment in these key projects supported by the State.
- 36 In 2005, for instance, Bank of America signed an agreement to invest \$2.5 billion in China Construction Bank for a 9% stake.
- 37 As a result, Japanese manufacturers planning to “expand business operations in ASEAN” within the next two years increased to 57% in the 2004 survey from 54% in the 2003 survey. Source: JETRO, “JETRO releases its survey of Japanese manufacturers in ASEAN and India”, *Press Release*, 6 April 2005, [www.jetro.go.jp](http://www.jetro.go.jp).
- 38 See “Ratan Tata to head Investment Commission”, *Economic Times*, 14 December 2004 ([www.economictimes.indiatimes.com](http://www.economictimes.indiatimes.com)).
- 39 In January 2004, Baosteel signed a framework agreement with Arcelor and CVRD to build a steel plant in Brazil. The total investment will be \$8 billion.
- 40 A group of Shanghai developers plans to invest over \$1.2 billion in a project in Saint Petersburg ([www.people.com.cn](http://www.people.com.cn), 18 October 2004).
- 41 Given the large sums of “Chinese dollars”, which are still rapidly accumulating, these and other developments suggest that China is looking to acquire corporate equities in the United States, rather than remaining merely a large holder of United States Treasury bonds.
- 42 In terms of real effective exchange rates, national currencies appreciated in 2004 in countries like Brazil (4%), Chile (6.9%), Colombia (8.4%), Guatemala (1.9%) and Paraguay (5.1%), but they remained at lower levels than in 2000, except in the case of Guatemala. Between 2000 and 2004 the five largest depreciations in national currency occurred in Argentina (55%), Uruguay (37%), Venezuela (30%), Brazil (23%) and Jamaica (16%) (calculations based on data in ECLAC 2004a).
- 43 Interbrew acquired 100% of Braco S.A., a Brazilian holding company with a 52.8% voting interest and 21.8% financial interest in AmBev. The operation was registered as both inward and outward FDI because the former shareholders of Braco S.A. (Brazil) received shares of Inbev from Interbrew (Belgium). Inbev is the new group that resulted from the operation, and is headquartered in Belgium.
- 44 For instance, the Swiss cement company Holcim acquired the remainder of its Mexican affiliate, Holcim Apasco, for \$750 million.
- 45 In 2004, Cargill (United States) completed an acquisition in the meat industry in Argentina for \$70 million, and announced an acquisition in Brazil for \$130 million. It is also spending \$200 million in Argentina for a new soya-processing plant and a private port to handle exports (*Business Latin America*, 8 March 2004 (London: EIU)). Dreyfus (France), Archer Daniels Midland and Bunge (both United States) are expanding their capacities in Argentina (“Argentina: soya’s heady days”, *Business Latin America*, 23 February 2004 (London: EIU)).
- 46 “Brazilian car parts suppliers cut back”, *Business Latin America*, 23 May 2005 (London: EIU).
- 47 *Business Latin America*, 19 January 2004 (London: EIU).
- 48 *Nihon Kaizai Shimbun*, 24 February 2005, and ECLAC 2005.
- 49 Source: “Siderurgia investirá US\$ 13 bilhões até 2010”, IBS, [www.ibs.org.br](http://www.ibs.org.br). Among foreign investors, Arcelor (Luxembourg), plans to invest \$3 billion by 2008, after having invested more than \$1 billion in 2004; Nippon Steel (Japan) plans to build a fourth high-blast furnace worth \$600 million at Usiminas; and China’s largest steel producer, Shanghai Baosteel Group, is planning to set up a joint-venture steel mill in Brazil with CVRD, which will involve investments of \$1-1.4 billion in its first stage (*Business Latin America*, 24 May 2004 and 13 September 2004 (London: EIU)); Arcelor press releases, 29 June 2004 and 20 December 2004, [www.arcelor.com](http://www.arcelor.com); “Baosteel Moves To Secure Brazilian Iron Ore Sources With JV”, *China Business Strategy*, 4 February 2004, [www.china-ready.com](http://www.china-ready.com).
- 50 Fonterra (New Zealand) plans to build a new milk-processing plant in Chile and to expand its dairy exports, mostly to Latin America, from its Soprole affiliate there. Meanwhile, the joint venture of its Dairy Partners Americas (DPA) with Nestlé (Switzerland) is expanding its activities from Brazil, Argentina and Venezuela to Ecuador, Colombia and Trinidad and Tobago. (“Latin America: Industry forecast: Redeeming brands”, *Business Latin America*, 10 May 2004 (London: EIU)).
- 51 Volkswagen, Fiat, General Motors and Ford Motor have launched a range of 40 flex-fuel models since the mid-2003. Renault (France) launched its first flex-fuel model in November 2004, and PSA Peugeot Citroën (France) will follow suit in June 2005 (“Brazil: refined drive”, *Business Latin America*, 13 December 2004 (London: EIU)).
- 52 Source: “Brazil: refined drive”, *Business Latin America*, 13 December 2004 (London: EIU) and “Latin America: Industry forecast: Trading back-up”, *Business Latin America*, 13 December 2004 (London: EIU).
- 53 Information from Instituto Nacional de Estadística Geografía e Informática (INEGI) of Mexico.
- 54 In these six countries, the apparel industry accounts for a significant share of total manufacturing employment (generating around 500,000 jobs), and has been responsible for most of the growth of their manufactured exports since the mid-1980s (IADB, 2004).
- 55 Fourteen textile firms are reported as having already closed in Guatemala in the first 49 days of 2005, with 3,426 job losses (*Lapress*, 10 March 2005, [www.lapress.org](http://www.lapress.org)).
- 56 In the retail industry, Royal Ahold sold its assets in Argentina and Brazil, while Carrefour withdrew from Chile and announced in March 2005 its retreat from Mexico. Cencosud (Chile) bought Royal Ahold’s assets

in Argentina after acquiring in 2003 the company's assets in Chile, and Walmart (United States) purchased Royal Ahold's Bompreço chain in Brazil. In the telecom sector, Telmex (Mexico) acquired AT&T Latin America, which gave it a region-wide reach in the fixed-line segment.

- <sup>57</sup> Electricité de France (EDF) is considering the sale of its majority stake in Edenor, one of Argentina's biggest electricity distributors ("Argentina govt not concerned over EDF's withdrawal - cabinet chief Messenger", *Yahoo! Finance*, 27 April 2005); Worldcom is in negotiations to divest itself of its controlling stake in Embratel, Brazil's long-distance telephone company; British Gas (United Kingdom) is in negotiations with Emgasud (Argentina), for the sale of its Argentinean affiliate Metrogas ("Un grupo argentino, cerca de MetroGas", *Clarín*, 5 May 2005); and the water company Uragua (Spain), announced in November 2004 its intention to leave the Uruguayan market ("Uruguay: Vázquez's investor nod", *Business Latin America*, 18 April 2005 (London: EIU)).
- <sup>58</sup> For example, in Chile, foreign investors and Chileans with residence abroad can invest through the Foreign Investment Statute known as Decree Law 600 that offers some tax advantages for foreign investors. They are provided with a stable tax horizon. Indeed, the decree allows investors to lock into the tax regime prevailing at the time an investment is made (Chile Foreign Investment Committee, "FDI in Chile, regulations and procedures", [www.cinver.cl](http://www.cinver.cl)).
- <sup>59</sup> In Chile, the debt-to-equity swap mechanism was limited to foreigners or Chileans with residence and domicile abroad. In Mexico, foreign companies were given priority in terms of eligibility for investment under the debt-for-equity conversion programme.
- <sup>60</sup> ECLAC press releases, "Latin America will have to design and implement better foreign direct investment policies", 9 January 2002, available at [www.eclac.cl](http://www.eclac.cl), quoting the Regional Seminar on FDI Policies in Latin America: "Evaluating the Old, Contemplating the New", jointly organized by ECLAC and UNCTAD, and held at ECLAC headquarters in Santiago, Chile, 7-9 January 2002.
- <sup>61</sup> Surveys implemented by Latinobarometro in 17 Latin American and Caribbean countries indicate that the general public has increasingly turned against the privatization process, with the percentage of respondents dissatisfied with the process rising from 43% in 1988 to 75% in 2004. (LatinoBarometro 1998-2000, 2003, 2004, [www.latinobarometro.org](http://www.latinobarometro.org)).
- <sup>62</sup> ENARSA will be the vehicle for companies wanting to enter the energy market or to obtain government incentives for investing in exploration and production. In May 2005, the Government presented before Congress a package of fiscal incentives featuring tax breaks for hydrocarbon companies that invest in exploration and production. To be eligible for these benefits the firms will have to work in partnership with the new State energy company ("Argentina: official investment push", *Business Latin America*, 30 May 2005 (London: EIU)).
- <sup>63</sup> TNCs oppose this law, claiming that it is in violation of their contracts, and they are threatening to take their case to international tribunals. It is also opposed by civil society groups (native Indian groups, labour unions, teachers, miners and coca-leaf farmers), which are pressing for the nationalization of Bolivia's energy industry and greater indigenous rights, among other demands. The growing tensions led the President to resign in June 2005.
- <sup>64</sup> *Avances de la Nueva PDVSA*, 15 April 2005, [www.pdvsa.com](http://www.pdvsa.com).
- <sup>65</sup> To benefit from these fiscal incentives, investment projects must be approved by the authorities following public bids. A number of foreign firms such as Repsol-YPF, Peugeot Citroen, General Motors Argentina, Volkswagen Argentina, Cargill and Louis Dreyfus are among those that won the bids. ("Grandes inversiones en marcha están vinculadas a los subsidios estatales", *Clarín*, 15 May 2005).
- <sup>66</sup> To compensate for the effects of high interest rates and a strong currency, Brazilian officials pledged in May 2005 to grant incentives to exporters and software manufacturers to boost medium- and long-term foreign sales and investments ("Lula offers exporters tax breaks", *Business Latin America*, 30 May 2005 (London: EIU)).
- <sup>67</sup> In a 2004 survey by the Japan Bank for International Cooperation, for example, Brazil and Mexico were ranked 8th and 10th in the world, respectively, among the top destinations of Japanese automobile TNCs for the next three years (JBIC 2005).
- <sup>68</sup> DR-CAFTA is currently before the United States Congress. Opponents to the agreement are concerned about its potential to undermine the domestic sugar and apparel industries, the impact on the United States trade deficit and the differences prevailing in labour and environmental protection laws between the United States and the other signatory countries (*Bloomberg*, 3 May 2005, [www.bloomberg.com](http://www.bloomberg.com), and Economist Intelligence Unit, *Viewswire*, 13 May 2005, [www.viewswire.com](http://www.viewswire.com)). The agreement is also opposed by civil society groups in the Dominican Republic and the Central American countries, where the issues of greatest concern include the provisions on investment, services, and government procurement that might lead to or extend privatizations. There are also concerns about the impact of the free access of United States agricultural products to Central American markets on the Central American agricultural sector, which is the source of half of local employment.
- <sup>69</sup> The main activity of the oil company Petrom is petroleum products and this is registered as part of manufacturing.
- <sup>70</sup> The FDI statistics for Turkmenistan, another natural-resource-rich country of the region, are incomplete and may underestimate the extent of investment in oil and natural gas there. Sources other than balance of payments indicate that foreign firms in that industry have invested large sums ("2005 Investment Climate Statement - Turkmenistan", Washington, D.C.: United States Department of State, [www.state.gov](http://www.state.gov)).
- <sup>71</sup> In 2004, Cyprus was the largest source of foreign investment in the Russian Federation, and Luxembourg was third (Russian Federation, State Statistical Service, *Current Statistical Survey: Quarterly Magazine*, No. 1 (52), 2005). As noted in *WIR00* (p. 65), most FDI coming from Cyprus is actually round-tripping Russian



- capital. See also Pelto et al. 2003. Similarly, Luxembourg is a source of “trans-shipped” FDI (WIR04, p. 69).
- 72 The strategic importance of the Baku-Tbilisi-Ceyhan pipeline lies in the fact that it is the first alternative route outside the Russian Federation for transporting Caspian oil to Western Europe. The construction of the pipeline has been accompanied by an intense debate on its environmental and human rights impact (Shelley 2005, pp. 107-109).
- 73 Global firms include such as the BG Group (United Kingdom), Agip (Italy), Chevron Corp. (United States), ExxonMobil (United States), Lukoil (Russian Federation) and BP (United Kingdom). Independent companies are incorporated and listed abroad, despite the fact that all of their oil exploration and extraction takes place in Kazakhstan. Petrokazakhstan (Canada), the largest independent oil company operating in Kazakhstan, is the second largest foreign-owned petroleum producer there (Dashevsky and Loukashov 2004, p. 38). There are other independent oil firms in the country such as Chaparral Resources (United States), Nelson Resources (Bermuda) and Transmeridian Exploration (United States), BMB Munai (United States), Aurado Energy (Canada) and EMPS (United States).
- 74 “OAO Lukoil: oil company, Uzbekistan sign \$1 billion natural gas deal”, *Wall Street Journal*, 17 June 2004, p. 1.
- 75 As Yukos could not pay its tax arrears, its assets were seized and put on auction. At one auction in December 2004, the Yuganskneftegaz oil extraction affiliate of Yukos was sold to a financial company, which in turn was taken over by the State-owned Rosneft company three days later (“Kremlin-owned firm buys Yukos asset”, *Wall Street Journal*, 23 December 2004, p. A.3; “Rosneft buys Yukos unit’s mysterious new owner” *International Herald Tribune*, 24 December 2004, p. 13).
- 76 “TNK-BP faces dollars 87m back-tax bill”, *Financial Times*, 12 November 2004, p. 16. In April 2005, the tax arrears claim on BP-TNK was increased from less than \$100 million to almost \$1 billion (“Putin gives big oil the cold shoulder”, *Fortune*, 16 May 2005, p. 32.)
- 77 “Ukraine trims privatisation check”, *BBC News*, 21 February 2005, [www.news.bbc.co.uk](http://www.news.bbc.co.uk), and “Daily news and analysis”, *MFK Investment Bank* (Kiev), 16 February 2005, mimeo.
- 78 The term “Dutch disease” is named after the effects on the economy of natural gas discoveries in the Netherlands, and is most commonly applied to exchange rate appreciation caused by massive exports by the natural resource extractive industries, leading to high production costs (including wages) in other manufacturing activities.
- 79 FDI inflows to the chemicals industry more than doubled to \$7.5 billion and they also rose in the electrical equipment industry, from -\$6.5 billion in 2003 to \$1 billion in 2004. This industry accounted for more than one-fifth of total United States exports in 2003 (data from United States Department of Commerce, [www.bea.gov.doc](http://www.bea.gov.doc) and annex table A.I.1).
- 80 In 2004, the euro appreciated substantially against the United States dollar. This appreciation alone resulted in a 4% decline in the dollar value of FDI inflows into the euro-zone countries.
- 81 Total FDI inflows were negative as the net repayment of intra-company debt (\$13 billion) by foreign affiliates in the Netherlands was larger than inflows of equity investment (\$2.8 billion) and reinvested earnings (\$5.7 billion) combined.
- 82 Germany became the world’s third largest private equity market by value after the United States and the United Kingdom in 2004. “German business welcomes the private equity “locusts”, *Financial Times*, 5 May 2005. Carlyle, Kohlberg Kravis Roberts and Goldman Sachs are typical foreign equity investors active in the German market. (For a brief description of private equity companies and their cross-border investments, see chapter I, footnotes 30 and 31).
- 83 FDI inflows to France fell by nearly half, from \$42 billion in 2003 to \$24 billion in 2004, due primarily to divestment in equity capital linked to cross-border M&As and a sizeable reduction in intra-company loans. In 2004, inward equity investment flows to France fell by 67% and intra-company loans (which are recorded in the category “other types of inward investment”) fell by 37%.
- 84 In Ireland, FDI inflows fell sharply from \$27 billion in 2003 to \$9 billion in 2004. This is largely explained by a fall in inward equity investment, by \$5.7 billion in 2004, combined with a sizeable decline (\$8.8 billion) in reinvested earnings.
- 85 In Spain, FDI inflows have been declining over the last couple of years owing to the diminishing impact of a special corporate income tax regime (Law 43/1995, last amendment 2000) of which companies have already taken advantage. Also, Spain’s traditional low-labour-cost advantage, which had successfully attracted manufacturing investors, might be eroded with the enlargement of the EU to include countries with even lower labour costs. This may affect FDI inflows adversely. For example, Samsung withdrew from Spain and relocated its affiliate to lower cost Slovenia.
- 86 In 2004, 40% and 43% of cross-border M&A sales, in terms of value and number respectively, in the United Kingdom were concluded with United States firms/investors (data from United Kingdom, National Statistical Office).
- 87 The Government sold a 49% stake of Zapadoslovenska Energetika to Germany’s EON Energie, a 49% stake in Stredoslovenska Energetika to Electricité de France and a 49% stake in Yvyehodoslovenska Energetika to Germany’s RWE Plus ([www.slovakia.org](http://www.slovakia.org)).
- 88 Out of 88 cross-border M&As completed in Japan in 2004, almost one-third were undertaken by either asset management companies (fund managers) or security brokers (e.g. Carlyle Group (United States), Lone Star Fund (United States), Morgan Stanley (United States)).
- 89 For example, a new immigration law approved in July 2004 makes it easier for companies to attract and keep highly qualified foreign employees, and for foreign investors to gain permanent resident status in Germany by investing one million euros and creating ten new jobs.
- 90 The largest FDI-related investment – \$800 million by Apollo Rida (United States) in Poland in 2004 – was in real estate (Polish Information and Foreign Investment Agency).



- <sup>91</sup> For example, Fondo Immobili Pubblici was acquired by a United Kingdom Investor group for \$1.9 billion and New Real SpA was acquired by Excelsia Otto (Germany) for \$1.7 billion in 2004 (annex table A.I.1).
- <sup>92</sup> In 2004, the Government of Canada sold all Petro Canada shares in a global offer, making this the fifth largest global privatization of the decade (Department of Finance, Canada, [www.fin.gc.ca](http://www.fin.gc.ca)).
- <sup>93</sup> Under the Act, corporate taxes on dividends to the parent firm are taxed at a one-off effective tax rate of 5.25%, available for one of two tax years, as opposed to the previous rate of 35% under certain conditions.

This is aimed at boosting job creation and R&D in the United States.

- <sup>94</sup> Estimated by Deutsche Bank ([www.db.riskwaters.com](http://www.db.riskwaters.com)).
- <sup>95</sup> *Financial Times*, 31 Jan 2005, p.17.
- <sup>96</sup> *European Central Bank*, June 2005, p. 68.
- <sup>97</sup> For instance Terna (Italy's national power grid), Snecma (France's national maker of aircraft engines), Electricité de France (EDF) and Gaz de France (GDF) have gone or are expected to go to initial public offerings in 2005.
- <sup>98</sup> The survey did not include the 10 new EU accession countries.