Geo Factsheet

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GLOBAL TRENDS IN FOREIGN DIRECT INVESTMENT

The globalisation of production is reshaping the international economic landscape. With that, the conventional wisdom of developed countries as capital and technology exporters and developing countries as importers is gradually giving way to a more complex set of relationships. The geography of international investment flows is changing. Developing countries, especially NICs, are emerging as outward investors, and their importance as recipients of foreign direct investment in more knowledge-intensive activities is increasing.

The World Investment Report 2005

Key Terms
Foreign Direct Investment (FDI): *overseas investments in physical capital by transnational corporations.*
Transnational corporation: *'a firm that has the power to co-ordinate and control operations in more than one country, even if it does not own them' (Peter Dicken).*
Newly industrialised countries: *nations that have undergone rapid and successful industrialisation since the 1960s.*
Globalisation: *the increasing interconnectedness of the world economically, culturally and politically.*
Greenfield Investment: *investment in a totally new project such as building a new factory.*

Introduction

Foreign direct investment brings private (i.e. non-government) funds into a country for investments in the primary, secondary and tertiary sectors of the economy. FDI largely occurs through the actions of transnational corporations although FDI may also be undertaken by individuals who have large financial resources. A high level of FDI can result is impressive rates of economic growth. The rapid expansion of the Chinese, Indian and most recently the Brazilian economies over the last decade or so has much to do with very considerable foreign direct investment, although other factors have also played a part. Similarly, within the EU the high growth rate experienced by the Republic of Ireland owes much to the country's ability to attract a high level of FDI.

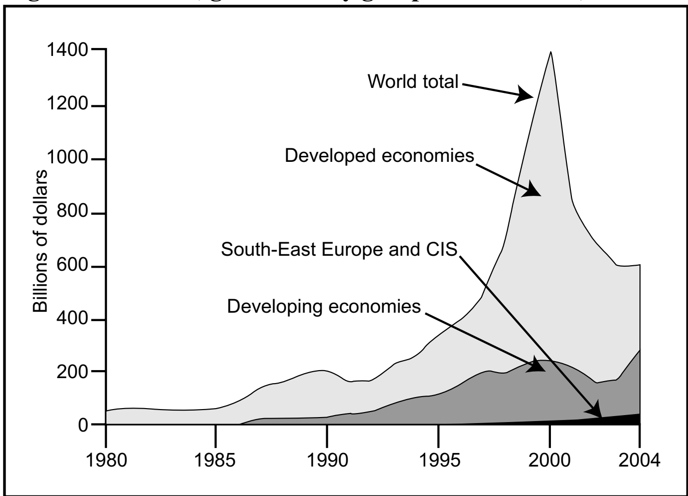
In terms of the UK, a British firm investing in a chemical factory in Brazil provides an example of **outward** direct investment. Conversely the decision of a Japanese car producer to set up a factory in the UK is an example of inward direct investment. Both constitute FDI. The first is an outflow from the UK and an inflow into Brazil. The second is an outflow from Japan and an inflow into the UK.

According to the World Investment Report foreign direct investment is defined as 'an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy in an enterprise resident in another economy. FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy.'

Recent Trends in FDI Inflows

In 2004 there was a slight increase in foreign direct investment (FDI) flows after three years of decline *(Fig. 1)*. At $648 billion, world FDI inflows were 2% higher than in the previous year. This growth was mainly due to greater flows to developing countries as well as to South-East Europe and the CIS (Commonwealth of Independent States). The CIS includes all of the former republics that were part of the former USSR except the Baltic States.

Fig. 1 FDI inflows, global and by groups of economies, 1980-2004.



This followed declines of 41% in 2001, 13% in 2002, and 12% in 2003. While inflows to LEDCs increased by 40% to $233 billion in 2004, FDI inflows to MEDCs fell by 14%. The fall was particularly marked in the EU where FDI was down 36% to its lowest level since 1996. As a result the share of LEDCs in world FDI inflows was 36%, the highest level since 1997. The increase in FDI flows to LEDCs was mainly associated with new greenfield investments, particularly Asia. The global total of greenfield FDI projects expanded from 9,300 in 2003 to 9,800 in 2004. About half of all new investment projects in 2004 were in China. In 2004 the USA received the highest level of FDI inflows, followed by the UK and China.

Fig. 1 shows the very considerable increase in FDI inflows over the last two decades, firstly in the late 1980s, and secondly in the late 1990s. The peak achieved in 2000 was shattered by concerns about the global economy and of course 9/11 (the terrorist attacks on the United States).

Fig. 2 shows FDI flows by world region for 2003 and 2004. FDI flows can vary considerably from one year to the next. For some countries FDI inflows are heavily concentrated on one industry. *Fig. 3* shows the share of petroleum in FDI inflows in four African countries. For Nigeria, Angola and Equatorial Guinea petroleum accounts for 90% or more of total FDI inflows.

Fig. 2 FDI flows by region, 2003 and 2004.

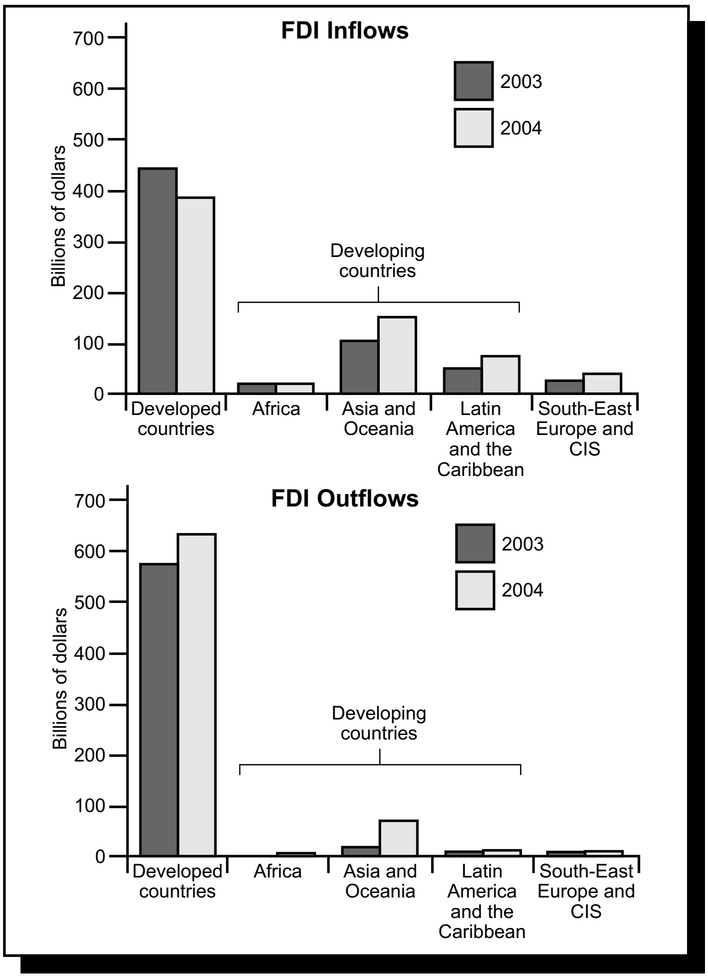
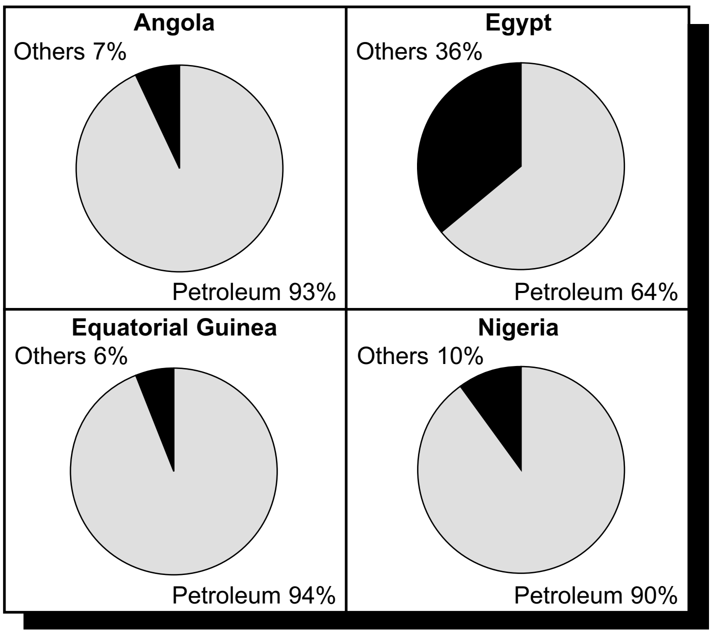


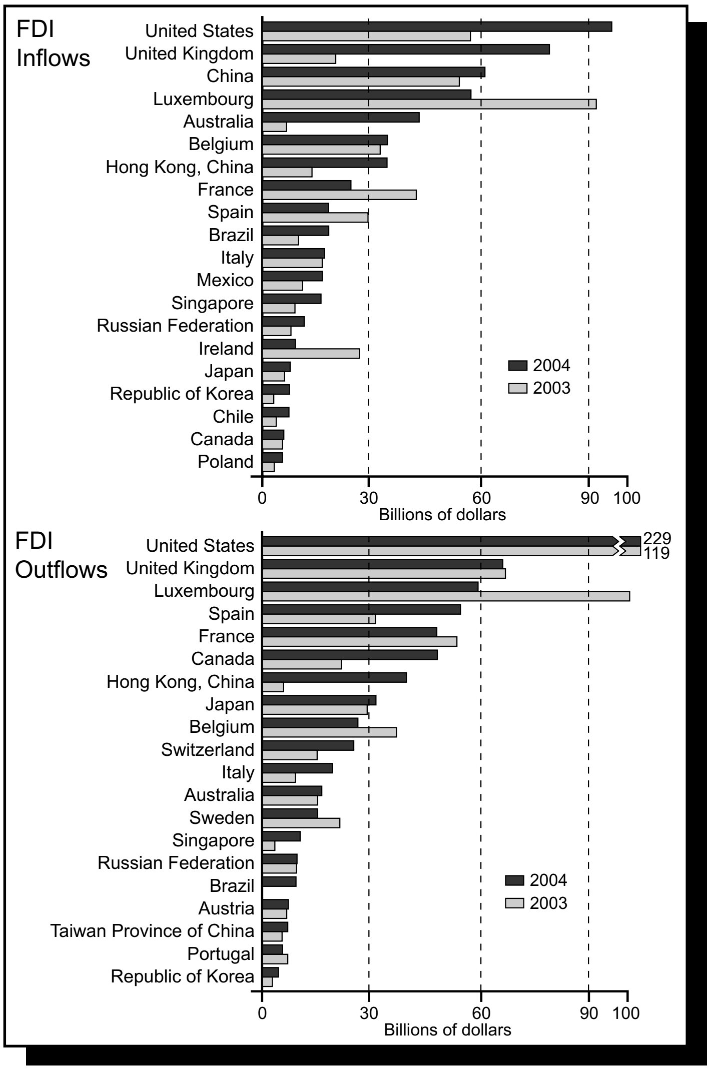
Fig. 3 Share of petroleum in FDI inflows to four major African countries, 2004.



Recent Trends in FDI Outflows

FDI outflows increased by 18% in 2004 over the previous year. Here, MEDCs accounted for $637 billion out of the total of $730 billion. Almost half of all outward FDI came from just three countries: the USA, the UK and Luxembourg. The MEDCs remained large net exporters of FDI *(Fig. 4)* with net outflows exceeding net inflows by $260 billion. Although FDI outflows from the EU fell by 25% in 2004, most other MEDCs increased their investment abroad. Outflows from the USA rose by more than 90% to a record $229 billion. Outflows from LEDCs have risen from a minimal level in the early 1980s to $83 billion in 2004. This positive trend is likely to continue in the future.

Fig. 4 Global FDI flows in the top 20 economies, 2003 and 2004.



TNCs and the Total Stock of FDI

In 2004, the total stock of FDI amounted to $9 trillion. This vast sum is attributed to about 70,000 transnational corporations and their 690,000 affiliates abroad, with total sales by foreign affiliates amounting to almost $19 trillion. However, the rate at which the major 100 TNCs are expanding globally appears to have slowed down. In terms of the headquarters of TNCs, Japanese and American TNCs tend to less transnationalised than European TNCs.

In terms of foreign assets, General Electric (USA) remains the largest non-financial TNC worldwide, followed by Vodafone (UK) and Ford Motor (USA). Among the top 100 TNCs worldwide, four companies, led by Hutchison Whampoa (Hong Kong, China), are based in LEDCs. International investment in services accounts for the bulk of FDI stock. For example, large TNCs dominate global financial services. Financial TNCs from the USA, UK, Japan, Germany and France accounted for 74% of the total assets of the top 50 financial TNCs in 2003.

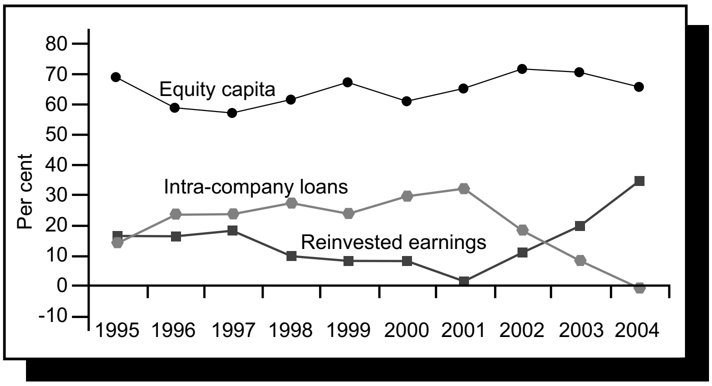
Types of FDI

The three main forms of FDI, financed by TNCs, are:

- **Equity investment** - for example the building and equipping of a new factory in another country. This category also includes the purchase of majority shareholdings in a company based in another country. For example many companies in the UK which were once British owned are now owned by foreign companies.
- **Intra-company loans** - for example, moving funds from the country where the company headquarters is located to its operations in an LEDC.
- **Reinvested earnings** - for example, using profits made in another country to expand operations there.

Equity capital is the largest component of world FDI inflows *(Fig. 5)*, accounting for about two-thirds of total FDI flows over the last ten years, although there are substantial differences between countries. In recent years reinvested earnings have become more important than intra-company loans. *Table 1* shows FDI inflows by country ranked by the size of the three components for 2003. Inflows into the UK were much lower in 2003 compared to 2004.

Fig. 5 Share of different financing components in world FDI inflows, 1995-2004.



Modes of FDI Entry into a Country

TNCs may begin economic activity in a new country through:

- Either 'greenfield investment'
- Or merger and acquisition.

The type of entry into a new country often depends on the nature of the industry and the laws and regulations of the country concerned. Mergers and acquisitions play an important part in the restructuring and consolidation process of many industries, particularly in MEDCs. The largest M&A deal in 2004 was the acquisition of Abbey National (UK) by Santander Central Hispano (Spain) valued at $16 billion. In LEDCs, cross-border M&A's account for a lower share of overall FDI activity.

FDI versus Official Development Assistance to LEDCs

FDI continues to be greater than other private capital flows to LEDCs (i.e. remittances) as well as flows of official development assistance (ODA). However, FDI is concentrated in a relatively small number of LEDCs, while ODA remains the most important source of finance in many poor countries.

The Globalisation of Research and Development

Large TNCs are increasingly establishing research and development facilities in selected developing countries. For example:

- Motorola set up the first foreign-owned R&D facility in China in 1993. Today the number of foreign R&D units is 700
- From virtually zero in the mid-1990s, the contribution of South-East and East Asia to global semiconductor design reached almost 30% in 2002.

TNCs are increasing R&D facilities in such countries to:

- Enhance efficiency
- Access expanding pools of scientists and engineers
- Meet increasingly sophisticated demand in these countries

The spatial diffusion of R&D opens the door not only for the transfer of technology created elsewhere, but also for the technology creation process itself. However, it must be pointed out that most LEDCs do not participate in global research and development.

Table 1 FDI inflows to the top 20 economies, ranked by size of different financing components, 2003.

	Equity capital		Reinvested earnings		Intra-company loans	
Rank	**Economy**	**$ billions**	**Economy**	**$ billions**	**Economy**	**$ billions**
1	United States	87.0	Ireland	19.4	France	27.7
2	Luxembourg	80.9	Hong Kong, China	16.0	Spain	14.2
3	Germany	45.7	United Kingdom	12.2	Italy	8.8
4	China	37.4	China	7.2	Luxembourg	6.4
5	Belgium	26.2	Russian Federation	7.1	Belgium	5.9
6	France	17.0	Canada	6.7	Mexico	5.8
7	Netherlands	14.6	Australia	5.7	Switzerland	5.3
8	Spain	13.0	Netherlands	5.2	Sweden	3.2
9	Brazil	9.3	Italy	4.8	Angola	2.8
10	Switzerland	8.3	Luxembourg	3.7	Russian Federation	2.8
11	Portugal	7.7	Switzerland	2.9	United Kingdom	2.8
12	Japan	7.6	Malaysia	2.8	China	2.5
13	Ireland	6.0	Mexico	2.3	New Zealand	2.3
14	United KIngdom	5.4	Finland	2.3	Ireland	1.5
15	Poland	4.6	Czech Republic	2.2	Norway	1.4
16	Austria	4.4	Hungary	2.1	Austria	1.3
17	Thailand	4.1	Chile	1.9	Ecuador	1.3
18	Azerbaijan	3.3	Nigeria	1.9	Venezuela	1.2
19	Argentina	3.0	Spain	1.9	Chad	1.0
20	Israel	2.9	India	1.8	Kazakhstan	0.9

The UK Case Study

In 2004/05, FDI was up 31% on the previous year (Fig. 6) with1,066 foreign companies investing in the UK - almost half in new projects with the rest in extensions, mergers and acquisitions. Almost half of these projects to locate or expand in the UK were by American companies. This number of investments exceeded the previous peak recorded in 2000/01. New investment was spread across a wide range of activities and sectors. The largest growth was in services (Fig. 7) but there were also considerable increases in headquarters, R&D and distribution activity. Manufacturing grew only marginally and call centre projects fell.

Fig. 6 Projects by operation type, 2001/02 to 2004/05.

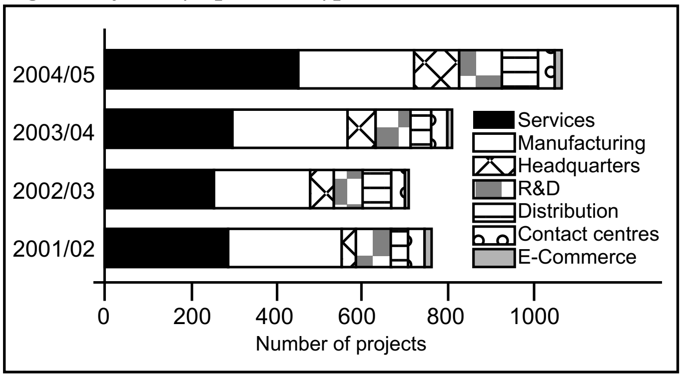
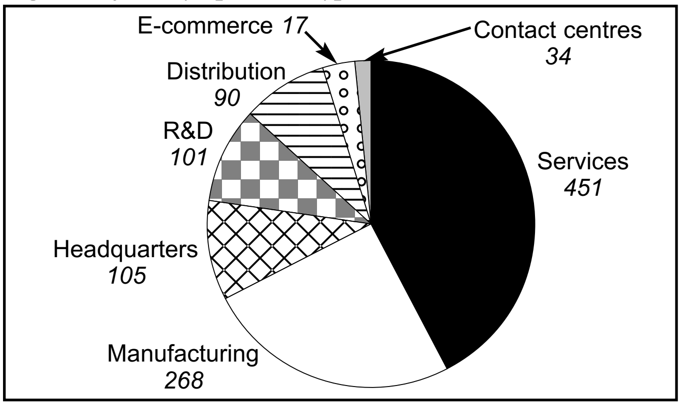


Fig. 7 Projects by operation type, 2004/05.



In terms of business sectors, the greatest number of projects were in IT, which increased by about two-thirds. The other largest increases were software (up more than 50%), creative industries, financial services, telecommunications, pharmaceuticals and biotechnology. Overall, new investment created 39,592 new jobs, 55% up on the previous year. Fig. 9 shows the total number of inward investors in the UK with the USA leading the way by a substantial margin. India is the largest lEDC/NIC on the list.

Hundreds of thousands of jobs in the UK depend on foreign investors. Many of these jobs are in economically depressed areas such as the North East and South Wales. In 1963, just 7% of the stock market was owned by overseas investors. It is now 32%. Foreign direct investment in London alone totalled £38 billion in 2004. The gap between London and Paris, the second-placed EU magnet for FDI is widening. 182 of the 247 authorised banks in the UK are foreign and only 83 are purely British owned. According to the Financial Services Authority, "The more investment we bring into the UK the better. Ownership is not the issue. What is being brought in is investment, not to mention a huge amount of work for the likes of professional service firms such as lawyers, bankers and accountants."

There is of course a downside – certain areas of the UK are investment hotspots such as the Japanese into Telford. In changing economic circumstances it is these clusters of branch plants which are vulnerable to closure. The UK also, of course, benefits from its investments abroad. In 2004, the profit for all UK companies on direct investment abroad was £48.3 billion. Ten years earlier it was just £19.2 billion. More than a third of FTSE companies revenues are derived from foreign operations. For example, for Vodafone, the UK accounts for just 15% of the company's turnover.

References:

The World Investment Report 2005, United Nations Conference on Trade and Development (UNCTAD), 2005.

Changing legislation

More and more countries are changing laws and regulations to create a more foreign investor friendly environment. However, there are exceptions. For example, Some African and latin American countries have toughened the rules for foreign investment with regard to natural resources. This has happened because the host countries have felt that the balance of benefits of such investment have been too heavily in favour of the foreign investor.

Major Risks to Future Flows

As *Fig. 1* shows, the level of global FDI can vary significantly from year to year. Business confidence is the key to a high level of investment. According to UNCTAD the major threats to the continuing increase in global FDI are:

- Protectionism
- Slow growth in industrialised economies
- Financial instability of major economies
- Global terrorism threat
- Price volatility of petroleum and other raw materials
- Political instability and civil war
- Exchange rate volatility.

References

The World Investment Report 2005, United Nations Conference on Trade and Development (UNCTAD), 2005.
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