FOREIGN DIRECT INVESTMENT IN EMERGING MARKET COUNTRIES

Report of the Working Group of the
Capital Markets Consultative Group

September 2003

This report reflects the views of private sector participants in a working group examining the determinants, trends and prospects of foreign direct investment (FDI) in emerging market countries. The views expressed should not be attributed to the staff and management of HSBC, members of the CMCG, the International Monetary Fund, and the World Bank.

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Main Findings[1]

FDI flows to emerging market countries (EMCs) increased rapidly in the 1990s and have become by far the single largest component of their net capital inflows. The surge in FDI to EMCs was led largely by mergers and acquisitions, reflecting the extensive privatization of state-owned assets in a number of countries in Latin America and Eastern Europe and the sale of distressed banking and corporate assets in several Asian economies following the crises there. Furthermore, in contrast to traditional forms of FDI associated with either extractive activity or labor-intensive manufacturing for exports, the 1990s witnessed a significant shift toward market-seeking FDI in a number of countries, notably into the services sector.

More recently, FDI flows to EMCs have declined owing largely to falling investments in Latin America. To some extent, the recent decline can be attributed to cyclical movements reflecting, among other things, growth trends in the world economy and the fallout from the bursting of the technology and telecommunications bubble. At the same time, regional and domestic growth prospects have also affected FDI in selected EMCs. Some concern has also been expressed that risks pertaining to FDI in EMCs, particularly of a regulatory nature, have increased more recently—reflected, for example, by the abrogation of contracts in Argentina—and in light of the global economic uncertainty and increasing balance-sheet pressures, a broad-based reassessment of risks could lead to a corresponding decline of FDI to many of these countries.

Motivation for and determinants of FDI

Investors underscore that motivations for investing in EMCs and determinants of investment location differ among countries and across the economic sectors. They concur, however, that certain general factors consistently determine which countries attract the most FDI. Investors cite, in particular the following:

- **Market size and growth prospects** of the host country play an important role in affecting investment location since FDI in EMCs is increasingly being undertaken to service domestic demand rather than to tap cheap labor.

- **Wage-adjusted productivity of labor, rather than the cost of local labor** *per se*, will increasingly drive efficiency-seeking investments of "footloose" firms that use EMCs as export platforms.

- The **availability of infrastructure** is critical. EMCs that are best prepared to address infrastructure bottlenecks will secure greater amounts of FDI.

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[1] A brief summary of key conclusions is provided on page 30 of the report.

- Except in some sectors, tax incentives (holidays) do not play an important role in determining investment location, although **reasonable levels of taxation and the overall stability of the tax regime** do.

In addition to these factors that appeal to investors' economic and commercial interests, investors also underscore the importance of other factors that could facilitate more broad-based FDI. These are especially important when deciding on whether to enter a new country and in evaluating major expansions of an ongoing business:

- A broad consensus in the host country in favor of foreign investment is an important consideration for investors**.** In this context, a reasonably **stable political environment, as well as conditions that support physical and personal security,** is an important benchmark that is used in judging the likelihood of adverse changes in the investment climate for foreign-owned firms.

- **Corruption and governance concerns** have a significant bearing on investment prospects. The investment regime and the environment for business—including the business licensing system, the tax regime, and the attitude and quality of the bureaucracy—are vital.

- Recent crises have magnified perceptions of regulatory risks and greater attention is now being focused on the **legal framework and the rule of law**. A predictable legal system, which among other things respects the sanctity of contracts and facilitates a level playing field, will further enable EMCs to secure large amounts of FDI on a sustained basis.

Financing FDI and managing risks

Investors note that economic and political shocks and crisis-related events have led to balance sheet losses on FDI investments in some countries. Many companies are therefore paying greater attention to the **financing of FDI and the management and control of investment risks**. Coupled with developments in international capital markets and changes in the transactions that underpin financing and hedging of foreign investments, such a reevaluation could affect business expansion plans and prospective FDI flows. Findings of the working group suggest:

- Many parent companies increasingly prefer to economize on the amount of equity and intercompany loans to encourage subsidiaries to be self-sustaining, while generating sufficient returns to finance internally ongoing expansion. For these companies, the share of FDI flows to EMCs accounted for by reinvested earnings, rather than new equity and intercompany debt transactions, is likely to increase, while subsidiaries will be forced to rely more on local financing in the host country.

- Global banks' appetite for providing cross border and project loans in support of FDI investment in EMCs is declining. The trend away from wholesale lending is of course broad-based and not confined to EMCs. However, in the context of the limited ability of EMC subsidiaries to substitute capital market financing for bank lending, FDI and expansion of businesses, more generally, could be constrained.

- The growing sophistication of capital markets has resulted in a "chain of financing and secondary markets" that have become important preconditions for supporting robust FDI flows. Disruptions to this financing chain could affect the size and scale of FDI in EMCs.

Recent events—including lower-than-expected growth both globally and in some major EMCs and regulatory and legal problems faced by some sectors—have, among other things, underscored the importance of **managing investment risks**. In particular,

- Unfavorable experiences with emerging markets have prompted a number of companies to seek partial 'insurance' against economic and political risks. In some cases this has meant calculating profitability on the basis of explicit risk-weighted capital costs. In other cases, local subsidiaries have moved away from businesses that are particularly sensitive to currency risk. Many firms are reporting more scrutiny from headquarters, and less automaticity, in deciding on retained versus repatriated earnings. Most firms now pay careful attention to currency exposure and many at least hedge current transactions, some through their own central treasuries.

- While many FDI investors find the costs of hedging prohibitive, some are making greater use of it to protect against heightened uncertainty. In this context, recent hedging strategies have taken the form of greater reliance on local borrowing, foreign exchange and derivative markets, and increasing use of proxy hedges to protect against various types of risks. However, in most cases these strategies cannot cover more than a fraction of the total balance sheets of local subsidiaries.

- Some investors, particularly with a Latin America concentration, are also refocusing their investments on countries where perceived risks are smaller.

Impact of crises and FDI prospects

Investors emphasize that the relatively long time horizon of FDI serves as an automatic stabilizer in response to short-term developments, both in host countries and in the global economy. Moreover, many investors take a very long run view on the profitability of FDI investments and are prepared to accept periods of low or volatile returns. Findings suggest the following:

- *No large-scale withdrawal of FDI from Latin America*. Contrary to some fears that following events in Argentina, which involved the abrogation of contracts, FDI in EMCs could be significantly undermined, there is little evidence to support the "worst-case" fears of large-scale pullout from Latin America. A few foreign banks have exited the region, however, and there is some downsizing of future FDI plans.

- *Prospective FDI flows to EMCs could be affected.* Most investors remain committed to investing in EMCs and to their existing businesses there, but they stress the heightening of risks to investing in these countries and the need to pay greater attention to issues relating to the legal framework and the enforceability of contracts. Some companies also emphasize that following the rapid expansion of FDI in the 1990s, they are reevaluating their investments in EMCs in light of falling profitability and greater perceptions of risks.

- *Investments in selected sectors and countries have been hurt more by recent events.* In particular, FDI in utilities and in the banking sector have been affected by greater perceptions of regulatory risks, as well as by lower-than-expected profits and growth prospects in a number of countries, most significantly in Latin America. Banks, in particular, emphasize that certain policy actions, such as the asymmetric pesification in Argentina, have undermined their capacity and willingness to invest further. Going forward, a sustained decline in investment in FDI in these sectors could affect FDI more broadly, especially since investors attribute significant importance to the availability of infrastructure and banking services in determining FDI location.

Views on FDI prospects for EMCs differ depending on both the regional and sectoral focus of investors. More generally:

- FDI in EMCs is likely to be led by **market-seeking investments** that will focus on countries with large markets and promising growth prospects. In this context, participation of countries in free trade agreements and regional trade integration schemes—that, among other things, increase regional demand and potential market size—will likely increase their appeal to investors.

- Countries with attractive productivity-adjusted labor costs will continue to secure **efficiency-seeking investments**, a trend likely to accelerate as liberalization in textiles and clothing progresses.

- Investors engaged in **extractive activity** emphasize that investment decisions are driven primarily by the availability of natural resources, and they see no significant impact on current and prospective investments in Latin America, and in EMCs more generally.

- On the contrary, investors in selected **other sectors, especially in banking and utilities,** underscore that crisis-related events have magnified previously latent risks of investing in EMCs. These investors plan to reduce exposure to Latin America, and possibly to other EMCs.

FDI prospects across the various geographic regions highlight a number of differences concerning risk perceptions:

Asia

A majority of investors note that Asia will lead the geographic regions, at least in the near term, as the predominant location for FDI.

- Within Asia, China will remain the prime location for FDI because of a large market with growing middle class, sound growth prospects, and continued competitiveness. Furthermore, membership in the WTO will provide greater incentives for new investments. Some investors are shifting efficiency-seeking investments from other relatively high-cost Asian countries, including Malaysia to China.

- India, with a large market and a well-educated and English-speaking labor force, will continue to attract FDI in selected sectors, including technology. More broad-based FDI is being impeded, however, by a difficult business environment, uncertainties about receptivity to FDI, red tape and bureaucracy, and a lack of adequate infrastructure facilities.

- Companies in labor-intensive manufacturing and natural resource sectors plan to maintain their investments in Thailand and Malaysia. The investment climate in Indonesia is perceived as weak, with foreign investors narrowly focused on the natural resource sector.

Europe

The outlook for FDI in Emerging Europe is highly uneven. In broad terms, the key countries in the region can be separated into three categories: the accession countries poised to join the European Union in May 2004; the CIS countries (especially Russia); and Turkey.

- Accession to EU is playing an important role in bolstering the framework for foreign investment in a number of countries in Eastern Europe. While domestic market potential is rather limited, the region continues to attract large volumes of FDI owing to production cost advantages vis-à-vis the rest of the EU. FDI is likely to continue taking the form of export-oriented investment by firms, particularly from Western Europe, seeking to lower manufacturing and services costs.

- Investors note that Russia, with its large market and rich endowment of natural resources—especially oil—has significant potential for securing large amounts of FDI. However, along with governance and corruption concerns, investors note that institutions require strengthening and the business environment improved significantly.

- Turkey is seen as having significant potential for market-seeking FDI, but the potential is unlikely to translate into concrete outcomes until political and economic risks perceived to be very high are alleviated, growth prospects become clear, and bureaucratic impediments to FDI are removed.

Latin America

- Most firms report they are in a "digestive" mode owing mainly to growth having been lower than anticipated when substantial expansions were undertaken several years ago. While a few investors are pulling out local businesses, there is little interest at present in M&A activities, despite the large volume of distressed assets. In some countries, low growth has exacerbated regulatory problems in the electricity and telecom sectors.

- Brazil, largely because of its market size, continues to be Latin America's preferred location for FDI. While investors are encouraged by the new government's macroeconomic policy stance and FDI is likely to recover if economic growth gains momentum, regulatory risks could undermine sentiment and the prospects for investment in some sectors.

- Many companies for whom investment reflects a regional specialization emphasize they will refocus their investments, at least in the near term, on selected countries in the region, notably Mexico, where risks are perceived to be less.

- FDI in Mexico will be driven by NAFTA and its large market. It is also likely to benefit from investors, particularly banks, refocusing their investments in Latin America. This said, investments in the manufacturing sector could be hurt by increased competition from China.

- Political problems limit the attractiveness of the Andean countries, apart from the extractive industries.

Investor recommendations

Investors highlight a number of areas in which the international financial institutions (IFIs) can focus greater attention, including through public-private partnerships, to improve the investment environment in EMCs:

- **Focus greater attention on FDI flows**. A number of investors note that IFIs focus too much on debt-creating flows, but too little on understanding FDI flows and their impact on the real economy.

- **Assess regularly the investment climate**. Investors underscore that more regular and in depth assessments of the investment climate in EMCs, including in the context of the IMF's Article IV consultation discussions and the World Bank's economic and sectoral work, could help investors make informed judgments about investment opportunities and associated risks.

- **Address legal and regulatory risks in EMCs**. Investors stress that IFIs should focus a lot more on addressing legal and regulatory risks in EMCs, including in the context of their surveillance and support for economic adjustment programs.

- **Develop local capital markets.** Emphasizing that building a wider range of financing and hedging sources is an important precondition for supporting robust FDI flows, a number of investors want IFIs to give more emphasis to promoting and developing local capital markets in EMCs.

- **Engage in further dialogue.** Investors favor a continuous dialogue between the IFIs and the private sector and emphasize the need for established channels of communication.

I. INTRODUCTION

1. **The 1990s witnessed a number of major events, including the fall of communism, the opening of China, and a radical shift in economic and political regimes in many countries of Latin America.** Following the adoption of economic and structural reforms by a number of emerging market countries (EMCs), which included, among other things, the elimination of trade barriers and a reduction of restrictions on international capital flows, globalization of production processes gained rapid momentum. These reforms coincided with remarkable advancements in transportation and communication technology, making it easier for companies to manage and control geographically dispersed production networks and supply chains, while allowing EMCs to serve as venues for investment.

2. **As a result of these developments, trade and financial flows, notably foreign direct investment (FDI), to EMCs surged in the 1990s.** FDI and portfolio flows have surpassed private debt flows to become the major source of international capital for EMCs and **FDI is by far the single largest component of net capital inflows to EMCs.** Estimates suggest that at end-2000, almost one-quarter of the global stock of FDI—estimated to be $6.8 trillion in book value—was located in EMCs.

3. **FDI and globalization tend to reinforce one another.** In particular, while globalization has led to higher FDI flows to a number of EMCs, the benefits of FDI and the opportunity of receiving a greater share of global FDI flows has, among other things, motivated a number of countries to undertake further liberalization. For example, investment in certain sectors, such as telecommunications and transportation, that were long closed to foreign participation in many EMCs are now open to foreign investment. At the same time, other impediments to FDI, including restrictions on the forms of investment and the level of foreign ownership, have been gradually eased. Furthermore, a number of countries have undertaken reforms to address administrative, regulatory, legal, and institutional barriers to investment, with the overarching objective of improving the climate for investment and private sector activity.

4. **FDI facilitates the international integration of markets for goods and services.** By selling directly to residents within the host economy, foreign direct investors may overcome natural or policy-induced barriers to market access and hence substitute for trade. FDI has traditionally performed this function, and in service markets where a local presence is often essential, it will continue to do so. By contrast, so-called "efficiency-seeking" FDI has facilitated the international division of labor, and hence stimulated the expansion of trade. Recent estimates suggest that for two-thirds of world merchandise trade, a multinational company is involved on at least one end of the transaction, and that about half of that share is conducted in the form of intrafirm trade.[2]

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[2] Statistics of affiliate trade are sparse and this estimate of UNCTAD (1999) is based on only selected industrial countries.

5. **In addition to generating relatively large multiplier effects for the economy, FDI typically facilitates the transfer of technology and promotes sound employment and corporate governance practices**.[3] For example, FDI in the financial sector is commonly credited with raising the efficiency of financial intermediation and the quality of supervision through importing higher prudential standards. These benefits accrue either through the direct linkages with local enterprises or through positive spillovers—that is, outside contractual relationships, for instance, by demonstrating to local firms ways of accessing international markets.

6. **Furthermore, in the context of increasing the integration of financial markets, FDI can serve as a source of stability at times of emerging pressures in the balance of payments**. In particular, FDI flows appear to be more stable than other capital flows, possibly because the long time horizon of FDI allows the forbearance of investors to short-run economic upheavals, including those that arise from host country policies. Also, unlike debt capital, for which payoffs are not linked to the state of the economy, FDI entails an element of risk sharing between the investors and the host country since the rate of return is designed to be "state contingent"—the cost of servicing the investment moves in step with the recipient's economic fortunes.

7. **More recently, FDI flows to EMCs have been declining, owing in large part to a sharp reduction in flows to Latin America.** To some extent, the recent decline can be attributed to cyclical movements reflecting, among other things, growth trends in the world economy, the fallout from the bursting of the technology and telecommunications bubble, and regional and local growth prospects. Some concern has, however, been expressed that risks, particularly of a regulatory nature, pertaining to FDI in EMCs have increased. For example, recent events in Argentina have involved the abrogation of contracts. Thus, and in light of the global economic uncertainty and increasing balance sheet pressures, a broad-based reassessment of risks could lead to a corresponding decline of FDI to many of these countries.

8. **To better understand recent trends, the determinants of FDI in EMCs, investment strategies of large multinational companies, underlying risks and prospects for FDI to these countries**, a working group of the Capital Markets Consultative Group was established under the chairmanship of Stephen Green, Group Chief Executive of HSBC, and Gerd Häusler, Counsellor and Director of the International Capital Markets Departments at the IMF. It consists of senior representatives from a number of large multinational companies with investments in EMCs across various economic sectors and staff of the IMF and the World Bank (Box 1). Attached to this report of the working group are the terms of reference of the working group and a list of members who have participated in the exercise.

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[3] Recent estimates by the OECD indicate that a rise of one percentage point in the ratio of the stock of FDI to GDP will raise GDP by 0.4 percent.

9. Section II provides a brief overview of FDI in EMCs. Section III draws upon the discussions with private sector representatives and their response to a broad questionnaire, to elaborate upon the motivations for FDI and the factors affecting their location in the EMCs. It also provides an assessment of how corporates draw upon public information and due diligence to formulate their investment strategy, notably on location. Section IV contains a discussion of issues relating to the financing of FDI and various methods firms use to manage their risks relating to investments in EMCs, including during (or near) times of crises. Section V draws upon the discussions relating to corporate strategy and the determinants of FDI to provide conclusions, prospects, and regional and country experiences for FDI in EMCs going forward. Section VI offers recommendations of investors concerning the role of the IMF and the World Bank in facilitating greater FDI in EMCs.

Box 1: CMCG Working Group on FDI Flows to EMCs 1/

The Capital Markets Consultative Group (CMCG) was established in July 2000 by the IMF's management to serve as a channel of communications with participants in international capital markets. The CMCG—consisting of individuals from key institutions in all major sectors involved in international capital markets and flows—meets periodically with management and senior staff to discuss matters of common interest and is part of the IMF's broader effort at constructive engagement with the private sector. In addition to the periodic meetings of the CMCG, staff of the IMF's International Capital Markets Department maintain an ongoing dialogue with the private sector, including the members of the CMCG, in the context of multilateral surveillance and seminars and conferences on issues of common interest.

At the meeting of Capital Markets Consultative Group (CMCG) held in Tokyo in September 2002, the Managing Director of the IMF decided to establish a working group on foreign direct investment (FDI) to, among other things, gain better insights into investment decisions and structural changes that may affect such flows to EMCs, particularly in the aftermath of recent crises and related events. The working group is cochaired by Stephen Green, Group Chief Executive of HSBC, and Gerd Häusler, Counsellor and Director of the International Capital Markets Departments at the IMF. It includes as interlocutors senior representatives from leading multinational companies with investments in EMCs, along with staff from the IMF and the World Bank.

In the context of initial contacts with private sector representatives to solicit their participation in the working group, some members noted that because of confidentiality concerns, a large meeting involving all members would not facilitate a candid exchange of views. As a consequence, it was decided that the cochairs of the working group, along with a small staff of the secretariat—consisting of IMF and World Bank staff—would seek out views of participants through a broad questionnaire and/or one-on-one meetings. About 40 corporate investors participated in the discussions of the working group, and meetings with private sector representatives were conducted either in person or through a videoconference. In addition, working group participants provided comments and suggestions on earlier drafts of the report, including in the context of a joint meeting held in London.

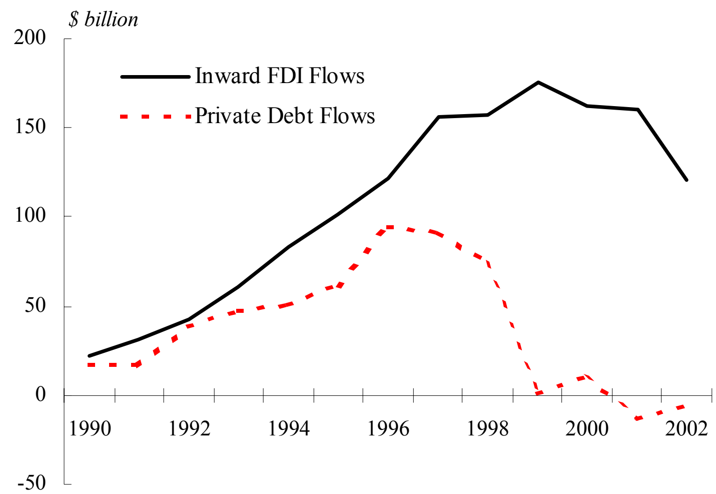
Although the sample of private sector participants is relatively small, it is quite representative of large firms having significant exposure to EMCs across various economic sectors and regions. Institutions participating in the group include, ABN Amro, AIG, AIG Global Trade and Political Risk, Anglo American, Asahi Glass, BAE Systems, Banco Santander, Bank of East Asia, Bank of Tokyo-Mitsubshi, Carrefour, CEMEX, China Light and Power, Citibank, DaimlerChrysler, Esquel Group, Exxon, GE Capital Market Services, Goldman Sachs, Honda, HSBC, Hutchison Whampoa, International Power, International Institute of Finance, Imperial Tobacco, Kerry Group, LonMin, Mitsubishi Corp., Nestle, Pfizer, Siemens, Sony, SUEZ, Sumitomo Chemical, Telephonica, TESCO, Texas-Pacific, Thyssen Krupp, Unicredito, Wal-Mart, and the World Bank.

1/ Emerging market countries are defined in this report as including Argentina, Bolivia, Brazil, Bulgaria, Chile, China Mainland, Columbia, Costa Rica, Croatia, the Czech Republic, the Dominican Republic, Ecuador, Egypt, El Salvador, Hungary, India, Indonesia, Jordon, Malaysia, Mexico, Morocco, Panama, Pakistan, Paraguay, Peru, the Philippines, Poland, Romania, the Russian Federation, the Slovak Republic, South Africa, Thailand, Tunisia, Turkey, Ukraine, Uruguay, Venezuela, and Vietnam.

II. Overview of FDI in EMCs

10. During the 1990s, as the flow of private capital—both equity and debt—to EMCs steadily gained momentum, the composition of flows shifted toward FDI (Figure 1). To a large extent, this shift reflected the altered preference of debt investors and policymakers following various financial crises in emerging markets. On the one hand, following the recent crises and related fall in profitability, the appetite of banks for engaging in cross-border lending declined, while other investors became more discerning toward investment in EMCs, more generally. On the other hand, authorities in a number of EMCs tried to limit their exposure to debt financing by reducing existing liabilities and shifting their capital-seeking policies toward more stable forms of capital, such as FDI.

Figure 1. Private Flows to Emerging Market Economies (1990–2002)



Source: The World Bank, *Global Development Finance*, 2003.

11. **Three important features characterize FDI flows to EMCs.** First, FDI in EMCs increased rapidly in the 1990s, owing largely to the adoption of macroeconomic and structural reforms by a number of countries and the associated strengthening of growth prospects. Second, the surge in FDI to EMCs was led largely by M&A activity, reflecting the extensive privatization of state-owned assets in a number of countries in Latin America and Eastern Europe and the sale of distressed banking and corporate assets in several Asian economies following the crises there. Third, in contrast to traditional forms of FDI engaged in either extractive activity or labor-intensive manufacturing for exports, a number of countries experienced a significant shift toward market-seeking FDI in the 1990s, notably in the services sector.

12. Over the past decade or more, owing largely to economic developments, relative importance of various geographic regions has changed—particularly Asia and

Latin America—as FDI destinations. Aggregate data, however, conceal interesting inter and intraregional dynamics (Attachment II provides greater detail of regional trends in FDI flows to EMCs).

13. **As mentioned above, more recently FDI in EMCs has been on the wane, owing largely to a sharp decline of investments in Latin America** (Attachment II). To the extent that the rapid rise of FDI in the 1990s was associated with the privatization of state-owned assets in a number of EMCs, and that similar opportunities are likely to be on the decline for many of these countries, FDI prospects will be linked to the ability of host country factors to provide an attractive framework for more broad-based greenfield investment and for firms to expand existing businesses. It is thus important to examine the motivation for, and determinants of, FDI in EMCs and how companies decide where to invest.

III. Motivation, Location, and Decision-Making

14. Based on discussions with members of the working group and their responses to the questionnaire, it is clear that the **motivations for investing abroad and determinants of investment location differ considerably**. While this report articulates a diversity of views, broad conclusions have emerged concerning a number of host country determinants of FDI.

A. Motivation

15. Traditionally FDI in EMCs has been driven by investments in extractive activity and by "footloose" firms that sought to take advantage of lower costs of product assembly—typically for exports to world markets—with much less emphasis on servicing domestic demand in the host country. **A majority of investors, however, underscore that more recently FDI in EMCs is increasingly being undertaken to service domestic demand in the host country**, particularly to overcome natural or policy induced barriers to trade. By way of example, investors observe that the recent increase in FDI to China and India reflect market size, rather than competitiveness, considerations. Most investors further emphasize that their focus going forward will be to invest in countries with large markets and promising growth prospects. At the same time, investors with efficiency-seeking investments in EMCs stress that their expansion plans will, among other things, target countries with productivity-adjusted low costs of labor, while those engaged in extractive activity note that foreign investments will be driven largely by the availability of natural resources.

16. **Most investors emphasize that the relatively long time horizon of FDI serves as an automatic stabilizer in the face of macroeconomic shocks and unexpected events, and that once investments are made, companies remain committed to their businesses**. Most strategic investors take a long run view on the profitability of FDI investments and are prepared to accept periods of low or volatile returns. In this context, a number of them observe that recent financial crises have highlighted the underlying risks of investing in EMCs and the need for paying greater attention to issues relating to the legal framework and the enforceability of contracts, but that they remain committed to investing in these countries. Around 90 percent of the survey respondents indicate that they are either very likely or

somewhat likely to invest in an EMC over the next three years. Almost all, however, say that they will be more selective as to where they invest.

B. Locational Determinants of FDI

17. *Investors broadly concur that determinants of investment location are likely to differ both across economic sectors and between market-seeking and efficiency-seeking investments within individual sectors. They concur, however, that over and beyond the sector-specific determinants of FDI, certain general host country characteristics consistently decide which countries attract the most FDI, and that the better these are understood, the more investment countries are likely to receive. In addition to underscoring the important role* **sound macroeconomic fundamentals***—reflected, among other things, by a stable exchange rate, low inflation, and sustained growth—play in creating a favorable environment for FDI,* ***investors broadly differentiate between two sets of factors:*** *First, those that directly underpin their economic or commercial interests—such as market size and growth prospects, cost of local labor, availability of infrastructure, and the tax regime; and second, institutional and regulatory factors and policies, such as the licensing system, legal framework, and quality of the bureaucracy, that, among other things, facilitate FDI.*

18. Elaborating on the variables affecting their economic and commercial interests, a number of investors emphasize that **size of the domestic market—**measured by GDP, per capita income, or size of the middle class—**and potential for growth** are key influences on investment location decisions. Almost 70 percent of survey respondents note that "**current and potential market access**" is the most important determinant of FDI location. In this context, investors observe that because of significant vertical linkages in production networks, some types of FDI in EMCs are motivated by "following existing clients into a new market," which, among other things, generates agglomeration effects and creates FDI clusters (for example, foreign investment by a automobile manufacturer leads to the foreign investment by firms that supply components to the manufacturer). More than 75 percent of the survey respondents, including large integrated manufacturing companies, emphasize that they currently invest in EMCs primarily to meet domestic demand rather than to reduce global manufacturing costs.

19. While survey respondents underscore the importance of demand in the host country**,** many note the importance of **free trade agreements and regional trade integration** schemes—that, among other things, increase regional demand and potential market size. In this context, investors call for greater trade integration, particularly in the context of analyzing the FDI prospects for a number of EMCs in Africa and Asia that are too small to attract market-seeking FDI. Investors also stress the need for greater investment provisions in trade agreements. Many acknowledge that a number of recent regional trade agreements, such as NAFTA, have strengthened investment provisions, including through a broadening of asset protection, reduction of investment distortions, and establishing dispute resolution mechanisms. They note, however, that the preferential treatment of certain investors and the rules of origin requirements under regional trade agreements could distort the flow of FDI to

various EMCs and possibly increase their vulnerability to shocks if the source of FDI becomes highly concentrated.

20. Investors engaged in efficiency-seeking activities cite the importance of the **availability of skilled labor and wage-adjusted labor productivity,** more generally, rather than the cost of local labor *per se*, as being an important consideration in location decisions**.**[4] Some investors note that EMCs in Latin America and Africa that possess cheap labor often fail to receive export-oriented FDI seeking to exploit trade concessions provided by developed countries largely because of productivity considerations. Also, for largely competitiveness considerations, some footloose firms engaged in export-oriented investments are moving from Mexico to China, while EMCs in Eastern Europe stand to gain from similar investments from other countries in the EU.

21. Investors point to the importance of **infrastructure—**especially the availability of electricity, water, transportation, and telecommunication, rather than their costs in influencing FDI location decisions. A number of investors cite the lack of adequate infrastructure in many large EMCs, notably India, as a deterrent to FDI in the country. Some investors also note that many EMCs, notably in Africa, are small in size and are better-placed to secure greater efficiency-seeking investments, but prospects are undermined because infrastructure constraints impede the ability of investors to use these countries as export platforms to serve regional and global markets. In this context, they underscore that EMCs that are best prepared to address infrastructure bottlenecks will secure greater amounts of FDI in the near to medium term. Concerning infrastructure-related determinants of FDI, while more than 70 percent of the investors surveyed rank the availability of infrastructure first in order of importance, a number of investors rank utility costs and institutional impediments to the access to infrastructure facilities second.

22. Investors underscore **the predictability and stability of the tax system** as important in determining investment decisions, but, with a few exceptions, they note that **tax incentives are not critical.** Investors note, in particular, that tax incentives cannot substitute for political stability, good macroeconomic fundamentals, the availability of infrastructure, and a sound legal framework. Some investors, however, note that tax incentives could play an important role in attracting FDI in the extractive sectors of the economy where the fixed costs are relatively high and investments are generally front-loaded. Some investors, especially "footloose" firms, also underscore the potential role nonfinancial incentives—such as access to land and infrastructure—have played in export processing zones (EPZs) in attracting FDI in selected EMCs in Africa and Asia.

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[4] Around 9 percent of survey respondents noted that their investments in EMCs was primarily for exports, while for another 30 percent, investment for exports was an important, although not the primary, consideration.

23. Elaborating on factors creating a favorable environment for FDI, investors underscore the overarching importance of **stable politics, as well as conditions that support physical and personal security,** in affecting investment location, with some emphasizing that a stable political environment is a precondition for FDI in EMCs. Views, however, differ on how stable politics manifests itself in affecting location decisions. In particular, investors engaged in extractive activity observe that the biggest FDI-related risk is political—specifically, indirect expropriation, including through punitive taxation, and controls on either repatriation of profits or capital. They stress that stable politics, that, among other things, provides for a free and fair access to the legal system is a key driver of FDI. Investors engaged in other lines of activity, however, note that stable politics manifests itself in the form of stable rules and regulations governing foreign investment that are key for sustaining FDI in EMCs.

24. **Investors note the "investment regime and the environment for business"—that, among other things, is reflected in corruption and governance concerns in a number of EMCs—has a significant bearing on their investment prospects.** Most survey respondents (66 percent) rank the investment regime and the environment for business second in order of importance among factors determining investment location. In discussing the importance of individual components of the investment regime, investors broadly concur that factors, such as the Investment Act, business licensing system, access to land and infrastructure, and the tax system all bear upon investment location decisions, but the relative importance of each will vary across investments in the different sectors of the economy. Investors in extractive activity, for example, note that while their investment location decisions are motivated largely by the availability of resources, they pay significant attention to the Investment Act and the tax regime, both of which govern the payments they have to make to the government. At the same time, investors in manufacturing activity underscore the relative importance of access to land and infrastructure.

25. To further articulate the importance of the business environment, a number of investors cite Russia and Turkey as examples of EMCs with large markets and significant potential for FDI, but whose constraining environment for business has made it difficult to transform the potential into concrete outcomes. Some investors also stress that **red tape and bureaucracy** has also undermined investor sentiment in many large EMCs with significant growth prospects. They note that investing in India, for example, is more difficult than investing in China.

26. Responding to the issue of the **legal system and the rule of law,** a number of investors draw upon their most recent experience in Argentina and elsewhere to underscore that **predictable rules for investment and a sound legal framework—which among other things respects the sanctity of contracts—**are important for EMCs to secure large amounts of FDI on a sustained basis. Investors cite a number of other examples, including Pakistan's unilateral cancellation of a range of electric power agreements, the dispute over tolls for the Bangkok toll road projects, and conflicts over power generation contracts in Indonesia, to emphasize how the reneging of contractual obligations have undermined investment sentiment in a number of EMCs. Underscoring that regulatory and political risks in EMCs tend to increase in the context of economic crises, more than 50 percent of investors note that

access to the legal system and the enforceability of contracts rank first in analyzing the legal risks of investing in EMCs. A number of foreign investors engaged in activities relating to utilities and infrastructure note that FDI is affected by political economy considerations, since contracts—sometimes based on unrealistic price of utilities relative to what consumers are used to paying—risk being reneged upon when governments change. This, investors emphasize, has undermined investor sentiment in selected EMCs.

27. In response to the preferred forms of FDI, a large majority of investors note that **their first preference would either be to acquire a domestic firm in the host country (40 percent), undertake greenfield investment (22 percent), or expand the size of their affiliate in the host country (13 percent).** Investors note that investments through M&A are made largely to enter a host-country market for the first time and/or to strengthen the subsidiary's competitive position, while FDI through additional equity injections and intercompany loans to existing subsidiaries is made primarily to increase market-share in the host country—including through greater visibility—and/or to consolidate regional operations.

28. Some investors note that **because of domestic regulatory regulations and/or the nature of the host-country market, they are often left with little choice, but to form joint ventures with local companies**. In determining the local partner, investors prefer firms that either have a large presence in the host country or can ease the entry of the foreign investor, including through their experience with other alliances. Some investors, however, emphasize that because of reasons concerning lack of familiarity with the host-country market, they often willingly invest in joint ventures, at least while exploring an EMC for the first time, but remain ready to buy out the local partner once they are reasonably confident of operating independently. Investors note that joint ventures can be quite useful in sourcing cheap local inputs and materials and access to established local distribution networks, and can also provide insurance against political risks.

C. Decision-Making

29. *There is no one approach that describes how companies use their own due diligence and publicly available information, particularly on host country factors, to arrive at decisions concerning investment location, control, and risk management. While some investors underscore that benchmark criteria— including hurdle rates and risk premia, and company philosophy— often drive such decisions, others use a strategic framework to formulate investment decisions. Some also concede that investment location is often based on some combination of trial and error, experimentation, and learning from previous experiences. Investors also stress that decision-making often differs quite significantly when firms are contemplating new FDI locations compared with expanding existing businesses and across the forms of FDI, including whether investments are greenfield, joint ventures, or M&A.*

30. **A number of investors note that investment location decisions are often based on a strategic framework.** Some companies, particularly banks and those engaged in extractive activity, use a top down approach, where the management and senior executives emphasize the big picture rather than relying on the view from the ground, with deliberations centering on issues concerning global investment programs. Under this form of decision-making, for example, senior management first decides on the kinds of businesses it wants the company to pursue. Views are then formed on various aspects of the geography and demography of potential investment locations (regions and countries), including on market size, input availability, income distribution, savings pattern, and age distribution. Finally, the regulatory environment and overall policy framework of various investment locations are analyzed, often followed by a ranking or grouping of these countries, before reaching decisions on where to invest. In this context, investors emphasize that in addition to their due diligence, companies rely on information disseminated by various public institutions, including IFIs. Investors note that under such a strategic framework, foreign investment is often centralized at the highest level, including in terms of control and risk management, with relatively less reliance on the business intuition of local management.

31. **In contrast to the more centralized approach toward investment decisions, some investors note that corporate decisions concerning FDI location involves significant autonomy**. Under this alternate form of decision-making, the global corporate center adopts a more "hands off" approach, and issues concerning strategy and investment are the responsibilities of the executives heading each business unit of the company. In effect, each business stream operates as an autonomous unit. The global corporate center often merely provides guidance and counsel. Under this form of decision-making, the management of FDI-related risks—including strategies for financing and hedging of underlying transactions—are also often autonomous and are made by business heads of each unit. Some investors note, however, that notwithstanding a decentralization of operations, management of FDI-related risks more recently is being integrated across the business units.

32. **Some investors, especially large manufacturing companies, also identify a hybrid form of decision-making, where within an overall centralized approval process, different business units or operational lines develop their own plans for investment in EMCs**. As a result, each business unit may have a different strategic focus. Under this approach, while investment decisions are centralized, ideas, sponsorship and investment management are decentralized. In other words, there is some coordination and the company is neither completely independent, nor is it controlled from the center. Various business units that have responsibility for sourcing investment decisions put forward ideas and investment proposals, including from the field. These are vetted and approved (or not) by the corporate center, but oversight and management of investments are a local responsibility. Under this approach, while a number of decisions concerning the financing of investment transactions are handled by the business unit, the corporate center plays a reasonably active role through the central treasury. Investors note that one drawback of this hybrid-approach to decision-making is that it has led to administrative inefficiencies, as well as complications in striking a consolidated picture.

33. **To summarize, in the context of global economic uncertainty and balance-sheet pressures, investors note that along with a move toward the centralization of investment location decisions, there has been a marked shift toward more integrated management of FDI-related risks**. This has, among other things, manifested itself in companies instituting more stringent management of investment risks in EMCs that is supervised by either top executives and/or the Board, consolidation of operations, and greater attention paid by the management and Board to the allocation of scarce capital.

IV. Financing, Global Conditions, and Managing FDI Risks

34. *Corporate managers plan to economize even more on the amount of equity and intercompany loans and have subsidiaries borrow more on their own capacity and balance sheet, both locally and overseas, while generating sufficient returns to finance internally ongoing expansion. At the same time, international capital market conditions are less supportive of FDI financing because global banks—hit by weaker global economic conditions and in some cases crises in emerging markets—have less appetite for supporting FDI in EMCs. Volatile conditions in emerging markets have prompted several companies to tighten control of exposure to emerging markets, seek insurance against political risk, and use financial hedges, particularly when currency depreciation is foreseen. More generally, companies suggest that returns on investment in emerging markets must compensate for higher risks, and in some cases hurdle rates have been raised.*

A. Financing Business Ventures in Emerging Markets

35. The survey of investors revealed that the methods of financing FDI and business ventures in emerging markets, more generally, reflects not only costs and global market conditions, but also strategic issues specific to the type of investor and the nature of investing in EMCs:

- **The source of equity for start-up FDI and the form it takes tends to reflect the type of business venture and the strategic approach to FDI, the availability of capital, and opportunities for leverage and risk sharing.** In starting a greenfield venture, most multinational companies interviewed prefer to contribute 100 percent of *equity.* This reflects a priority for control over management and operations, and importantly to hold proprietary—and therefore competitive—advantage in markets entered, while enjoying fully the returns on assets. However, other multinational companies, nonstrategic investors, smaller investors, as well as those engaged in large projects notably in the extractive sectors, seek equity partners for a variety of reasons. Taking on partners and passive investors (either foreign or local) can help to spread investment risks and widen the scope of business operations (and therefore leverage) in EMCs, more generally. Particularly in Asia, this has given rise to significant cross ownership of business entities, allowing investors to diversify across business ventures and build leverage and presence in emerging markets. As highlighted above, some investors form joint ventures with local partners either because of entry requirements or to gain a stronger local footing in EMCs.

- **In addition to equity invested, capital intensive FDI typically requires significant *debt-related borrowings* through intercompany and/or project loans.** Multinational companies interviewed enjoyed a high degree of access to international capital markets at very competitive costs. Accordingly—and particularly where FDI investments are 100 parent owned—the parent provides an intercompany loan, charging costs to the subsidiary. *Project loans*—often collateralized by the assets of the specific project assets and with a claim on the revenue stream of the project—are also raised from international banks and capital markets for capital-intensive ventures in emerging markets.

- **Several companies also sought participation by IFIs—from International Finance Corporation (IFC) and other similar private sector windows of the regional development banks, and developmental and long-term financing agencies—for strategic, as well as financial reasons.** In addition to providing financing, investors noted that having the support of IFIs infers a "seal of approval" by the government, and provides some indirect insurance against political risk, including adverse changes in regulation. This said, some investors noted that lending by IFIs has been curtailed in recent years, which has reduced FDI investment in some areas, such as infrastructure projects, even though private borrowing can substitute.

36. **The *capital structure*—debt versus equity—depends mainly on the type of business venture, but also on capital market conditions and the origin of the FDI investor**. Companies suggested that the degree of leverage reflects sound financial practices based on underlying business risk and cost factors. Accordingly, some ventures are more highly levered than others: financial companies, utilities, and other large projects have significant liabilities relative to equity. Some companies maintain less leverage in the capital structure as a buffer against emerging market risks and possible adverse investor perceptions, especially if the origin of the parent is not in a G-7 country.

37. **Regarding the mix of debt financing, some corporate managers intend to press their subsidiaries to borrow more externally, thereby better aligning subsidiary borrowings with their access to international capital markets and with the merits of the venture**. However, many banks charge a premium for such cross-border lending, compared to lending directly to the parent, sometimes even when the subsidiary borrowing carries a guarantee or comfort letter from the parent. Many companies provide such guarantees but only reluctantly. International capital markets would normally impose a higher cost of capital to subsidiary borrowing. Whether corporate managers would be willing to pay higher costs and gain greater separation of a subsidiary's sovereign risk from that of the parent remains to be seen.

38. **Corporate managers are also scrutinizing policies for *retaining and reinvesting earnings* that provide a self-financing source of FDI expansion in emerging markets**. Generally, where prospects for growth are promising, earnings are plowed back into businesses. However, where expansion prospects are more limited or where risks for a particular business are elevated, some if not all earnings are likely to be repatriated.

Decisions on expanding capital beyond natural growth were typically made by the head office after considering the expansion in the context of the overall corporate strategy. Some corporate managers formulate a medium-term capital budget for foreign operations, which is reviewed periodically.

39. **Some corporate managers are seeking to increase reliance on *local currency borrowing*, at least for purposes supporting ongoing operations**. While many managers found local currency financing prohibitively expensive and/or lacked availability to support a substantive portion of initial capital investment in capital intensive projects, they generally accessed local markets to borrow working capital. Most of such borrowing is from local banks (foreign and domestic). However, growing interest was expressed by many corporations in borrowing directly in local securities markets, in addition to banks, to broaden the availability of local financing—including for supporting further expansion of country operations—and manage currency and interest rate risks.

40. **But attempts to borrow in *local securities markets* have so far met with limited success in many emerging markets**. This owes partly to regulations (some related to capital account restrictions), the lack of developed local markets, and a lack of local investor awareness. One major company interviewed has made significant efforts to work with IFIs and local authorities to allow it to raise financing in local money markets not only as a means of finance but more importantly to stimulate development of local securities markets.

B. The Role of Banks and International Capital Markets

41. **International banks and capital markets play a critical role in the "*supply chain of financing*" for FDI and business ventures in emerging markets**. International banks both help to originate, as well as widen the market for such financing through syndication to institutional investors and sales of loans in secondary markets. This includes loans directly to parents—which are then on-lent to subsidiaries—and cross-border loans to subsidiaries. Access to bank financing is of also important for enabling FDI-agglomeration since small firms—including those that supply inputs and components—that follow large investors into an EMC rely on their availability. International capital markets provide funding for parents that undertake FDI ventures and, more directly, through specialized markets, such as for project loans. In addition, private equity channels—through mutual funds and directly through investment banks—are increasingly supporting business ventures in emerging markets, particularly in Asia. Derivative markets, including interest rate, currency and credit transfer markets, also help distribute credit risk and manage financial market exposure. Taken together, these instruments, markets and channels create a "*chain of financing and secondary market*s" that supplies finance for business ventures in emerging markets.

42. **But indications from banks suggest that overall conditions for supporting FDI have weakened, possibly affecting prospective flows**. Following the bursting of the equity asset bubble and having absorbed significant losses in various crises in emerging markets, global banks concede that their appetite for financing in EMCs is on the wane. Banks are also less inclined to provide project lending, owing at least partly to some failures of project loans

in crisis countries. These developments could have a dampening impact on the amount of financing available to support foreign direct investment and on the forms it will take over the near term.

43. **In the above context, some investors underscore that revised regulations and prudential guidelines underpinning Basel II will further affect bank financing of FDI**. The introduction of Basel Capital Accord is intended to provide for improved alignment between the true risks undertaken by banks and the regulatory capital associated with these risks. However, one direct result of the new regulation will be to reduce the capital requirements for highly rated borrowers while increasing the capital requirement for lower rated entities. The implications for EMCs therefore are significant, since Basel II in its current form is likely to overestimate the risks banks would incur when lending to EMCs. While there is no current consensus as to how much lending margins would have to increase under the proposed framework, it is widely believed that spreads for lending to EMCs would rise at a disproportionate rate to those of developed countries. As a result, if the framework is adopted in its present form, bank financing of FDI may no longer be cost effective. It is likely that institutions that will not be subject to Basel II, including insurance companies, re-insurance companies and potentially some multinational corporations, may provide additional lending. Such institutions may include

44. **A key question is to what extent the shrinking appetite by banks can be offset with alternative financing in international capital markets.** For instance, some investment banks interviewed noted that venture or private capital is beginning to play an increasing role in some EMCs, particularly in Asia. As this develops and spreads more widely to other regions, it could become a valuable source of funding for FDI. A strategy to strengthen local securities markets would encourage such growth, it was noted. In addition, the still nascent but growing asset market for project loan securities has created some alternatives to bank financing. However, the costs of raising financing from international capital markets has historically been higher than what banks offer, raising the cost of capital and possibly reducing interest in FDI in EMCs.

45. **Unlike traditional FDI investors, private equity investors emphasized the importance of an "exit strategy" for FDI through capital markets**. As a precondition for their investment, capital markets (both debt and equity and local and international) provide a pool of risk capital and available liquidity, thereby permitting the sale of FDI investments and realization of gains once a turnaround or business success has been accomplished. The ability to realize gains from investment in emerging markets through supporting capital markets was also seen as a key step in both equalizing returns across countries and integrating emerging markets with the global economy.

46. **In view of the critical role of banking and capital markets in support of FDI ventures, developments in international banking and capital markets require close monitoring**. Changes in the business strategies of financial intermediaries, including importantly a reduction in their appetite for providing cross-border financing and/or disruptions to this financing chain can affect the size and range of financing available for FDI

ventures, and raise the overall risks (liquidity and financing risks) associated with business ventures to emerging markets.

C. Controlling and Managing Risks to FDI in Emerging Markets

47. As economic and political shocks in emerging markets have led to balance sheet losses on some FDI investments, **corporate managers indicated that they are increasingly reviewing practices for managing FDI risks in EMCs and are expanding their control over those risks**. This includes more clearly identifying risks, evaluating hedging instruments against currency and other risks, controlling exposure to equity losses, and reviewing corporate practices for managing risk.

48. **Companies use a range of tools to control *overall exposure and risks* of business ventures in emerging markets**. For example,

- **In determining whether to invest, and the pace of further investment, many companies use "hurdle rates" over which ventures must deliver on long-run expected returns.** The practical use of such measures and the degree of sophistication in arriving at hurdle rates varied widely among those interviewed.[5] Some companies used tools and measures more aligned with their strategic goals, for example, for market share and potential revenue growth.

- **The *cost and availability of intercompany loans* is another tool used by corporations to control overall exposure**. Several company executives reported that the transfer price of intercompany loans can vary across subsidiaries and can differ from the cost of financing from the parent. Such an approach helps ensure that reported profits of subsidiary operations in emerging markets reflects the risk of the underlying activity. Companies also use intercompany loans to keep management of subsidiary operations in emerging markets "disciplined," even if it means that the cost of finance from external sources for the subsidiary is higher than borrowing from the parent.

- **Companies also use the *repatriation of earnings* and *capital limits* to control overall growth and exposure of capital to emerging markets.** In many cases, repatriation policies are tied to the investment pattern and life of the project.

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[5] Some companies use hurdle rates based on the weighted average cost of capital (WACC) of the parent. However, some noted that the risks associated with emerging market ventures are reflected in the WACC only indirectly, to the extent that emerging market ventures push up the overall cost of financing to the firm, and therefore require an additional judgment of emerging market risks. Some managers make an explicit assessment of idiosyncratic and country risks—based on an economic return on capital or economic value added—giving a more explicit premium to account for differences in risk across emerging markets.

However, some corporations more actively decide on repatriation of earnings through dividends, as a means of controlling exposure. Financial institutions in particular tend to set capital limits and credit risk exposure for this purpose.

49. **Some companies reported that against the backdrop of global developments, increasing pressure from shareholders, and rising perception of risk in EMCs, they are assigning a higher cost of capital to business ventures**. A review of capital and financing, as well as heightened risk perceptions and poor experience, has led some managers to conclude that they are "overinvested" in emerging markets as projects fail to return economic profit. This helps explain why some global executives are less inclined to increase FDI investments.

50. **In addition to tightening control of overall exposure, many corporations seek to manage specific risks to emerging markets**, including political and regulatory risk, foreign exchange risk, operational risks, and risk of crisis. Regarding political and regulatory risk:

- Following developments in Argentina, **demand for political insurance in Latin American economies has reportedly increased, while some private providers may be more reluctant to supply new insurance.** The working group spoke with both buyers of *political insurance* and sellers of such insurance.[6] Demand for insurance also increased for economies considered most politically stable in the region, including Chile. At the same time, indications suggest that private insurance providers are more reluctant to provide *new* insurance cover where countries have or are experiencing crises. A combination of heightened political concerns and rising demand for political insurance, coupled with rising costs and/or withdrawal by providers private insurance, may make less attractive FDI to some EMCs seen to carry greater political risk. Public providers of insurance, however, might substitute for a fall-off in coverage by private insurance providers.

- Extractive companies, as well as utility providers are particularly vulnerable to *regulatory and tax risks* in view of the large scale of capital investment required—specifically, expropriation and other forms of indirect expropriation, for example pecuniary taxation and other transfer devices. They are also concerned about controls on either repatriation of profits or capital. Some companies seek to nurture a private-public partnership to promote a greater understanding among the government sector of the joint self-interest in FDI. Also, many companies are seeking more transparency

[6] Typically such insurance covers confiscation of property, inconvertibility of currency, physical damage, arbitration of award default and risks specific to a particular business. Such insurance typically provides a payout to cover a loss of equity invested in the FDI venture, or it may cover particular payouts of contracts. Insurance providers include private sector insurers, public sector insurers such as MIGA (associated with the World Bank), JBIC, OPIC, and national agencies (for insuring domestically domiciled companies).

in their relations with host governments so as to promote a more level playing field and safeguard against corrupt practices.

51. **While *foreign currency exposure* poses a large potential risk, most long-term nonfinancial FDI investors viewed the costs of sustaining hedges as prohibitively expensive and the risks inevitable in doing business in emerging markets**.[7] Instruments and avenues for hedging and containing losses are provided by financial and currency markets (both onshore and offshore), but no where near the extent in mature markets. Accordingly, many corporations that finance FDI do not hedge foreign exchange exposure. Some managers that invest across several emerging markets suggested that their overall exposure was diversified and therefore naturally hedged.

52. Nevertheless, policies controlling foreign exchange exposure have been tightened and hedging instruments and strategies used—particularly where a build up of vulnerabilities is detected and a potential crisis foreseen.

- **Many companies surveyed focused closely on segments of the balance sheet—in particular working capital.** Asset and liability management policies have been tightened to keep foreign currency exposure within prudent limits. Policies have been put in place to ensure that local funding is used to support lending activities, thereby immunizing against currency risk.

- **Companies also manage cash flows across currencies and local borrowing to hedge currency exposure.** Controlling the leads and lags of export receipts and import payments are instruments used to reduce currency exposure. Some companies have instituted centralized treasuries to further economize on cash balances and reduce the gross size of international transactions through netting (against the central treasury), while reducing float and interest charges.

- **Increasingly, corporate managers are seeking to use foreign exchange and derivative markets, particularly when risks of a large depreciations heighten.** In some companies, decisions on foreign exchange risk are taken in central treasuries that assess such risks on an ongoing basis. Hedges in foreign exchange forward

[7] During the crises experienced in Asia and Latin America, servicing of foreign currency loans—financing fixed and other assets of FDI—could, in many cases, not be met with revenues earned in local currency but exchanged for foreign currency at deeply depreciated rates. Prices of even tradable goods sometimes did not rise fully in local currency, while demand suffered as domestic residents lost purchasing power, creating under utilized capacity in production. As well, funding mismatches were also exposed. For instance, finance company subsidiaries of FDI investors producing durable goods, such as autos, suffered losses when finance loans were in local currencies (even though some were pegged to the dollar) whereas funding came from abroad.

markets and options markets all provide avenues to hedge currency risk. Where markets are thin or nonexistent, some managers have made use of "proxy hedges." [8]

53. **Foreign-owned financial companies operating in emerging markets are typically exposed to a significant amount of *sovereign and corporate credit risk,* and, in Latin America, have moved to reduce their exposure**. The growth in credit default swap markets offers an avenue to remove (transfer) credit risk by buying insurance or hedging their asset value. However, once again, such markets are nascent, lacking both depth and liquidity. In response to recent crisis-related events, banks also appear to be more extensively hedged and have sought to reduce cross-border exposure by encouraging their clients to borrow locally rather than from the parent abroad. To reduce exposure, banks reported repatriating earnings in an expeditious manner during (or near) times of crises.

54. **In addition to financial risks, *operational risks* may arise during a period of crisis when using a local banking and securities markets in particular**. Some corporate managers that rely on local banking systems for collection of revenues from sales and maintaining working capital have found their assets encumbered or degraded during banking crises. Some suggested that local banks may not have the detailed policies and procedures found within many international banks. By following these procedures, they hope to minimize the incidence of settlement errors, fraud, and other operational risks. The presence of foreign banks in the local market may give some corporations investing in the EMC added comfort that should problems arise, there will be recourse to the parent bank. Furthermore, the international bank will be strictly regulated by an internationally recognized body, which may not be the case for the local bank. Also, as access to local securities and hedging markets increases, operational and other risks need to be carefully managed, especially in nascent markets and where standards and infrastructure are underdeveloped.

55. **Recent events in emerging markets and rising geopolitical concerns have led some corporate mangers to consider worst-case scenarios with implications for overall risk assessments of operating in EMCs.** In particular, corporate managers are looking more seriously at the implications of providing implicit and explicit guarantees for subsidiaries in the context of events that result in a large, continuing loss to the subsidiary. While the prevailing view is that the head office would stand behind their subsidiaries, some firms note that subsidiaries cannot assume for granted implicit guarantees from the head office. More generally, corporations are trying to shed greater light on the costs and implications of implicit and explicit guarantees. This development mimics banks' increasing reluctance to provide financing at comparable costs in the absence of parent guarantees.

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[8] For example, if local currency protection is seen as overly expensive, currencies of regional economies that move in tandem might be used to create a hedge. The nondeliverable forward exchange markets, often traded offshore, allow foreign players interested in taking country exposure (such as hedge funds) to take positions.

V. Conclusions, FDI Prospects, and Country Experiences

56. *Concerning future prospects for FDI in EMCs, many investors note that following the rapid expansion of FDI in the 1990s, they are reevaluating their investments in a number of countries in light of falling profitability and greater perceptions of risks. Investors, however, broadly concur that FDI will, among other things, be driven by the business prospects of individual firms and global economic developments. Citing the efforts being targeted at strengthening balance sheets in a period of weak equity markets and shareholder pressures, most investors will be more discerning about both new investments and expanding existing businesses. Views on FDI prospects for EMCs differ, depending on both the regional and sectoral focus of investors. Key conclusions of the study are elaborated in Box 2.*

A. Broad Perspectives

57. A large majority of investors with a ***global focus*** underscore that recent crises have magnified regulatory risks, particularly in Latin America. They are therefore in a "digestive" mode concerning investments in the region and are unlikely to expand their investments in the near term. They note, however, that FDI could recover quickly in selected countries, notably Brazil, if growth prospects gain momentum. Most investors note that FDI in EMCs in the near term will focus on Asia, with China being the prime location. Many observe that accession to EU could play an important role in bolstering the framework for foreign investment in a number of countries in Eastern Europe, but market saturation and limited upside potential could impede large-scale expansion there.

58. In contrast to the investors with a global focus, many companies for whom investment in Latin America reflects a ***regional specialization*** emphasize that they are likely to refocus their investment on countries in the region where risks are perceived to be less—notably Mexico. Some others, however, note that despite problems concerning the macroeconomic environment and local politics in EMCs in the regions, they are likely to expand their businesses through reinvested earnings. Following the trend of firms with a global focus, most investors focused on Asia reiterate that FDI in the region will be led by China, while those focusing on Eastern Europe note that FDI expansion in this region will increasingly take the form of export-oriented investment by firms, particularly from Western Europe, seeking to lower global manufacturing costs.

59. Investors engaged in ***extractive activities***—whose investment decisions are driven primarily by the availability of natural resources—emphasize that recent financial crises have had little impact on current and prospective investments in Latin America, and EMCs more generally. To this end, abstracting from commodity price cycles, FDI in the extractive sector is likely to emerge unscathed.

Box 2. Key Conclusions

Motivation and determinants

- FDI in EMCs is increasingly being undertaken to service domestic demand in the host country rather than to tap cheap labor. Going forward, the focus of many companies will be to invest in countries with large markets and promising growth prospects.
- Corruption and governance concerns have a significant bearing on investment prospects. As a result, the "investment regime and the environment for business" play an important role in determining investment location.
- EMCs best prepared to address infrastructure bottlenecks are likely to secure greater amounts of FDI in the near to medium term.

Impact of crises and crisis-related events

- Recent financial crises have highlighted the underlying risks of investing in EMCs and the need for paying greater attention to issues relating to the legal framework and the enforceability of contracts.
- Firms plan to economize increasingly on the amount of equity and intercompany loans. As a result, subsidiaries will have to borrow more on their own capacity and balance sheet, both locally and overseas, while generating sufficient returns to finance internally ongoing expansion.
- International capital market conditions are less supportive of FDI financing because global banks—hit by weaker global economic condition and in some cases crises in emerging markets—have less appetite for supporting FDI investment in EMCs.
- Volatile conditions in emerging markets have prompted several companies to tighten control of exposure to emerging markets, seek insurance against political risk, and use financial hedges, particularly when currency depreciation is foreseen. More generally, returns on investment in EMCs are increasingly being required to compensate for higher risks and hurdle rates are being raised.
- In the context of global economic uncertainty and balance-sheet pressures, there is an increasing centralization of investment location decisions and a marked shift toward a more integrated management of FDI-related risks.

FDI prospects

- Contrary to some fears that following recent crises-related events in EMCs—which have included the abrogation of contracts—FDI in EMCs could be significantly undermined, there is little evidence to support the "worst-case" fears of large-scale pull out from Latin America and EMCs, more generally.
- Incipient flows could, however, be affected. Following the rapid expansion of FDI in the 1990s, companies are reevaluating their investments in a number of countries in light of falling profitability and greater perceptions of risks. That said, investors broadly concur that FDI will, among other things, be driven by the business prospects of individual firms and global economic developments.
- Investments in selected sectors—banking and utilities—are likely to be more adversely affected, owing largely to greater perceptions of regulatory risks and lower than expected profits and growth prospects in a number of EMCs, notably in Latin America.

60. Investors in selected ***other sectors***, ***especially in banking and utilities***, underscore that recent events have magnified previously latent risks of investing in EMCs. They indicate

their intention to reduce exposure to Latin America, and possibly to other EMCs. Some foreign banks in Latin America have sold their businesses in selected countries, especially where they lack critical mass in terms of size in the local market, while most others emphasize the need to pay *closer attention to worst-case scenario*s concerning investments in EMCs. Similarly, investors note that FDI in utilities has been hurt in Argentina by policy changes that have led to an abrogation of market contracts dictating the costs of utilities. Citing risks of possible policy contagion, some large FDI investors in the utilities sector wish to scale back their exposure to EMCs, in particular to countries in Latin America.

B. Region and Country Experiences

Latin America

61. The importance of Latin America as a destination for FDI is reflected in the fact that most firms participating in the working group have some (and in many cases, considerable) exposure in the region. Investors in the region generally fall into one of two categories: truly global companies, for whom the large economies of Latin America are an inevitable component; and companies for whom investment in Latin America reflects a regional specialization. Some large Spanish and several American companies fall into this latter category, and therefore have been especially affected by recent adverse developments in the region.

62. Many of the truly global firms have had long histories in Latin America and have thus experienced several severe cycles and regular instability in the operating environment. With these experiences in mind, many look back on the past two years of turmoil as more of the same and report that they are not substantially changing their previous business strategies. Most remain committed to the region for the long haul.

63. For investors with a regional focus, the main concerns are the persistent low-growth environment and political instability, which could lead both to crises and to more basic changes in the business environment. The experience of Argentina's collapse—and in particular the asymmetric pesification and the breaking of investment contracts—has undermined investor sentiment and is likely to affect FDI in the region, including through:

- **Dampening enthusiasm for investment in the region.** For example, none of the companies in the survey reported that they viewed the sharp decline in local asset prices in 2001–02 as an opportunity to buy cheap assets. At present, regional M&A involves primarily local companies.

- **Greater attention to worst-case scenarios**. Many investors report that perceived risk levels have risen and are reflected in higher hurdle rates of return for proposed new projects. For new investments in the region, risk exposure will be limited by active hedging, including political risk insurance.

- **Changes in financial priorities**. Many companies say that their propensity to reinvest earnings has fallen (and profit repatriation ratios have thus risen). As a result, they are putting more emphasis on the ability to fund operations locally. Some investors, on the contrary, continue to expand their business through reinvested earnings, believing that prospects for the region are overly gloomy.

- **Changes in the management of risks by global financial institutions.** Banks underscore an accelerated emphasis on lending by local subsidiaries and de-emphasis of cross-border lending. Given the greater strategic emphasis on markets where local subsidiaries have a large market share, banks have sold businesses where they lack critical mass in terms of size in the local market. Some report that they want in the future to be in the position to cut themselves off more rapidly from a sinking local operation.

Mexico

64. Within Latin America, Mexico is most appealing to the broadest range of companies in our sample, largely because of NAFTA. A number of investors emphasized that **NAFTA had led to an improvement of the rule of law** in Mexico, in addition to the obvious benefits of access to the U.S. market. Mexico is considered an attractive destination for regional investors, especially for banks that are refocusing their investments in the region. On the other hand, **rising real labor costs and low labor productivity** have somewhat eroded Mexico's competitiveness as an export platform. As a consequence, some manufacturing companies are moving their production plants from Mexico to China or other Asian countries.

Brazil

65. Underscoring that **economic and political stability** is a key element in investment location decisions, investors appear to be guarded about new investments in Brazil, although it remains the main FDI destination in the region and the second largest among EMCs. Unlike Mexico, where the emphasis is often on exports, the focus of most investors in Brazil is on the sizable local market. A large number of investors, including in the banking and utilities sectors, remain interested in Brazil. At the same time, they acknowledge that profits have been down in the **recent slow growth environment** and that last year's near crisis had in some instances led to significant balance sheet losses.

66. Overall, while recent crises have increased the level of risk awareness, most investors identify as the main impediment to increasing their own investment the current low growth environment. Investors have been pleasantly surprised by the policy stance of President Lula although they note that regulatory risks remain. To the extent that investment potential is being undermined by low growth prospects, however, a **rapid turnaround in economic growth in Brazil could bolster investor sentiment towards the region**.

Argentina

67. Argentina has been the epicenter of recent problems and the near universal view from investors is one of frustration and disappointment over the way that the **rule of law and contractual obligations were overridden during the crisis**. This has made for an extremely unstable and unappealing operating environment. The crisis has affected companies in different sectors quite differently. Banks and utilities have been most affected, while at least one natural resource firm reported that all their contracts have so far been honored. A number of firms note that their local subsidiaries are still cash positive and were now experiencing a period of growing sales volume. However, there seems to be little appetite for increased investment, even among those companies that are benefiting from a depreciated real exchange rate or the pickup in local demand. These firms generally are not repatriating local profits, but neither are they yet willing to inject new funding from headquarters. A number of other firms, however, report that they have continued their local operations in large measure for reputational reasons, but might reconsider if the policy environment does not improve.

Chile

68. Firms with a regional focus indicate a willingness to invest assuming the economic situation continues to improve. They note that over the past few years the government has taken several measures—including the removal of impediments to greater access to capital, the signing of bilateral trade agreements with the European Union, South Korea, and the United States, and elimination of double taxation—in order to attract FDI. Investors, however, underscore that red tape and bureaucracy, a string of corruption scandals in recent months, and a heightening of regulatory risks have somewhat undermined business confidence.

Other Latin countries

69. The main message on the smaller Latin American countries from the investors in our sample is one of greater selectivity. With many countries experiencing both their own severe political and economic problems in recent years, as well as spillover from difficulties in the major economies, companies are becoming more wary of investment in these countries. A number of companies, including those with regional specialization, report that they have shifted their emphasis to focus just on the largest economies in the region.

Asia

70. **FDI in Asia over the medium-term is likely to be dominated by investments in China.** With almost no exceptions, for investors with a global focus, China is at the top of the list for new FDI, despite considerable variance in profitability of current investments. While investors emphasize the significant potential for India to become an attractive destination for FDI, they observe that red tape and bureaucracy and poor infrastructure facilities serve to undermine investor sentiment. Among other countries in the region, Thailand and, to a lesser extent Malaysia, are expected to sustain investor interest. Investors

note that the decline in FDI in other countries in the region reflects largely country-specific problems, although excess capacity in many key industries could limit FDI expansion even if these problems are addressed successfully.

China

71. Because of the **size of the domestic market and strong growth prospects and for reasons of cost competitiveness**, a number of foreign companies are both engaging in new investments and relocating their production base from other EMCs to China. This development is bolstered by the broad consensus that China's policies are steadily improving, with accession to the WTO being a stabilizing anchor. To some extent, however, FDI in China is driven by "peer pressure" since many firms have followed their competitors into China to preserve their global market share. Most of these investors believe that China's market is too big to allow them to postpone their investments.

72. Going forward, in addition to greenfield investments in China, M&A transactions are expected to surge as the privatization of state-owned assets gains momentum. Investors in the services sector, notably in telecommunication and retail trade, also emphasize China's growing potential for securing larger amounts of FDI; investors note that China has the largest number of cell phone users (200 million) in the world, with the numbers likely to increase significantly over the next several years. The infrastructure sector is also seen as representing a significant opportunity for investors.

73. Notwithstanding the positive characteristics that have facilitated large FDI flows into China, **investors express particularly serious concerns over the violations of Intellectual Property Rights** (see Box 3). Some investors in such capital-intensive sectors as energy also indicate that cost of capital is a big constraint to investing in China because of the inability to raise cheap capital locally. Investors, however, broadly concur that government policies in general are moving in the right direction.

Box 3. FDI in China and Intellectual Property Rights

Investors across most sectors note that violation of intellectual property rights (IPR) is an impediment to FDI in China, but are quick to note that this in isolation is unlikely to seriously affect FDI flows to the country, at least in the near term.

Most recently, in the first suit of its kind in China's car industry, Toyota Corp sued a Chinese automaker, Geely, in the Beijing Intermediate People's Court for infringing on its trademark and designs. Similarly, General Motors, the world's biggest carmaker, is investigating whether another auto manufacturer, Chery Automobile Co., has copied the design of its new models. Charges of unfair copying are pervasive across other industries. It is estimated that one in five products sold under the label of Procter & Gamble is fake and has cost the consumer-goods maker more than $150 million in lost sales. Similarly, about 90 percent of the computer software sold in the country is unlicensed according to the International Intellectual Property Alliance, a Washington-based group that represents more than a 1,000 U.S. companies.

Most investors in China reported that they have faced problems with enforcing intellectual property rights and those selling branded products often have had to deal with counterfeits. However, for the most part these firms note that such problems are not, at least in the short run, likely to lead to reduction of their investment plans in China as the situation generally was believed to be gradually improving. Regarding competition from fake products, some firms believed that this problem was likely to abate since rising incomes and growing taste for foreign brands are bolstering the sale of genuine products for firms across all sectors. Foreign investors are also finding innovative means to deal with the problem. For example, one firm in transportation manufacturing recently acquired a Chinese firm that was making a counterfeit, owing partly to the fact that the latter was very close to the original in quality.

To summarize, in the context of China's accession to the WTO, better enforcement of intellectual property rights (IPR) will further enable China's access to global FDI flows.

India

74. Most investors recognize the size of the Indian market and promising growth prospects. Investors emphasize the significant potential for India to become an attractive destination for FDI, but observe that the **business environment—particularly, red tape and bureaucracy and regulatory problems—a complex tax system, and most importantly poor infrastructure facilities (**electricity, water, and transportation network) undermine investor sentiment. Investors further note that while the legal system is relatively impartial, dispute resolution is typically a long and expensive process. Indeed, some manufacturing sector investors have scaled back their activities in India considerably because of regulatory problems and a lower-than-expected realized rate of return. This said, foreign investments in software-related activity and in telecommunications are likely to gain further momentum while FDI more generally is expected to maintain its upward trend.

Other Asian countries

75. Companies in **labor-intensive manufacturing and natural resource sectors plan to maintain their investments in Malaysia and Thailand.** Investment climate in Indonesia is

widely perceived as weak, with the main focus of foreign investors in the country limited to the natural resource sector.

Emerging Europe

76. Investors report an outlook for FDI in the emerging economies of Europe is very uneven. The key countries in the region can be broken into three categories: the accession countries poised to join the European Union in May 2004; the CIS countries, especially Russia, where institutional weaknesses are pervasive, but where rich natural resource endowments (especially oil) offer attractive opportunities; and Turkey, where political and economic risks are perceived to be high and bureaucratic impediments to FDI remain a key problem.

EU accession economies

77. Of the companies surveyed, those domiciled in Western Europe had invested the most in the region. Most had plans to continue such expansion, although at a slower pace than in recent years. In most cases, this was because much of the desired capacity has now been acquired and built up. Additionally, the weakness in overall European growth has left many European companies with excess capacity and limited appetite for expansion anywhere in the near term. **A key benefit of EU accession is that it has accelerated the convergence of the legal and regulatory frameworks in these countries to Western European standards**. Highly educated labor forces are another important benefit, although the rise in regional unit wage costs in recent years has worsened the region's global competitiveness.

Russian Federation

78. **Underscoring that political uncertainty, corruption, and predictable rules of the game** are important determinants in investment location decisions, investors note that these have been major negative factors, at least in the past, for Russia. Investors also cite the absence of a level playing field and the lack of even-handedness of the judiciary. Prospects for investment in Russia are, however, now improving. Many investors, including a few Asian investors, indicated that they might consider investing in the country in the future. There is inevitably most interest in the energy sector, although investors expressed reservations that the dominance of some domestic firms combined with lingering deep skepticism about the legal and regulatory environment made even this sector a risky proposition. Indeed, Russian oil and gas companies have themselves have been expanding throughout Eastern Europe. FDI in other sectors is most likely to be concentrated in Western Russia, where the market is perceived as growing and attractive. By contrast, per capita income is quite low in the rest of the country.

Turkey

79. Foreign investments in Turkey have been disappointing despite the country's favorable geographic location and significant market size, and investors do not expect this

situation to change soon. Although a number of firms participating in the survey, including several banks, have invested in Turkey, a number of others listed several reasons for not investing (or investing less than they might otherwise). These include political uncertainty, unstable and inefficient legal and regulatory framework, unfavorable macroeconomic conditions (mainly high inflation), corruption, and competition from other countries in the region.

Africa

80. In keeping with the macro data, the companies covered in the survey were least exposed to FDI in Africa. About one-third of companies surveyed reported that they had undertaken FDI in the region. Again in line with the macro level data, South Africa was the preferred destination, especially for companies in the manufacturing and service sectors. Investments outside South Africa were generally limited to the extractive and basic industry sectors, where the opportunities offered by natural resource availability (especially oil) offset the legal and institutional problems of operating in sub-Saharan Africa. One firm commented that it had long pursued a policy of modest local manufacturing investments across many countries in the region, using local agricultural ingredients to produce basic foodstuffs geared to local taste. For this company, the main challenge was finding the right infrastructure as the company's operations were typically quite remote. Investors cited poor infrastructure, low labor productivity, and security concerns as key negatives. Operating as a large-scale extractive producer in the small economies of Africa raises the risk of becoming a target of populist policies aimed against foreigners. Companies involved in South Africa were generally positive about the investment climate, which they found to be stable and transparent. The relatively developed financial system also offered important opportunities for local financing.

VI. INVESTOR RECOMMENDATIONS

81. A number of investors observe that in addition to their own due diligence concerning investment prospects in EMCs, they often rely on information disseminated by the international financial institutions (IFIs), including in the context of their routine surveillance of countries and during policy discussions pertaining to economic programs supported by the IMF and the World Bank. A number of investors, especially those engaged in the infrastructure and utilities sectors, also noted that they work closely with the World Bank Group, including the International Finance Corporation (IFC), Foreign Investment Advisory Services (FIAS), and the Multilateral Investment Guarantee Agency (MIGA), in securing financing for various projects in EMCs.

82. In the context of discussions with investors on how the IFIs could best help facilitate EMCs secure a greater share of global FDI, a number of important areas for further work were identified:

- **Encouraging sound macroeconomic policies that promote sustainable growth and address macro vulnerabilities.** Most investors appreciated the role of the IMF and the World Bank surveillance and program support for country policies. In particular, the IMF's lead role in assisting countries in near-crisis and crisis situations provided a degree of comfort to FDI investors in maintaining and continuing a presence in emerging market countries. Like themselves, they see the IFIs as taking a longer-run view on country prospects. Many suggested that the IMF and the World Bank should make even greater efforts to discuss with FDI investors, especially including investors in the nonfinancial sector, risks and vulnerabilities associated with doing business in emerging markets and would welcome opportunities to gain a greater understanding of IMF stabilization and reform policies in emerging markets.

- **Focusing greater attention on analyzing FDI and equity flows and their impact on the real economy**. A number of investors note that IFIs focus too much on monitoring trends, risks, and vulnerabilities concerning debt flows, but way too little on understanding equity flows and their impact on the real economy. Most of the investors emphasize the importance of governments' understanding the benefits of FDI much more clearly, so as to enhance their commitment to promoting greater inflows and improving the investment climate.

- **Increasing understanding and monitoring of banking and capital market support of FDI in EMCs**. A number of investors underscore that banks and capital markets play an important role in facilitating FDI in EMCs. They note that IFIs could improve their surveillance of disruptions to this financing chain—reflected by wider spreads and withdrawal of subsidiaries—and the associated impact on the size and range of financing available for FDI.

- **Systematic and regular assessments of investment climate issues.** Most investors note that more regular and in-depth assessments of the investment climate in EMCs—including in the context of the IMF's Article IV consultation discussions and the World Bank's economic and sectoral work—could be useful in enabling investors make informed judgments about investment opportunities and associated risks. Investors emphasize that better focusing the policy dialogue with member countries on issues relating to the investment regime—including the legal and regulatory framework, business environment, and the tax system—will further help the authorities appreciate the role of equity capital in promoting sustainable growth and facilitate a prioritization of structural reforms. Some investors underscore that regular assessments of investment climate issues will both promote FDI in EMCs and help reduce vulnerabilities by facilitating better risk management by foreign investors. Almost all investors, however, indicated their lack of familiarity with the Investment Climate Assessments carried out by the World Bank. While periodic assessments, such as those carried out by the World Bank, are important, investors see an urgent need for routine follow up on changes and improvements in the investment climate. Such follow-up could, among other things, help the private sector assess investment prospects in EMCs and formulate their medium-term FDI strategies. A number of investors noted that the regulatory regime, while largely liberalized, should be further reformed—including by eliminating requirements to form joint ventures, removing restrictions on FDI in certain economic sectors, and relaxing limits on ownership and merger and acquisition activity.

- **Further focus and assessments of latent risks.** A number of investors emphasize that recent crises have magnified latent risks of investing in EMCs. They stress the need for IFIs to focus a lot more attention on addressing legal and regulatory risks with a view to promoting sustained FDI inflows, particularly in the infrastructure and utilities sector where upfront fixed costs are large. Many investors note that some EMCs fail to secure large amounts of well-diversified FDI because of regulatory, legal, and taxation-related impediments and risks. Other investors report they are cutting back their investment plans in certain countries where they are experiencing unexpected problems in the regulatory regime. These risks, they note, are often magnified at times of a slump in economic activity or during crises. Investors observe that efforts to resolve crises often compromise the sanctity of contracts. Investors thus underscore the need for the IFIs to place greater emphasis on issues relating to the sanctity of contracts, especially in the context of IMF-supported programs and World Bank lending.

- **Greater emphasis on developing local capital markets**. A large number of investors emphasize that developing a wider range of financing sources is an important precondition for supporting robust FDI flows and underscore the need for IFIs to place greater emphasis on developing local capital markets in EMCs. In addition to enabling foreign investors ring-fence currency and credit risks, investors see significant ancillary benefits to the development of local capital markets. They argue that the existence of well-functioning local capital markets would help to reinforce the types of legal and stable tax setting that are crucial for businesses. Some note that the availability of such financing would help build greater linkages between domestic enterprises and FDI investors, including through a strengthening of supply chains and marketing networks. Investors also note that allowing nonbank financial institutions, such as pension funds and insurance companies, to participate in the provision of long-term financing to foreign investors could also enhance the acceptance of foreign participation in economic activity and facilitate a broader consensus on the role of FDI. In this context, some investors have expressed their willingness to work with IFIs in helping host-country authorities develop local financial markets, including through pilot projects in selected EMCs.

- **Promoting infrastructure and local business development in EMCs and adapting to changing demands of investors.** Investors, especially those in manufacturing, emphasize the importance of infrastructure and local supply chains for investing and operating in EMCs. Many stress the need for IFIs, especially the World Bank, to further promote and participate in infrastructure and local business development projects. Some investors note that IFIs, particularly IFC and MIGA, are often slow in addressing the needs of investors. As a result, they are less inclined to use their services. In this context, investors urge IFIs to improve and adapt their services to the changing demands of FDI investors. Citing their recent experiences in Latin America, some investors also underscore the need for MIGA to revise and expand its political risk coverage to reflect the exposure of FDI investors to a wider variety of risks in EMCs.

83. **More continuous dialogue with the private sector**. A majority of investors want the IMF and the World Bank to reach out to a broad spectrum of the private sector through various initiatives. They view the Capital Market Consultative Group (CMCG) Working Group on FDI Flows to EMCs as a useful model. As a group, investors value a continuous dialogue between the IFIs and the private sector and emphasize the need for established channels of contact at both ends to discuss issues of common interest.

What is FDI?

1. FDI is defined as a cross-border investment in which a resident in one economy (the direct investor) acquires a lasting interest in an enterprise in another economy (the direct investment enterprise). The lasting interest implies a long-term relationship between the direct investor and the direct investment enterprise and usually gives the direct investor an effective voice, or the potential for an effective voice, in the management of the direct investment enterprise. By convention, a direct investment is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad.

2. The lasting interest in a direct investment enterprise typically involves the establishment of manufacturing facilities, bank premises, warehouses, and other permanent or long-term organizations abroad. This may involve the creation of a new establishment or investment (greenfield investments), joint ventures, or the acquisition of an existing enterprise abroad (cross-border mergers and acquisitions). The investment can be incorporated or unincorporated and includes, by convention, ownership of land and buildings by individuals. Direct investment comprises not only the initial transaction establishing the FDI relationship between the direct investor and the direct investment enterprise, but all subsequent transactions between them and among affiliated enterprises. Thus, the direct investment relationship extends beyond the original direct investor and includes foreign subsidiaries and affiliates of the direct investor that are part of the "parent group."
Once FDI is established, increases in FDI can take the form of injections of additional equity capital, the reinvestment of earnings not distributed as dividends by subsidiaries or associated enterprises and undistributed branch profits, and various intercompany claims, such as the extension of suppliers' credits or loans, all of which represent FDI capital. These transactions cover only one aspect of financing available to direct investment enterprises that can also expand their operations by borrowing in local markets and in international capital markets (with or without the guarantee of direct investors).

3. There are a number of popular misconceptions of what FDI is. FDI does not imply control of the enterprise, as only a 10 percent ownership is required to establish a direct investment relationship. FDI does not comprise a "10 percent ownership" (or more) by a group of "unrelated" investors domiciled in the same foreign country—it must be one investor or a "related group" of investors. FDI is not based on the nationality or citizenship of the direct investor; it is based on residency. Borrowings from unrelated parties abroad that are guaranteed by direct investors are also not FDI. As regards FDI positions, FDI does not cover all of the assets of the direct investment enterprise, it covers only that portion financed by the direct investor or foreign subsidiaries and affiliates of the direct investor that are part of the parent group.

FDI Trends in Emerging Market Countries (EMCs)

1. **Three important features predominate FDI flows to EMCs** (Table 1). **First**, there was a rapid increase in FDI in EMCs in the 1990s, owing largely to the adoption of macroeconomic and structural reforms by a number of countries and the associated strengthening of growth prospects. Although FDI flows to selected regions, particularly Asia, vacillated in the latter half, they continued to rise in aggregate. Reflecting both the push of investors seeking high-return opportunities and the pull from EMCs seeking needed investment and technology, net FDI flows to EMCs grew at a remarkable average annual rate of 40 percent during 1990–94, and a slower, but still impressive, rate of 15 percent during 1995–99. As a result, the share of EMCs in global FDI flows increased steadily and on average accounted for a quarter of the global FDI flows through 1994, but has since declined. Notwithstanding the more recent decline in flows to EMCs, FDI growth rates have surpassed that of GDP and trade, with the ratio of FDI to GDP rising from 1.3 percent in 1990 to almost 3 percent in 2002.

2. **Second, the surge in FDI, especially in the latter half of the 1990s, was led by M&A activity.** A number of EMCs in Latin America and Eastern Europe—including Argentina, Brazil, the Czech Republic, and Mexico—undertook extensive privatization of state-owned assets during this period, with a number of privatization transactions taking the form of M&A. Moreover, following the Asian crisis, the acquisition of distressed banking and corporate assets surged in several Asian economies, because of which the value of cross-border M&A activity in Asia more than doubled in 1998 relative to 1996. This enhanced the importance of M&A activity as a form of FDI in EMCs during the 1990s.

3. **Third, for a number of countries there was a significant shift of FDI into the services sector.** Traditionally, FDI has been directed to the development of natural resources and to manufacturing enterprises. In the 1990s, however, increasingly larger shares of FDI went into service delivery, including into sectors, such as finance and telecommunications and more recently into wholesaling and retailing. This was led by the progress in privatization of state-owned assets and innovations in the information and telecommunication industry. For example, during the second half of 1990s, FDI into the services sector in Brazil accounted for 12 percent of the total FDI into EMCs. In the aftermath of recent financial crises, which in almost all instances led to a sharp exchange rate adjustment and a rapid fall in domestic incomes, however, investments in some countries shifted to tradable production and away from the services sector, thereby reversing some of the earlier trends. Nevertheless, by the end of the decade, almost 40 percent of the FDI stock in EMCs was in the services sector (GEP 2003, the World Bank).

Table 1. Foreign Direct Investment in Emerging Market Countries
(in millions US dollar)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
All Emerging Markets	19,715	29,389	41,380	59,992	83,050	99,737	119,293	152,377	153,963	164,458	149,532	151,024	128,899
Latin America	7,691	12,227	14,054	12,997	27,717	29,578	43,111	64,153	70,735	85,677	73,807	66,269	42,411
Argentina	1,836	2,439	4,431	2,793	3,635	5,609	6,949	9,160	7,291	23,988	10,418	2,166	775
Bolivia	27	52	93	124	130	393	474	731	949	1,011	725	662	657
Brazil	989	1,103	2,061	1,292	3,072	4,859	11,200	19,650	31,913	28,576	32,779	22,457	16,566
Chile	661	822	935	1,034	2,583	2,957	4,815	5,271	4,628	8,761	3,639	4,477	1,603
Colombia	500	457	729	959	1,447	968	3,112	5,562	2,829	1,452	2,237	2,521	2,034
Costa Rica	163	178	226	247	298	337	427	408	613	620	409	454	662
Dominican Republic	133	145	180	189	207	414	97	421	700	1,338	953	1,079	961
Ecuador	126	160	178	474	576	452	500	724	870	648	720	1,330	1,275
El Salvador	2	25	15	16	0	38	-5	59	1,104	216	173	268	280
Mexico	2,549	4,742	4,393	4,389	10,973	9,526	9,186	12,831	11,897	12,855	15,483	25,335	13,627
Panama	136	109	145	170	402	223	416	1,299	1,296	652	603	513	57
Paraguay	77	86	118	75	137	103	149	236	342	95	119	95	-22
Peru	41	-7	-79	761	3,289	2,557	3,471	2,139	1,644	1,940	810	1,144	2,391
Uruguay	0	0	0	102	155	157	137	126	164	235	274	320	177
Venezuela, RB	451	1,916	629	372	813	985	2,183	5,536	4,495	3,290	4,465	3,448	1,368
Asia	10,147	12,965	21,455	39,468	46,525	53,122	61,048	65,681	59,972	51,844	46,269	51,405	58,550
China Mainland	3,487	4,366	11,156	27,515	33,787	35,849	40,180	44,237	43,751	38,753	38,399	44,241	49,308
India[1/]	0	74	277	550	973	2,144	2,426	3,577	2,635	2,169	2,315	*3,403*	*3,449*
Indonesia	1,093	1,482	1,777	2,004	2,109	4,346	6,194	4,677	-356	-2,745	-4,550	-3,278	-1,513
Malaysia	2,332	3,998	5,183	5,006	4,342	4,178	5,078	5,137	2,163	3,895	3,788	554	3,203
Pakistan	245	258	336	349	421	723	922	716	506	532	308	383	*823*
Philippines	530	544	228	1,238	1,591	1,478	1,517	1,222	2,287	1,725	1,345	982	1,111
Thailand	2,444	2,014	2,113	1,804	1,366	2,068	2,336	3,895	7,315	6,103	3,366	3,820	969
Vietnam	*16*	*229*	*385*	*1,002*	*1,936*	*2,336*	2,395	2,220	1,671	1,412	1,298	1,300	*1,200*
East and Central Asia	940	3,260	4,420	6,004	6,192	14,822	13,352	17,137	20,658	23,858	25,492	24,869	25,556
Bulgaria	4	56	42	40	105	90	109	505	537	806	1,002	813	479
Croatia	..	..	..	120	120	114	511	533	932	1,467	1,089	1,561	981
Czech Republic	*70*	*520*	*1,000*	650	880	2,568	1,435	1,286	3,700	6,313	4,987	4,924	*9,319*
Hungary	0	1,462	1,479	2,350	1,144	4,519	2,363	2,224	2,084	2,019	1,694	2,595	854
Poland	89	291	678	1,715	1,875	3,659	4,498	4,908	6,365	7,270	9,341	5,713	*4,119*
Romania	0	40	77	94	341	419	263	1,215	2,031	1,041	1,037	1,157	1,106
Russian Federation	..	..	..	..	690	2,065	2,579	4,864	2,764	3,309	2,713	2,469	2,956
Slovak Republic	*93*	*81*	*100*	199	270	236	351	174	562	354	2,052	1,579	4,012
Turkey	684	810	844	636	608	885	722	805	940	783	982	3,266	1,037
Ukraine	..	..	*200*	*200*	159	267	521	623	743	496	595	792	693
Middle East and Africa	937	937	1,451	1,523	2,616	2,215	1,782	5,406	2,598	3,079	3,964	8,481	2,382
Egypt, Arab Rep.	734	253	459	493	1,256	598	636	891	1,076	1,065	1,235	510	647
Jordan	38	-12	41	-34	3	13	16	361	310	158	787	100	*120*
Morocco	165	317	422	491	551	92	76	4	12	3	221	144	81
South Africa	-76	254	3	11	374	1,248	816	3,811	550	1,503	969	7,270	739
Tunisia	76	125	526	562	432	264	238	339	650	350	752	457	795

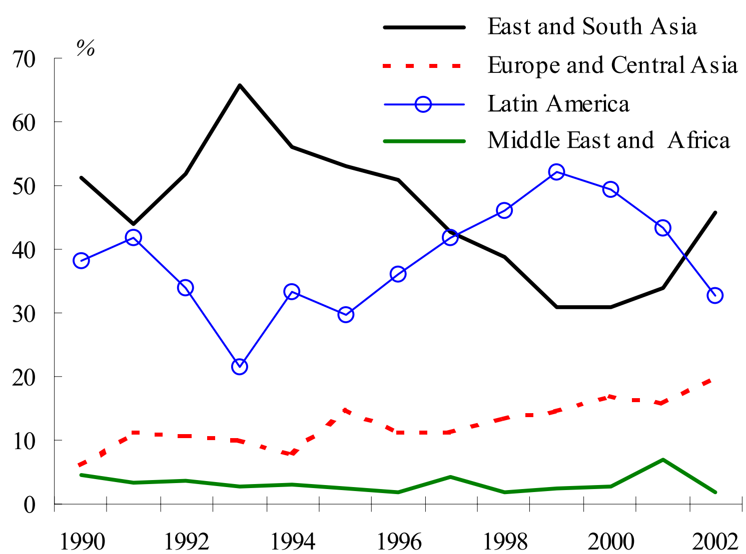
[1/] FDI data for India are in the process of revision to account for a change in methodology.
Source: 1990-2002, Balance of Payments Statistical Yearbook, IMF; data in italics is from UNCTAD database or national sources; World Bank.

A. Regional Trends in FDI

4. Over the past decade or more, owing largely to economic developments, there have been changes in the relative importance of various geographic regions—particularly Asia and Latin America—as FDI destinations. Driven by both market-seeking and efficiency-seeking investment, FDI in Asia rose rapidly in the early 1990s, with the region's share in FDI to EMCs peaking at 63 percent in 1993. However, following the adoption of market-oriented reforms and the acceleration of the privatization of state-owned assets in a number of

countries in Latin America, FDI to the region gained rapid momentum. This was reflected in the increasing share of Latin America in FDI to EMCs that mirrored the decline in the share of countries in Asia, with the latter reflecting inter alia the impact of financial crises. More recently, however, deteriorating economic conditions following the crisis in Argentina has led to a trend reversal, with FDI in Latin America declining, while flows to Asia continue to increase (Figure 2).

Figure 2. Geographic Distribution of FDI to EMCs
(Share in total)



Source: 1990-2002, Balance of Payments Statistical Yearbook; UNCTAD database or national sources.

5. **In the early 1990s, led largely by Mainland China, countries in Asia received almost half of the FDI directed to the EMCs.** Owing largely to the pursuit of economic reforms, the size of the domestic market, and its cost competitiveness, China was successful in receiving large amounts of FDI. Driven by ethnic and cultural ties, a large share of FDI flows originated from countries, including Hong Kong, Malaysia, Macao, and Taiwan, that have predominantly ethnic Chinese populations. A significant amount of FDI in China originating from the above-mentioned countries is, however, attributed to the "round-tripping" of Chinese savings for tax-efficiency purposes.[9] Other than China, Thailand, Malaysia, and Indonesia received relatively large amounts of FDI in the run up to the financial crises, while investments in India, albeit small in volume relative to China, continued to increase through the 1990s.

[9] Round-tripping of Chinese savings leave China in the form of bank deposits and come back through Hong Kong, Macao, and Virgin Islands as FDI. Preferential treatment for FDI and restrictions on local savings such as exchange rate limitation encouraged this activity (World Bank. 2002. Global Development Finance 2002. Washington, D.C.).

6. **Following the financial crises, annual FDI flows to Asia declined in aggregate from about \$66 billion in 1997 to about \$46 billion in 2000, but have since arisen** to \$63 billion in 2002 largely because of the rapid increase in flows to China.[10] Buoyed by the new round of market liberalization, a large and rapidly growing market size, and the country's accession to the World Trade Organization, China has accounted for more than 80 percent of the FDI to the region and for 43 percent of flows to EMCs. While India has registered only modest gains in FDI flows in recent years, official recording of FDI may understate actual flows, since the definition of FDI excludes earnings reinvested by foreign investors, other direct investments between direct investors and subsidiaries, branches, and associates, and investments by offshore and domestic venture-capital funds set up by foreigners.[11] Furthermore even some of the crises-stricken countries, especially Thailand, increased their share of FDI because foreign investors were able to acquire local firms or increase their shares in existing joint ventures at attractive prices.

7. **Aggregate data on FDI in Latin America conceal interesting dynamics within the region** (Figure 3). Led by economic reforms and the associated growth prospects, FDI in Chile and the Mercosur—that includes Argentina, Brazil, Paraguay, and Uruguay—increased sharply from \$10 billion in 1994 to \$62 billion in 1999. This was led initially by market-seeking investments and later by investments in the services sector that was catalyzed by rapid privatization of state-owned assets. At the same time, FDI in Mexico and Central American countries—including Costa Rica, the Dominican Republic, El Salvador, Mexico, and Panama—also rose rapidly, but owing mostly to efficiency seeking investments following NAFTA. Finally, FDI in the Andean Community—which includes Bolivia, Colombia, Ecuador, Peru and Venezuela—also increased, but it was driven largely by investments in the extractive sectors.

8. **More recently, FDI in Latin America has declined sharply, driven largely by the contraction in flows to Mercosur.** This has been triggered, among other things, by recent events in Argentina, sluggish growth and dim prospects, and the slowdown in the privatization process in other countries, notably Brazil. The decline in FDI flows to the Andean sub-region has been less dramatic, partly because of the nature of the FDI. Nonetheless, uncertainty in Venezuela has undermined investor sentiment, while flows to Mexico and sub-region remained reasonably stable (abstracting from the blip in 2001 because of the mega Banamex deal). The latter has been partly facilitated by larger investments in the services sector—some foreign banks in the region shifted their operations from Argentina and Brazil, to Mexico—although FDI in the manufacturing sector has been

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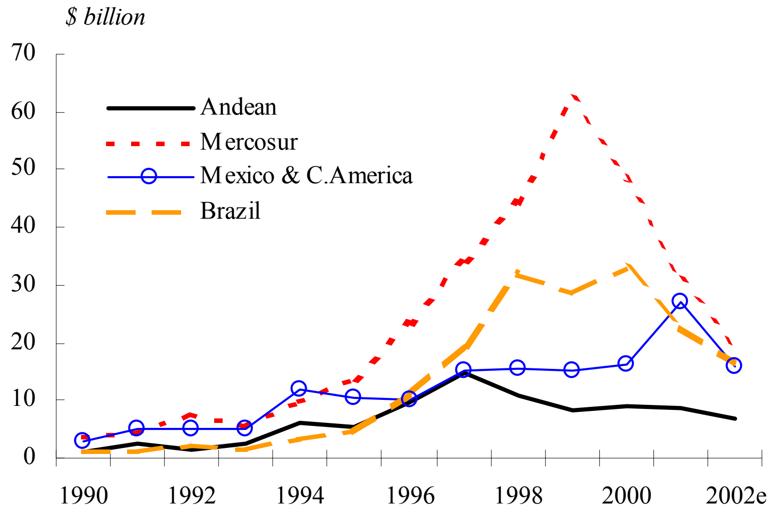
[10] Indonesia's FDI is believed to be underreported, including because official data does not include reinvested earnings as FDI inflows.

[11] According to the IFC, if properly recorded, actual level of FDI in India could be as high as \$8 billion.

on the wane following the appreciation of the peso and increased competition from Asian countries.

Figure 3. FDI Flows to Latin America



Source: Economic Commission for Latin America and the Caribbean, United Nations.

9. **In the first half the 1990s, foreign investors viewed investment prospects in the newly emerging markets of *Eastern Europe and Central Asia* with both interest and caution**. However, following the deepening of reforms in the latter half, EMCs in the regions received a steady flow of privatization and infrastructure-related FDI, along with small, but growing amounts of greenfield investments. FDI as a share of GDP increased from less than 1 percent in 1990–94 to around 2.8 percent in 1999, while as a share of fixed capital formation it increased to about 15 percent. While privatization of state-owned assets was the initial trigger for FDI inflows, over a period of time such flows have been sustained because of further capital injections by existing multinational corporations and through reinvested earnings—an average of 46 percent of the FDI earnings were reinvested in the region (World Bank Global Development Finance 2003. Washington, D.C.).

10. **More recently, FDI flows to the region declined from about $22 billion in 1999 to around $18 billion in 2002.** While flows to the Czech Republic, and to a lesser extent Russia, gained momentum in 2002, other countries in the region registered declines owing largely to a slowdown in privatization-related FDI. Flows to Turkey declined sharply in 2002, after having been boosted in 2001 by inflows from the sale of mobile phone licenses and a state bank.

11. **Emerging markets in the *Middle East and Africa* account for a small share in FDI flows to EMCs.** While the region has received FDI largely in extractive activity—following a deepening of reforms in selected countries that has included further liberalization of the investment regime and the acceleration of the privatization process—FDI has been

flowing to other sectors of the economy, particularly in the second half of the 1990s. FDI in the region was, however, adversely affected by the financial crises in Asia since considerable investments in South Africa originate from Malaysia and South Korea. More recently, adjusting for the sale of Morocco's Marco-Telecom to Vivid Universal for $2.2 billion in 2001, the Middle East and Africa region experienced a sharp decline in FDI, which fell to about $3.4 billion from a record $15 billion in 2001. In addition to global economic developments, trends reflect the uncertainty surrounding the region since September 11, 2001.

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