



THE GLOBAL BUSINESS POLICY COUNCIL
OCTOBER 2004, VOLUME 7

ATKEARNEY

FDI CONFIDENCE INDEX[®]

GLOBAL BUSINESS POLICY COUNCIL

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POLICY COUNCIL

The Global Business Policy Council is a strategic service that assists chief executives in monitoring and capitalizing on macroeconomic, geopolitical, socio-demographic and technological change worldwide. Council membership is limited to a select group of corporate leaders and their companies. The Council's core program includes periodic meetings in strategically important parts of the world, tailored analytical products, regular member briefings, regional events and other services.

Global Business Policy Council
A.T. Kearney, Inc.

333 John Carlyle Street
Alexandria, Virginia 22314, U.S.A.
Telephone 1 703 739 4714
Fax 1 703 739 4741

www.atkearney.com

A.T. Kearney is the management consulting subsidiary of EDS, a leader in the global information technology services industry for more than 35 years.

Executive Summary

For the first time since 2000, a sizable majority (69%) of leading executives are more optimistic about the global economy, compared to only one in ten expressing more pessimism. Helping spur likely future FDI, corporate investors see macroeconomic and political risks as less threatening and perceive greater profit opportunities, and reduced risk, in the world's leading emerging markets. A fundamental shift in investor outlook and risk perception is underway, which could presage the return to positive growth in global FDI flows. Yet, a complicated mix of operational risks could undercut investors' renewed interest in venturing overseas.

China maintained its position as the number one most attractive FDI destination in the world, while India rose from sixth to third most likely FDI location globally—the country's highest ranking ever, just behind the U.S. Although the United States remained the second most attractive FDI location in the world, the perception gap between the U.S. and India may be closing. Investors expect to pursue offshoring strategies more aggressively, intensifying the competitive pressures unleashed by China and India on the world.

Five of the six largest Index jumps in relative attractiveness were achieved by Asian markets: Hong Kong, Australia, Singapore, Malaysia and New Zealand. Japan entered the top ten most attractive investment destinations for the first time ever, moving from 15th to 10th place. Western Europe has regained lost ground in 2004 as the U.K., France and Italy rise in the rankings and Germany holds steady in fifth place. Brazil and Mexico lag behind their competitors—China, India and Poland—in terms of investor attractiveness and expected profitability. Poland, the Czech Republic and Hungary have returned to rankings roughly consistent with their historical averages as the novelty of EU membership fades.

It is in this global context that A.T. Kearney conducted the 2004 FDI Confidence Index® survey, which tracks the impact of likely political, economic and regulatory changes on the foreign direct investment intentions and preferences of the leaders of the world's leading companies (see figure 1).*

Over the past seven years, we have surveyed CEOs, CFOs and other top decision-makers of the world's largest 1,000 firms about their opinions of various FDI destinations, and their investment intentions. Responses from participating firms about their views of 65 countries, which receive more than 90 percent of global FDI flows, reveal likely foreign direct investment flows and point to the factors that drive corporate decisions to invest abroad. The companies surveyed are responsible for about 70 percent of global FDI flows and generate more than \$20 trillion in annual revenues. These companies represent all major regions and sectors.

**Foreign direct investment includes investments in physical assets, such as plant and equipment, in a foreign country. Holdings of 10 percent or more equity in a foreign enterprise is the commonly accepted threshold between direct and portfolio investment as it demonstrates an intent to influence management of the foreign entity. The main types of FDI are acquisition of a subsidiary or production facility, participation in a joint venture, licensing, and establishment of a greenfield operation.*

Major Findings

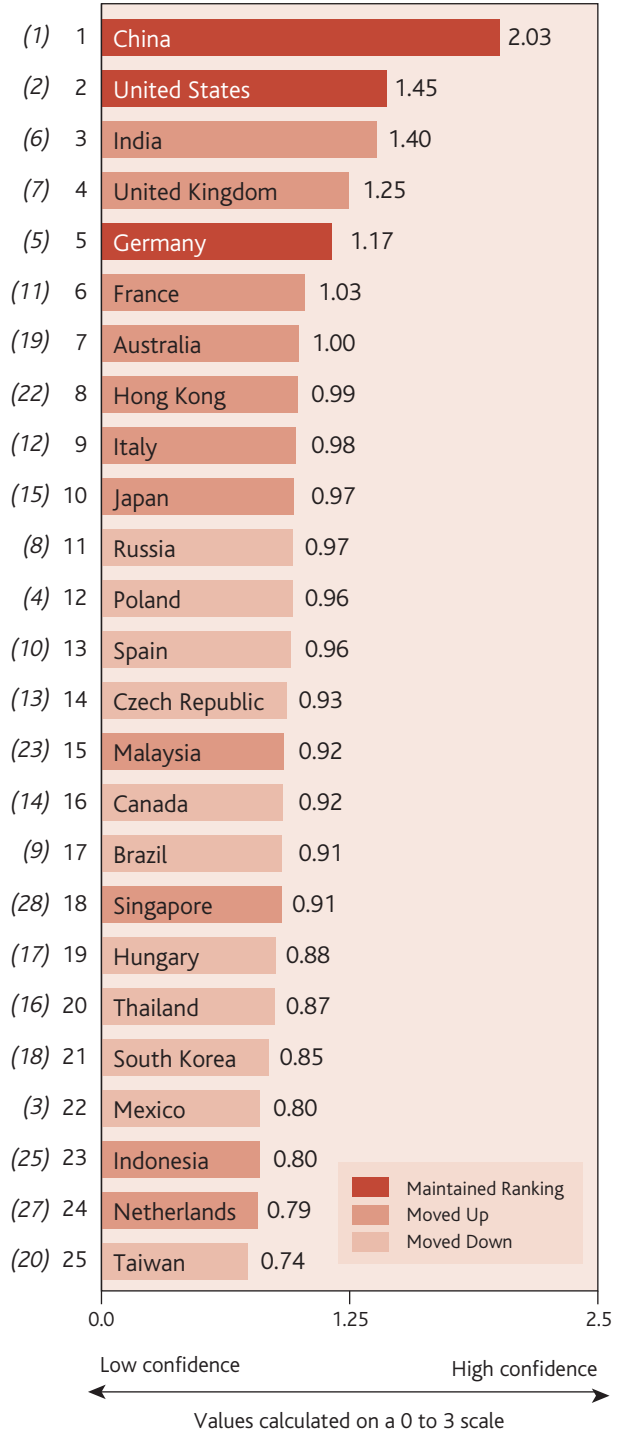
CEO OUTLOOK ON GLOBAL ECONOMY LEAPS

Nearly 70% of corporate investors are more upbeat on the global economy this year. The last time a majority of investors were so bullish on the global economy was in 2000, when global FDI flows reached the all-time high of \$1.4 trillion. For the first time since 2001, corporate investors' overall expressions of willingness to invest overseas rose year-to-year. Although they remain among the leading corporate risks identified by survey respondents, government regulation and instability (macroeconomic, political and social) appear to be slightly less daunting to global investors than before.

Most notably, 51% of global investors view currency and interest rate volatility as a critical risk to operations compared to 63% last year, whereas 46% of global investors cite political and social disturbances as a risk compared to 62% last year. More executives this year expect to achieve profitability targets in the big emerging markets — China, India, Brazil, Mexico and Poland — and aside from Mexico, fewer view these markets as “high” risk FDI locations than did last year.

Corporate investors' brighter outlook on the business environment could portend a turnaround in global FDI flows. Yet, investors have heightened concerns over corporate governance, theft of intellectual property, terrorism and security threats to employees and assets. FDI decisions will be tempered by the performance of the U.S. economy, the dollar, and the ability of the leadership in Beijing to

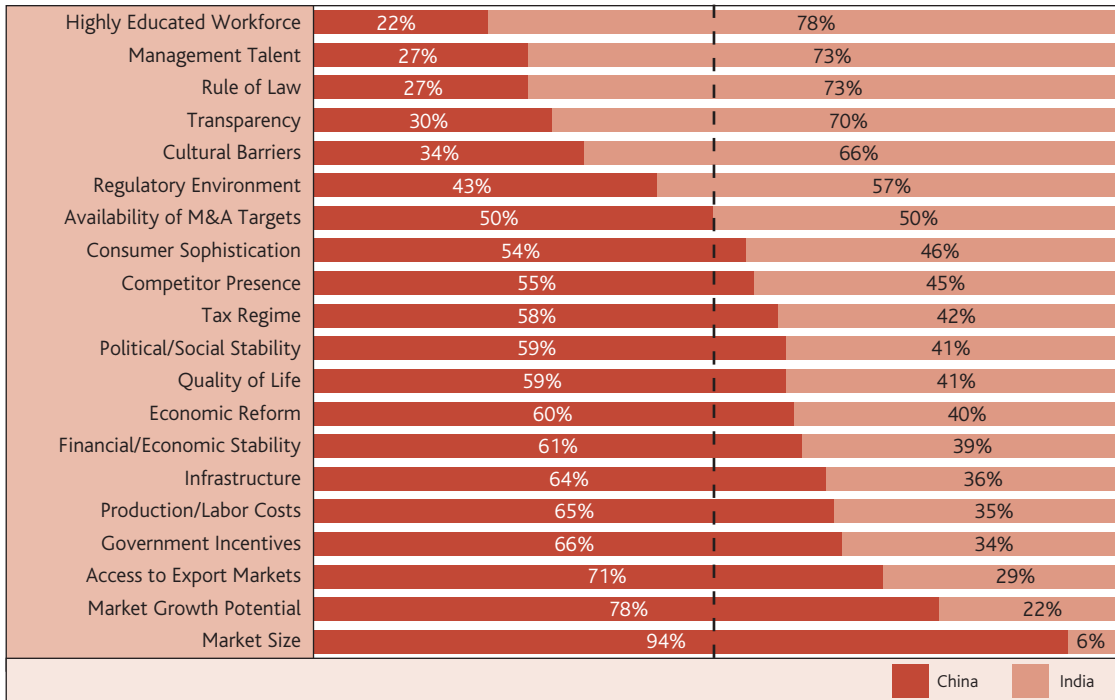
Figure 1: FDI Confidence Index®
(Top 25, October 2004)



Source: A.T. Kearney

() = 2003

Figure 2: Which is more attractive for the following FDI attributes — China or India?



Source: A.T. Kearney

(Percentage of Total Respondents)

engineer a soft-landing for the Chinese economy.

INDIA AND CHINA SPAR OVER FDI LIKE DAVID AND GOLIATH

China and India dominate the top two positions for most positive investor outlook, likely first-time investments, and most preferred offshore investment locations for business processing functions and IT services. Compared to other large emerging markets, China and India are cited by CEOs as the most attractive FDI destinations in the short-term (next three years) and well into the future, beating markets like Brazil, Mexico and Poland for medium-term attractiveness ten years out.

However, global investors view these

two destinations as distinctly different markets: China as the world's leading manufacturer and fastest growing consumer market and India as the world's business process and IT services provider with longer-term market potential. When asked what kinds of activities will be offshored to China and India, investors indicated that China leads for manufacturing and assembly, while India leads for IT, business processing and R&D investments. Investors favor China over India for its market size, access to export markets, government incentives, favorable cost structure, infrastructure and macroeconomic climate (see figure 2).

However, these same investors cite India's highly-educated workforce, management talent, rule of law, transparency, cul-

tural affinity, and regulatory environment as more favorable than what China presents. China's FDI flows are larger (\$53.5 billion) and primarily capital-intensive, while Indian FDI flows are smaller (\$4.3 billion) and skill-intensive, concentrated in information and technology areas.

U.S. LONG-TERM DOMINANCE IS CHALLENGED BY THE SINO-INDIAN DYNAMO.

For a third year in a row, the U.S. lagged China as the second most attractive investment destination in the world, and now India is not far behind. India's rise to the third most attractive market in the world is an all-time high ranking for this country. In leading the U.S., China ranks as the number one FDI location across all major sector investors including financial and non-financial services, manufacturing, primary, telecom & utility and wholesale & retail.

For the first time in the Index, India displaced the U.S. to become the second most attractive FDI location among manufacturing investors, while the U.S. fell to third place. Never before has the U.S. been ranked so low by manufacturing investors. Telecom & utility investors upgraded China from fourth to first and India from fifth to second most attractive FDI destination, while dropping the U.S. from first to fourth place—just behind Hong Kong. India's strong performance among manufacturing and telecom & utility firms was driven largely by their desire to make productivity-enhancing investments in IT, business process outsourcing, research and development, and knowledge management activities.

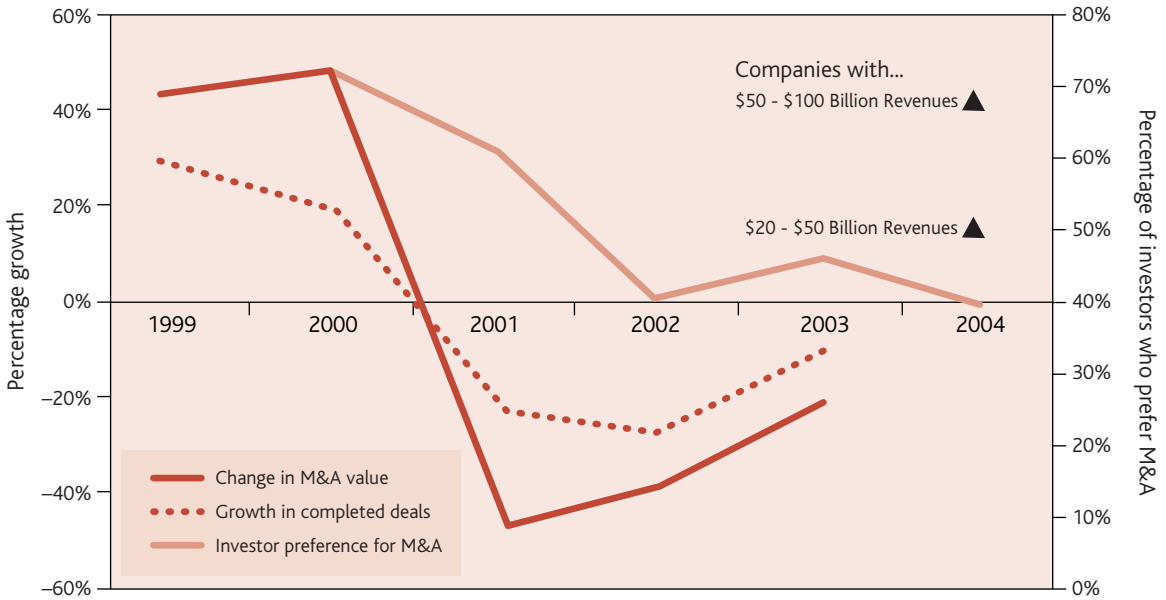
With an \$11 trillion economy, more than twice the size of the next largest market (Japan) the U.S. remains a behemoth and U.S. FDI inflows may be on the upswing. For the first half of 2004, U.S. FDI inflows are estimated to have reached \$42.9 billion, more than the total inflows received for the entire year in 2003. The U.S. also continues to be the dominant outward foreign investor, contributing more than twice the amount of global FDI than France, the next largest FDI exporter in 2003. Nonetheless, the hyper-growth, knowledge-based and lower-cost opportunities unleashed by China and India will continue to challenge the U.S. despite its global economic dominance.

FIRMS ARE HOLDING THEIR FIRE BEFORE ENGAGING IN CROSS-BORDER DEALS

Last year 45% of CEOs selected mergers and acquisitions as their preferred mode of entry into foreign markets, while this year 39% indicated the same (see figure 3). Through restructuring, asset disposals and increased profitability, the largest American and European firms have accumulated over \$2 trillion in cash. However, rather than investing abroad, many investors are buying back shares or limiting mergers and acquisitions to their home markets.

Executives remain acutely aware of the negative fallout from overseas mega-deals of the past: flawed due diligence, regulatory quagmires, unfulfilled performance expectations and huge debt burdens. This year global investors also expressed even greater concern over corporate governance issues with 30% of investors indicating that they will

Figure 3: Investor preference for mergers and acquisitions (M&A) as FDI mode of entry



Source: A.T. Kearney, KPMG, UNCTAD

pose a risk to their firms’ operations compared to 25% who said the same last year. Although the number of M&A deals rose by 2% last year, the average deal value continued to decline reaching half the value seen in 2000. We have entered a period of “à la carte” M&A where investors are selectively snatching up complementary strategic assets with heavyweight deals the exception.

TRANSATLANTIC COMMERCIAL BUDDIES

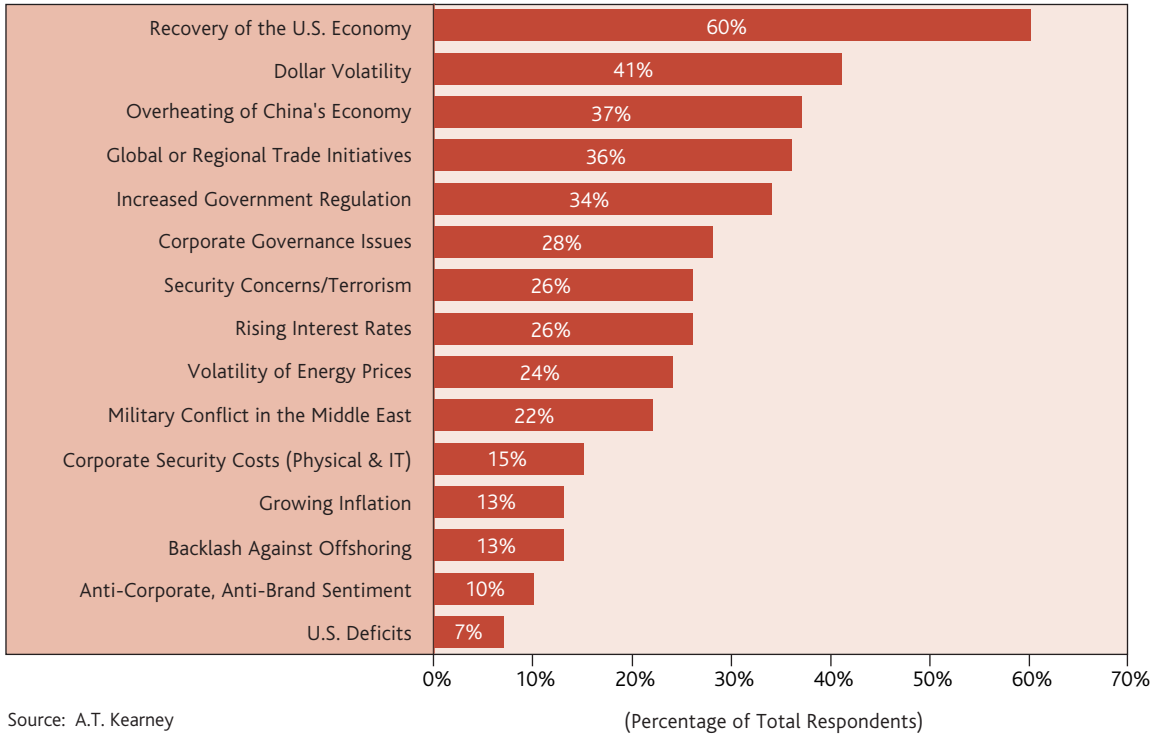
Despite the recent diplomatic row over the Iraq War, the U.S. and Europe remain each other’s most important economic partner. The transatlantic economy represents over \$2.5 trillion in total foreign affiliate sales and mutually supports over 12 million workers — nearly a quarter of the world’s entire foreign affiliate workforce employed by multinational corporations overseas. The transatlantic

economy effectively “insources” a substantial portion of the world’s overseas jobs.

While the U.S.-led war in Iraq sent transatlantic relations into a tailspin last year, the transatlantic economy was benefiting from a cyclical recovery noted by strengthening FDI flows and foreign affiliate profitability on both sides of the Atlantic. U.S. FDI into the EU rose from \$61 billion in 2002 to \$81 billion in 2003. Last year, U.S. investors remained the primary source of French FDI and created nearly one-quarter of the new FDI-related jobs in France. At the same time, European investors accounted for the largest share of cumulative U.S. inward investment amounting to 73% of total U.S. FDI stock, or \$1 trillion U.S.-bound FDI.

This year U.S. and European investors continued to express a robust preference for

Figure 4: Global developments most likely to influence FDI decisions



investing in each other's markets. U.S. investors expressed stronger confidence in Europe's major markets—ranking the United Kingdom second, up from 11th place, Germany seventh, up from ninth place, France 13th, up from 19th place, and Spain 11th, up from 17th place. Aside from China, European investors are more likely to invest in the United States than any other market in the world. One in three European investors is more optimistic on the U.S. market—nearly three times as many as last year.

U.S. ECONOMY AND THE GREENBACK TOP FDI DECISION FACTORS

When asking global investors what current or impending developments will most

likely impact their firm's FDI decisions, they ranked the U.S. economy as the most important factor influencing their overseas investment choices (see figure 4). Dollar volatility and the less accommodative stance by the Federal Reserve have kept the U.S. economy at the top of executives' concerns when considering an overseas investment. Roughly 60% of global investors indicated the state of the U.S. economy will have the biggest impact on their FDI decision-making. At the same time, more than a quarter of global investors view rising interest rates among their top concerns when considering an investment overseas.

Behind the performance of the U.S. economy, dollar volatility ranked the second

most important factor impacting executives' FDI decisions. From January 2002 to January 2004 the dollar lost about a quarter of its value (on a trade weighted basis), and so far this year the greenback has continued to experience unusual swings. Countervailing and unpredictable forces underlie dollar volatility. The rise in U.S. interest rates has led to the unwinding of fast-moving U.S. portfolio investments overseas, helping lift the dollar. But, the U.S.'s large and growing deficits are expected to continue to put downward pressure on the greenback. As a result, managing debt and revenue streams across currencies has become more challenging and critical long-term corporate investment planning has been further complicated.

ENTER THE DRAGON

The success of a growing number of major corporations is increasingly tied to that of China's. Over the past decade China has experienced a torrential pace of growth—reaching the red hot speed of 9.7% during the first half of 2004. Aside from the U.S., China has been the only leading engine of global growth over the course of the recent downturn, accounting for one-third of global economic growth during the past three years. The country's rapid modernization is generating export-led growth in Latin America, Africa, Russia, Canada and Australia.

Considering China's increased importance to corporate profitability as well as the vibrancy of the global economy, investors ranked the possible overheating of the Chinese economy as the third most

important factor influencing their FDI decisions—after U.S. economic recovery and dollar volatility.

MINI TRADE AGREEMENTS ARE NOT ENOUGH

More than a third of global investors consider global or regional trade agreements among the leading factors determining overseas investment decisions. Open trade provides lubrication to FDI by offering expanded market access to partners, suppliers, and subsidiaries and allows firms to leverage supply chain management strategies across a wider range of products and national territories. About one-third of global trade is intra-firm trade, namely the cross-border exchange of products between the parent company and subsidiaries within the same firm. Many trade agreements also include investment protocols, reducing FDI barriers as well as trade barriers between or among signatories.

A flurry of bilateral and regional free trade agreements (FTAs) have emerged or are under discussion worldwide. However, enthusiasm for these agreements has resulted in part from limited progress at the multilateral level where the biggest gains could be made. Much of the low-hanging fruit from past trade liberalization has been harvested. What remains for further liberalization are among the most difficult and contentious issues, such as intellectual property rights and agriculture. Even with the completion of the recent U.S. election cycle, trade negotiations could remain politically radioactive. Advances in trade that would unleash significant amounts of new invest-

ments, create new sources of growth and competitiveness and reduce poverty at best are uncertain in the near term.

OIL, TERRORISTS, AND REBELS MAKE A NASTY COCKTAIL

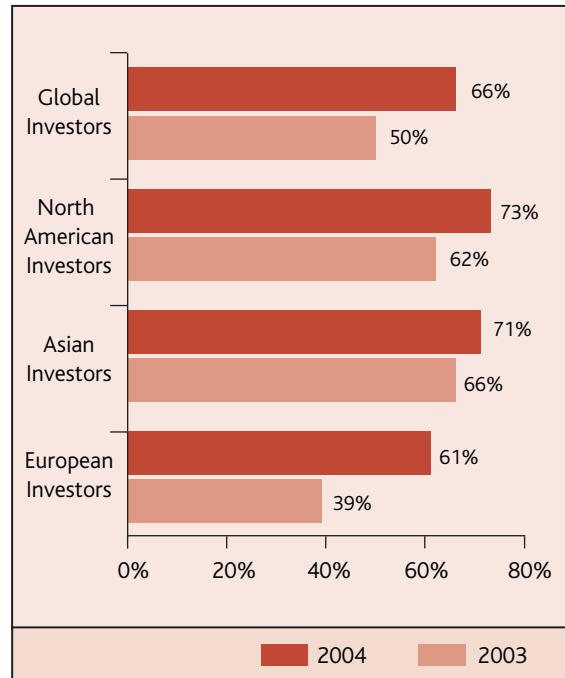
Roughly a quarter of global investors noted terrorism and volatile energy prices as influencing their overseas investment decisions. Nearly as many global investors view military conflict in the Middle East—undoubtedly linked to securing Iraq’s oil supplies—as impacting their FDI plans. Political disruptions in Venezuela, the investigation of the Russian oil giant Yukos, and questions surrounding spare capacity among the OPEC producers have not helped to calm oil markets. In late September this year—after this survey was completed—oil prices broke the psychological barrier of \$50/barrel.

On the demand side, China continues its rapid industrialization, surpassing Japan to become the second largest oil importer in the world, behind the U.S. The recovery of the U.S. economy coupled with fast growth in the developing world has added demand momentum. Yet, higher oil prices could delay investors’ FDI plans and will likely continue to be a drag on the economic recovery.

ALTHOUGH CORPORATE REPUTATION IS AT RISK, THE OFFSHORING PACE QUICKENS

Nearly one in four global investors cited the risk to corporate reputation as an important deterrent to offshoring operations to lower-cost locations. Service sector investors (financial and non-financial) revealed the

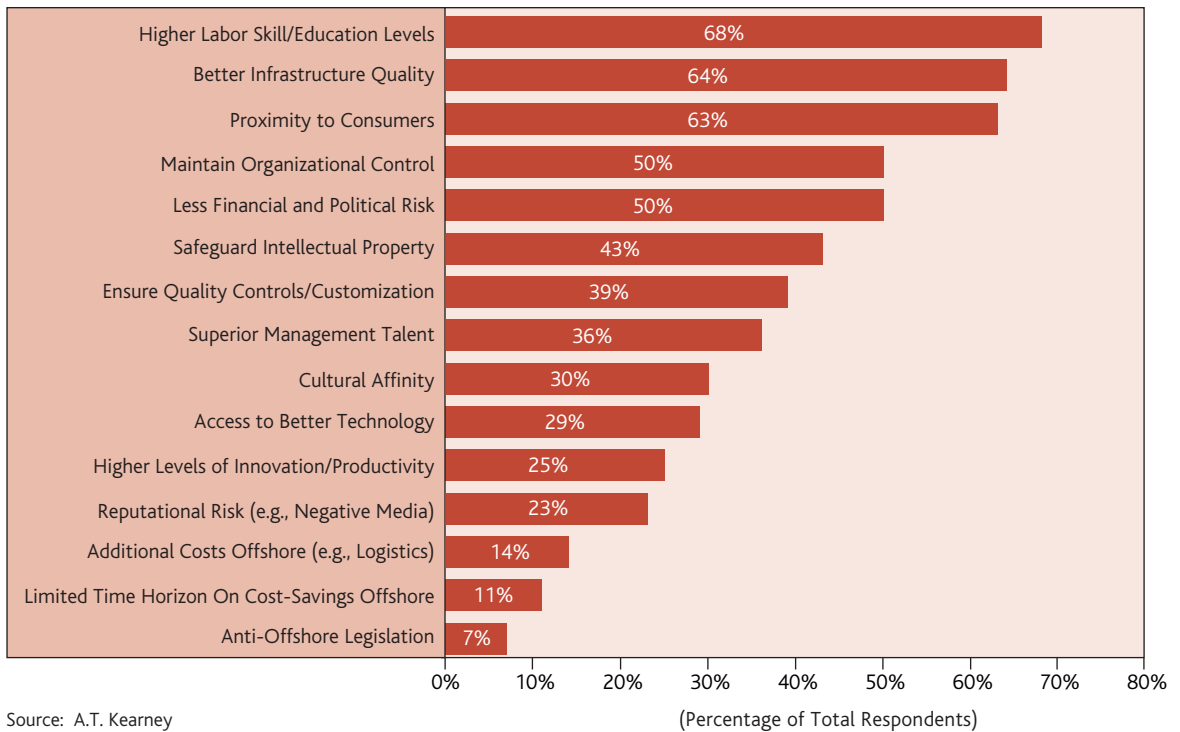
Figure 5: Percentage of investors planning on making offshore investments over the next three years



Source: A.T. Kearney

most concern over perceived reputational risk associated with offshoring. One in five wholesale & retail investors—with greater sensitivity to brand image—noted that a backlash against offshoring would impact their FDI decisions.

Nevertheless, the offshoring impulse has grown with 66% of global investors expressing a willingness to offshore compared to 50% last year (see figure 5). Investors who indicated they were deferring offshoring noted higher labor skills/education, better infrastructure, and proximity to consumers as their top reasons (see figure 6). Given their demographic and growth trajectories, many developing countries will become the focus of the world’s consumer markets over the next several decades. Expected advances in education and infrastructure in the devel-

Figure 6: Leading reason for *not* offshoring

oping world will likely add momentum to the offshoring pace. The labor arbitrage opportunities presented by offshoring are also expected to remain strong. Only 11% of investors regarded the cost-savings from offshoring to be transitory.

Offshore strategies lead to the geographical dispersion of corporate operations and can have significant impacts on intellectual property rights, organization, quality control and corporate culture. These factors are also noted as reasons for not offshoring to lower-cost locations. The speed at which firms may offshore more complex activities, such as research & development, software design, and product customization, will likely be tempered by these concerns.

ALTHOUGH A TWO-WAY STREET, MORE OFFSHORING TRAFFIC IS LIKELY HEADED TO EMERGING MARKETS

For a second year in a row, the United States, the United Kingdom and Ireland ranked among the most preferred offshore locations for corporate investors. Alongside China, India, Malaysia, Singapore, the Czech Republic, Slovakia and Poland, these three developed markets were most frequently cited as offshore destinations for global investors over the next three years.

From a regional perspective, for instance, Glasgow, Belfast, and Dublin are moderately low-cost service locations in their own right with attractive education levels, infrastructure, financial and political climates, safeguards for intellectual property

and quality control— factors that can outweigh the strong cost advantages of a Shanghai or Bangalore offshore destination. The U.S., the UK and Ireland are expected to benefit from IT, knowledge management, and business process offshore investments. Ireland was specifically noted as an attractive location for contact centers (call centers, web centers, etc).

Nevertheless, the offshore wave has just begun to ripple and with effective policy-making and investments in technology, infrastructure and people, emerging markets stand to reap the greatest benefits from offshoring investments. Investors indicate that they intend to place more than half of their offshore investments in China and India over the next three years.

Corporate Risk

GOVERNMENT REGULATION REMAINS A TOP CORPORATE RISK

Although slightly down from last year, government regulation remained the most frequently cited critical risk to corporate operations with 64% of global investors noting this among their most critical risks (see figure 7). At the same time roughly 30% of global investors cited corporate governance challenges among their top business risks—up from 25% last year. Activist institutional shareholders are urging more SEC reforms, withholding proxy votes, filing lawsuits and developing media strategies to force change in the business community. Proxy and rating agencies have developed corporate governance “score cards” that are shared with fund managers and major shareholders.

Increased executive focus on corporate governance is likely the result of the magnified impact that activist institutional investors and rating agencies are having on corporations’ shareholders and stakeholders—partners, suppliers and consumers.

TERRORISM HIGHER AMONG PERCEIVED CORPORATE RISKS

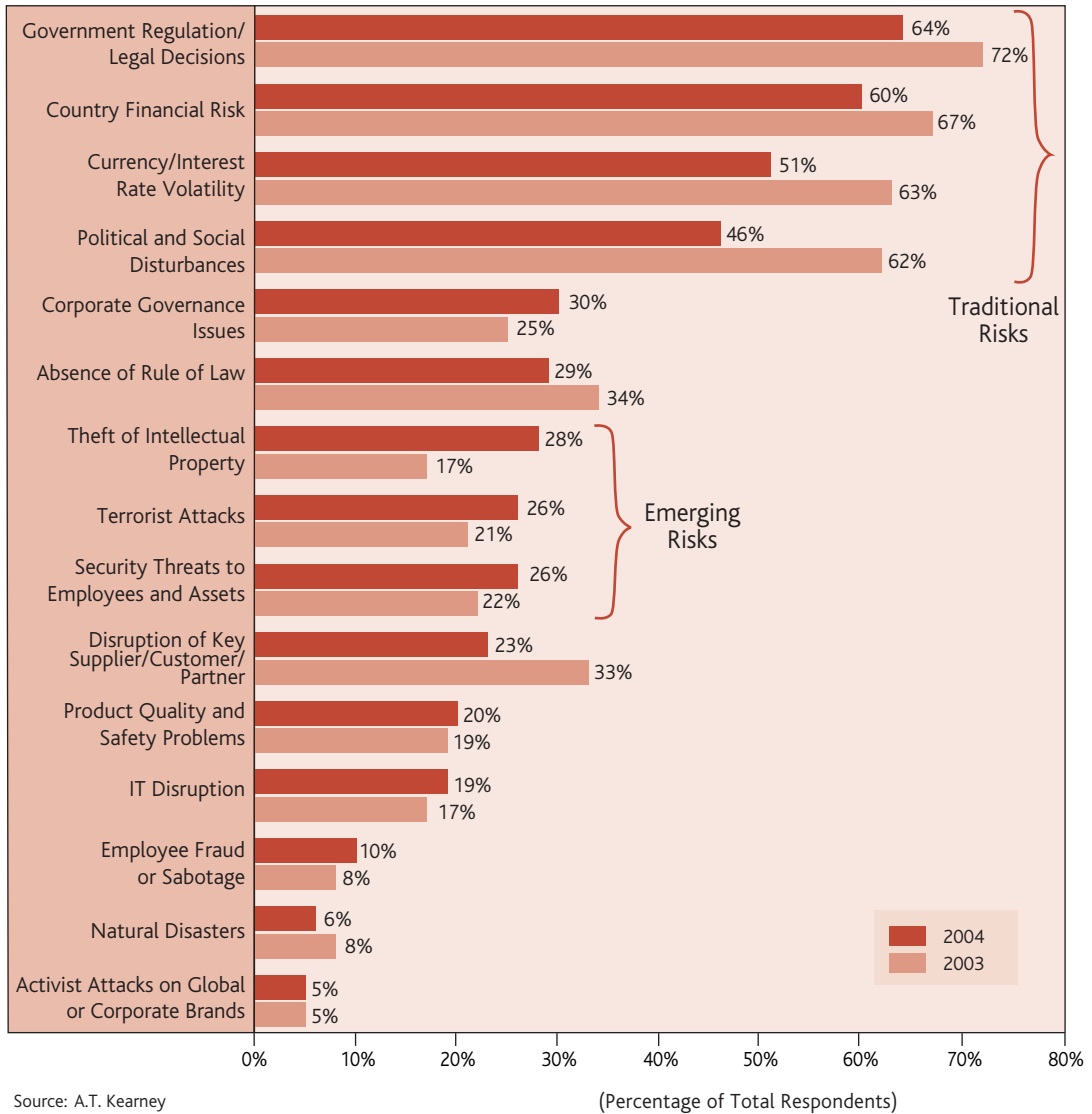
Traditional geopolitical and financial risks to corporations—while still high priorities—are viewed as less threatening than in the past. Instead, this year terrorism and security threats to employees and assets have risen in importance as corporate risks. Last year 21% of global investors cited terrorism as a critical source of risk to their firm’s operations, whereas 26% of them do this year. Security threats to employees and assets have also gained increasing attention as 26% of global investors noted this risk, up from 22% last year.

Roadside bombings, suicide attacks, kidnappings and beheadings have brought into focus the potential threat that terrorism poses in poor security environments. Executives have been targets of organized crime in places like Colombia, Russia, Brazil and Africa for years. But, third-world criminality has now been joined by violent and extreme terrorism prompting investors to reassess their FDI strategies.

SOFTWARE PIRATES AND REVERSE-ENGINEERED AUTOS EAT AWAY AT PROFITS

An FBI sting operation revealed \$80 million worth of pirated Microsoft products, while General Motors discovered a counterfeit

Figure 7: The most critical risks to firm operations 2003 vs. 2004



copy of an automobile in China. No doubt intellectual property is under siege and corporate wealth is at risk. Napster, cyber crime, knockoff designer handbags, and fake auto parts have eroded intellectual property rights on a global scale. Along with trade and investment, corporate innovation has globalized. To effectively sell advanced

technology or attractive consumer products in fast-growing markets overseas, it helps to have local R&D. Leveraging business processes, product development, and applied research and other new forms of intellectual capital globally has created new sources of corporate value, but also new sources of infringement.

In 2004 28% of investors noted intellectual property theft among their top critical risks compared to only 17% last year. Roughly 7% of global trade is in counterfeit goods and the counterfeit market is worth about \$350 billion annually. According to the Business Software Alliance, 36% of software installed on computers globally in 2003 was pirated. Increasing corporate exposure to countries such as China and India has likely fueled concerns surrounding intellectual property theft. Both China and India have high software piracy rates—92% and 73% of installed software is pirated, respectively, in the countries. China is the leading source of ill-gotten gains—accounting for 70% of the counterfeit goods seized by U.S. customs in 2003.

Regional Findings— North America

UNITED STATES

For a third year in a row, the United States remained behind China as the second most attractive investment in the world, with India not far behind. Investors ranked India as their third most attractive market in the world—an all-time high—having zoomed up from sixth place last year. U.S. FDI actual inflows plunged from \$63 billion in 2002 to \$30 billion in 2003, while China's FDI inflows continued to grow, reaching \$54 billion. India's more modest FDI inflows rose to \$4.3 billion.

Financial service investors ranked the U.S. their second most attractive market—behind China—and insurance carriers ranked the U.S. their number one FDI location worldwide. Continued consolidation in the finan-

cial services industry is providing attractive M&A targets and regulatory barriers in Europe are forcing European bankers across the Atlantic. Royal Bank of Scotland announced this year its intention to acquire Charter One Financial (U.S.) for \$10.5 billion. One of the largest deals so far in 2004 was Manulife Insurance (Canada) merging with Boston-based John Hancock Financial Services—a deal worth \$14 billion.

European corporate restructuring hits U.S. FDI inflows. U.S. FDI inflows have tumbled each year since the historic peak of \$314 billion in 2000 to \$30 billion last year—a 90% decline. While declines have been in part driven by diminished equity capital, they also have been the result of foreign affiliates (mostly European) in the U.S. making large repayments on loans to their parent companies. Excluding the net impact of these intercorporate transactions, U.S. FDI inflows would have been \$74.3 billion in 2003.

The U.S. will remain the vanguard of the global economy. For the first half of 2004, U.S. FDI inflows are estimated at \$42.9 billion—more than the total amount received for the entire year in 2003. With an \$11 trillion economy, more than twice the size of the next largest market, Japan, the U.S. remains a behemoth. The U.S. continues to be the dominant supplier of FDI flows to the world contributing more than twice the amount of FDI than France, the next largest FDI exporter in 2003. U.S. FDI outflows jumped from \$115 billion in 2002 to \$152 billion in 2003—the highest level since the \$209 billion historical peak in 1999.

U.S. law could mute U.S. FDI outflows and facilitate a reshuffling of global operations. The Homeland Investment Act (HIA)

is expected to provide a temporary tax relief on repatriated profits from overseas. U.S. holdings abroad worth up to approximately \$400 billion could be potentially eligible for this tax relief and could translate into earnings flowing back to the U.S. instead of being ploughed back into foreign operations.

While foreign affiliates with strong profitability and future growth prospects will likely encourage U.S. investors to reinvest earnings overseas, the tax benefit will provide U.S. companies an opportunity to reduce exposure in poor performing markets, reposition their global operations, improve balance sheets, reduce debt or buy back shares with repatriated earnings. With over 80% of U.S. FDI outflows in the form of reinvested earnings last year, the impact could be enormous on global investment levels or allocation.

CANADA

Canada continues to lose ground—slipping two spots to 16th place. Last year Canadian FDI shrank to a trickle—falling from \$21 billion in 2002 to \$6.6 billion. For the last half of 2003 Canadian net FDI inflows actually were negative. UK investors—the largest European contributor to Canadian FDI stock—downgraded Canada, from 17th to 20th most attractive destination.

NAFTA continues to pay dividends for Canada as U.S. investors upgraded Canada from fifth to fourth most attractive investment location globally. U.S. FDI to Canada rose from \$11.5 billion in 2002 to \$13.8 billion in 2003. Yet, U.S. outflows to Canada were offset by strong disinvestments in the last half of 2003, causing overall Canadian FDI

inflows to reach the lowest level in nearly a decade.

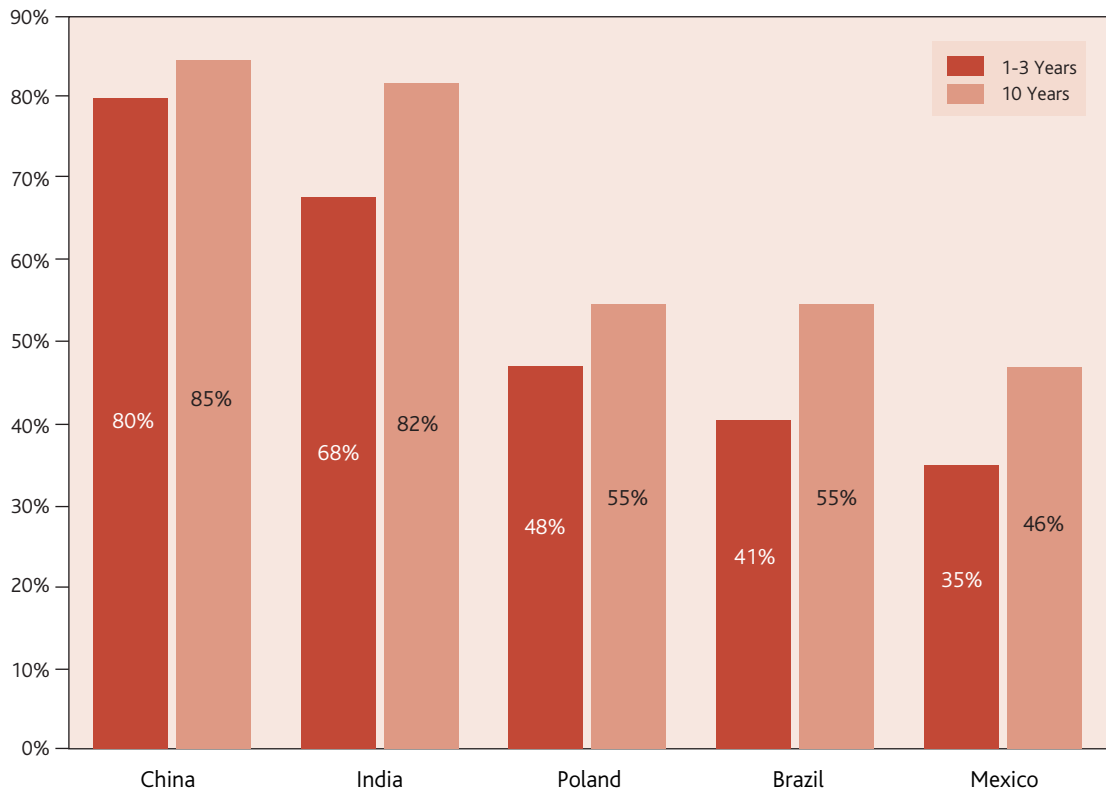
While non-financial service investors ranked Canada slightly lower this year—down two spots to seventh place—Canada remains among their top most attractive markets. Heavy manufacturing investors see greater investment prospects in Canada—having bumped Canada up from 16th to 13th most attractive market in the world. Canada is viewed positively among oil and gas investors who ranked it their 10th most attractive market in the world. Including unconventional tar-sand oil, Canadian deposits rival Middle-East heavy-weights Saudi Arabia and Iraq.

Financial service investors ranked Canada the 16th most attractive market globally—up from below the top 25 last year. Insurance companies are particularly bullish on Canada ranking it their fifth most attractive market globally. Canada's healthy working age population growth is helping to drive increasing demand for retail and corporate financial services.

MEXICO

After maintaining fairly high levels of investor confidence since the late 1990s, for the first time ever Mexico fell out of the top ten most attractive markets in the world—dropping from third to 22nd most attractive market globally. This decline is driven largely by weaker European and Asian investor confidence levels. Unfulfilled reforms in key areas—telecom, infrastructure, and energy—and the magnetic pull of China have led to diminished global investor interest in Mexico. Since the all-time high of \$26.8 bil-

Figure 8: Relative short- and medium-term attractiveness



Source: A.T. Kearney

(Percentage of Total Respondents)

lion in 2001, Mexican FDI inflows have declined each year — falling to \$10.8 billion by 2003 — the lowest level since 1996.

Mexico is losing ground to other emerging markets. While Mexico led major emerging markets in meeting investors' expected profit targets last year, this year China, Brazil, India and Poland surpassed Mexico's reported profitability. Moreover, when asking investors about their short-term (1-3 years) and medium-term (10 years) assessments of attractiveness vis-à-vis China, India, Poland, Brazil, and Mexico, Mexico falls to last position (see figure 8). From the end of 2000 to April 2004 roughly one in four of maquila enterprises left Mexico, cutting nearly a quarter of a million jobs. Among

these firms, about one in three relocated in China. Sanyo Electric (Japan) and Royal Philips Electronics (Netherlands), for example, are among those that have moved operations from Mexico to China.

The World Bank estimates that Mexico needs to spend \$20 billion annually over the next ten years in order to overcome its infrastructure deficit. Post-September 11 security policies have hindered road and airfreight capacity and infrastructure development has been slow. Limited telecom sector competition has kept fixed-line service costs high — inhibiting foreign investment, holding back internet penetration and e-commerce and limiting advances in knowledge-intensive industries. Political opposition and legal hur-

dles have stifled electricity sector liberalization aimed at meeting the energy needs of the country.

Oil and gas investors are upbeat on Mexico. Oil and gas investors are much more eager to invest in Mexico this year—ranking the country their seventh most attractive market, up from 22nd last year. The government seeks to tap foreign investment and technology to reach deep-sea oil deposits in the Gulf of Mexico. While opposition remains strong, the government continues to explore ways to allow state-oil company PEMEX to engage foreign investors through multiple service contracts.

For now, NAFTA provides an FDI buffer for Mexico. The country is the fifth most attractive market for U.S. companies and the third most attractive for Canadian companies. More than half of Mexican FDI inflows last year were from U.S. corporations. For now, Mexico's loss of competitiveness appears to be limited to labor-intensive industries characterized by low-cost and large-scale production. But, Mexico must graduate to more complex industrial production activities and services to offset lost manufacturing that is flowing to China and Central America. Relying on low-cost wages and investment incentives is no longer an option for Mexico.

EUROPE

Western Europe regains lost ground. The United Kingdom jumped from seventh to fourth place in overall investor attractiveness. After dropping out of the top ten last year, France and Italy reentered the top ten climbing from 11th to sixth and 12th to

ninth place, respectively. Germany held steady in fifth place. U.S. and French investors underlie Western Europe's healthy performance. A return to positive EU FDI inflows will depend largely on the broadening and strengthening of European economic recovery since a high portion of EU flows are from other EU members. Last year Western European FDI inflows declined from \$380 billion in 2002 to \$310 billion in 2003.

*For a third year in a row European investors are the most eager to engage in cross-border mergers & acquisitions—*with 46% of European investors preferring M&A over joint ventures or greenfield investments as a mode of entry compared to 36% of North American and 24% of Asian investors. From 2001 to 2003, the European Union accounted for more than half of all M&A purchases worldwide. In 2004 Bayer (Germany) acquired the consumer health division of Roche (Switzerland) for \$2.9 billion, the Spanish bank Santander Central Hispano agreed to buy UK-based Abbey National for a massive \$14.9 billion and the Royal Bank of Scotland announced plans to acquire Charter One Financial (U.S.) for \$10.5 billion.

Cash-strapped governments auction prized state assets. The largest economies in Europe have seen their tax bases shrink and deficits expand over the past few years, putting governments in a fiscal pinch. Terna, Italy's national power grid, Postbank, Germany's biggest retail bank and Snecma, France's national maker of aircraft engines are expected to go to initial public offerings. The semi-privatization of state-owned energy utilities, Electricité de France (EDF) and

Gaz de France (GDF) are expected in 2005.

UNITED KINGDOM

The United Kingdom rises from seventh to fourth place, beating out Germany as the number one FDI destination in Europe for global investors. Financial service investors—traditionally strong enthusiasts of the UK market—bumped the UK from fourth to third most attractive position globally. Chemical, petroleum and refining investors ranked the UK their fifth most attractive FDI location up from 11th in 2003, likely in anticipation of infrastructure investments needed to support import demand as North Sea reserves decline. Pharmaceutical firms are also eager to tap into the UK's robust R&D capabilities. The UK is the fourth-largest car producer in the EU and transportation equipment investors ranked it their ninth most attractive market globally, as they did last year. Nissan's Sunderland plant is the most productive in Europe and BMW's Oxford-produced, uniquely British and highly successful Mini is selling in 73 markets worldwide.

U.S. investors upgraded the UK from 11th to second most attractive market in the world in 2004. U.S. companies have made more cumulative investments in the UK than in any other country in the world—accounting for 15% of total U.S. outward FDI stock. The U.S. corporate asset base in the UK is greater than the U.S. asset base in Asia, and Latin America, Africa and the Middle East combined. The UK's innovation- and technology-driven economy has made UK firms attractive M&A targets. General Electric (U.S.) acquired the British medical

imaging and biotechnology firm Amersham last year for \$9.5 billion, one of the largest deals in 2003.

Last year FDI flows into the UK dropped by nearly half, from \$27.8 billion in 2002 to \$14.5 billion in 2003. This was likely driven by fewer investments from and disinvestments by European investors. Net EU FDI flows to the UK tumbled by an estimated 80% from 2002 to 2003. With the EU providing about 47% of UK FDI stock, the slow recovery and continued corporate restructuring on the European continent are likely undercutting UK FDI inflows.

Eurozone countries—more eager to remain under the umbrella of the single currency rather than investing in the UK—ranked it 12th down from ninth place last year and behind Germany, France, Spain and Italy and expected euro members Poland, the Czech Republic and Hungary. Moreover, just over half of global investors indicated that currency and interest rate volatility pose a serious risk to their operations—the third most frequently cited corporate risk behind financial and government regulation risks.

Offshore investors locate along the Celtic fringe. In addition to the U.S. and Ireland, the UK is considered a leading attractive offshore location according to global investors. Locations such as Belfast and Glasgow offer well-educated labor forces, advanced and dependable infrastructures, and significantly lower-costs compared to London. These destinations are preferred by investors keen on mitigating offshore risks, such as financial and political stability, intellectual property rights, and

quality control, but also interested in capturing cost-savings. The Indian IT firm, HCL, has in fact located its customer care unit in Northern Ireland stating that cost alone is not enough and citing quality as critical to their success.

British firms will continue to globalize and contribute heavily to the global economy. British executives are among the most optimistic global executives on the global economy. About 72% of UK investors have a more positive outlook for the global economy compared to 67% of Italian investors, 58% of German investors, 50% of Canadian investors and 38% of Dutch investors. Last year FDI outflows increased from \$35 billion in 2002 to \$55 billion in 2003, making the UK the leading FDI provider behind the U.S. and France.

GERMANY

Germany held steady in fifth place. Given the country's premium manufacturing quality, innovative capabilities and technical expertise, manufacturing investors ranked Germany their fourth most attractive market in the world. Chemical and allied product investors are especially eager to enter the German pharmaceutical market—which is the third largest in the world after the U.S. and Japan. Germany accounted for 12% of all the new global patents for pharmaceuticals based on genetic technology, the second largest amount after the U.S. Last year Germany's largest-ever leveraged buyout was U.S. Blackstone Group's purchase of the specialty chemicals producer Celanese for \$3.8 billion. Driven by aerospace and automotive investors, transportation equipment

investors ranked Germany their third most attractive market worldwide.

Reforms aimed at improving competitiveness have produced limited results and have been unpopular. The tax system remains burdensome and non-wage costs associated with healthcare, pensions, and social benefits could rise sharply given Germany's aging population. German FDI inflows declined from \$36 billion in 2002 to a mere \$13 billion in 2003—a 64% decline.

Germany has become a marginal FDI player. German FDI outflows have tumbled from \$109 billion in 1999 to a mere \$2.6 billion in 2003. Unlike other investors that view the U.S. economy as most critical to their FDI decisions, German executives noted increased government regulation as the number one factor impacting their FDI decisions. German investors are among the least optimistic about the global economy—only 58% of them were upbeat on the global economy compared to 74% of Asian, 70% North America and 66% European investors. While a majority of global investors report plans for increased FDI, only 38% of German investors indicated the same.

FRANCE

After falling from fifth to 11th place in the Index 2002-2003, France returns to the top ten most attractive FDI destinations, taking sixth place this year. In 2003 inflows to France hit \$47 billion, slightly below FDI in 2002 (\$48.9 billion). France became the leading FDI destination among the developed countries in 2003, receiving three times as much FDI as Germany and the UK. With high levels of private and public sector R&D

spending, and a high caliber skill-base, France is one of the world's top recipients of FDI in high-value segments such as pharmaceuticals, telecom, information technology, chemicals, and automotive.

Non-financial services—specifically telecom and IT—investors are more likely to invest in France, ranking it their sixth most attractive market up from 14th place. The country's mobile phone market doubled between 1999 and 2003. Telecom Italia is making a multi-million dollar investment in Marseilles to handle administrative, financial, commercial and call center functions and expects to link up a total of 13 cities, offering services to over 40% of the French population by 2005. The nation's regulator, Autorité de Régulation des Télécommunications (ART) is leaning toward policies that could open the market to foreign competition.

Government regulation remains burdensome. The compulsory reduction in the workweek has frustrated investors and many are expressing dissatisfaction with perceived negative impact on productivity. Limited labor market flexibility, corporate and local tax burden and bureaucracy continue to limit France from achieving even greater FDI potential. The government's consideration of financial aid to companies that do not outsource has raised French investors anxiety. About 27% of French executives—more than any other national group of investors—consider the potential public outcry from offshoring when making an FDI decision.

ITALY

Global investors ranked Italy ninth most

attractive worldwide—up from 12th place in 2003. Dutch, Belgium, British, and Swiss investors are the most upbeat on the Italian market. As a result, Italy ranked the fifth most attractive FDI location among European investors. Last year FDI inflows increased from \$14.5 billion in 2002 to \$16.4 billion in 2003.

The Parmalat affair fails to sway global investors. The collapse of Italy's eighth-largest company, the food group Parmalat, sent shock waves through the Italian business community and financial system. Nonetheless, financial service investors see opportunities in the Italian market—ranking the country their seventh most attractive market (albeit down from fifth place in 2003). Italy has one of the most fragmented banking systems in Europe and its three largest banks remain relatively small and vulnerable to an eventual pan-European consolidation in the industry. Given Italy's aging population, fiscal constraints, and pressures to reform the state pension system, insurance carriers ranked the country their second most attractive market globally.

Italy suffers from complex, rigid labor markets, inefficient state bureaucracy, and poor infrastructure in parts of the country. Poor public finances and slow progress on reform and privatization prohibit Italy from attracting significant FDI flows. Although the fourth largest economy in Europe, Italy receives relatively little FDI. FDI plays a limited role in the economy—representing only 5.8% of gross capital formation compared to 14.7% for EU countries on average. For the past two years Italy's FDI inflows

have been less than Ireland's.

Italian "mom and pop" shops face globalization. Many family-owned Italian businesses are internationalized, competitive and profitable. But, as a result of the relatively high portion of small- and medium-sized firms in the economy, there is greater risk aversion and limited overseas investment. Only three Italian companies are listed among the world's 100 largest MNCs ranked by foreign assets in 2002 despite the fact that it is the sixth-largest economy in the world.

SPAIN

Spain dropped out of the top 10 most attractive FDI locations—falling from 10th to 13th place in the Index. While falling from sixth to 10th most attractive among European investors, Spain ranked higher among U.S. investors jumping from 17th to 11th place. Last year Spanish FDI inflows declined from \$35.9 billion in 2002 to \$25.6 billion in 2003.

Heavy manufacturing investors—mostly chemicals and transportation equipment firms—are more likely to invest in Spain, ranking the country ninth most attractive globally (up from 15th place). Transportation equipment investors ranked Spain their fourth most attractive market in the world—one spot up from fifth place last year.

However, light manufacturing investors ranked Spain 24th most attractive destination, down from 15th place. In the enlarged European Union, Spain's traditional low-labor cost advantage has deteriorated. While Spanish wages are half those of Germany, they are three times higher than in Poland,

the Czech Republic and Hungary. Recently, Samsung withdrew from Spain and relocated in Slovenia.

THE NETHERLANDS

The Netherlands rose to 24th place, returning to the top 25 most attractive FDI destinations, having previously ranked in 19th place in 2002. European investors helped hoist the country in the rankings this year and consider it their 18th most attractive market in the world.

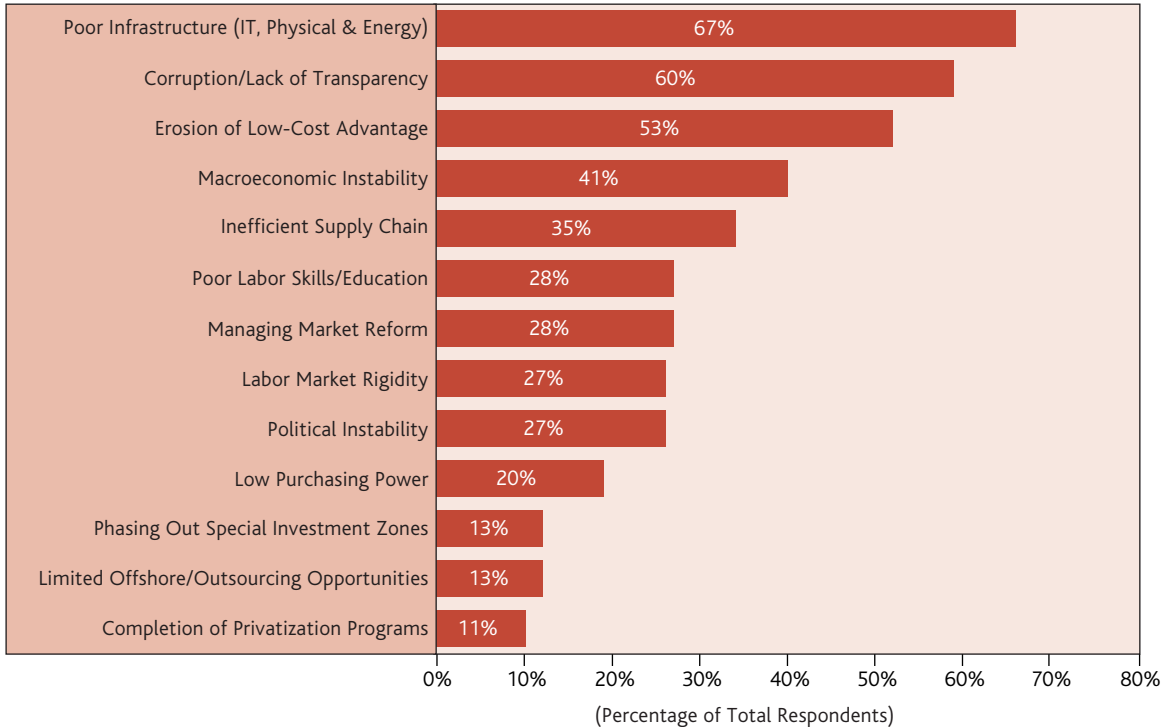
Recession and weak M&A activity dents Dutch FDI. The Dutch economy is just emerging from its worst recession since the early 1980s which has resulted in a deterioration in public finances. Given the Netherlands' heavy participation in cross-border M&A activity, it—along with the UK and the U.S.—experienced a sharp decline in FDI inflow after 2000, falling from \$64 billion in 2000 to \$20 billion in 2003.

However, the Netherlands' strong FDI attributes leave it well-positioned for a return to FDI growth. The Netherlands' FDI stock as a percentage of GDP is among the strongest in the EU—about 73%—and is the third highest in the EU. The country's liberalized and FDI-friendly business environment have helped attract significant amounts of FDI over the years. A highly-educated, multilingual workforce, well-developed infrastructure, and central location in the heart of Europe have led many investors to base regional headquarters and distribution centers in the Netherlands.

EMERGING EUROPE

Despite entry in the European Union and the

Figure 9: Most serious threats to the competitiveness of the ten new members of the European Union*



* Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia, and Slovakia joined the EU in May 2004
Source: A.T. Kearney

expected burst of investor enthusiasm, global investors this year actually expressed slightly lower levels of interest in these markets. Poland dropped from fourth to 12th place, Russia from eighth to 11th place, the Czech Republic from 13th to 14th place and Hungary from 17th to 19th place. With the novelty of EU membership fading, corporate investors are anxious to see how these markets perform given the challenges that the EU accession process poses.

Despite membership in the European Union, risks persist within these markets. Among the leading threats to the competitiveness of the ten new members, global investors cited poor infrastructure, corruption, and the erosion of low-cost advantage

(see figure 9). EU reforms are a double-edged sword. They are expected to bring infrastructure investments and regulatory stability within the EU single market, but at the same time the economic and social costs of adjustment are expected to be high.

Wholesale and retail investors—recognizing the expected rise in incomes in these markets—expressed the greatest confidence in the region, ranking Hungary second, Poland fourth, Russia fifth, the Czech Republic seventh, and the Baltic states 13th most attractive markets in the world. Yet, rising incomes may erode wage competitiveness. EU law will likely add a new layer of bureaucracy and may undermine new members' relative FDI advantages in areas such as

tax and labor. These factors could push investors further East and South outside the new EU and toward Romania, Bulgaria, the Balkans, Ukraine, and China.

While FDI volume declines, FDI quality increases. U.S. firms are offshoring activities to Central and Eastern Europe to service their European operations, while European companies are looking to cut costs without taking on the risks associated with far-flung locations like India or China. Only 13% of global investors see limited offshore/out-sourcing opportunities in the ten new European Union countries. Among the top ten countries and regions with the greatest positive outlook, half are in Central and Eastern Europe.

POLAND

After jumping from 11th to fourth place in the Index last year, Poland fell to 12th place in 2004—its lowest level in the Index ever. A slowdown in reforms and perceived political instability have diminished investor confidence in the Polish market. Despite having a slight edge over Mexico and Brazil, Poland is expected to face fierce competition from China and India over the next ten years. Agriculture is responsible for one-fifth of the employment, but only 3% of GDP—indicating that the country has a painful transition period ahead.

Nevertheless, Poland's large population and share of Central and Eastern European GDP continues to draw investors. Last year Polish FDI rose slightly from \$4.1 billion in 2002 to \$4.2 billion in 2003. This year nearly 30% of global investors are more positive on the Polish economy compared to only

half as many in 2003. Global investors consider Poland a lower-risk FDI location compared to China, India, Brazil and Mexico. Wholesale and retail investors ranked Poland fourth, heavy manufacturer investors ranked it fifth, and insurance, real estate and holding companies ranked it seventh most attractive worldwide. Major auto-part firms are investing in Poland to supply General Motors, Ford and DaimlerChrysler AG. Earlier this year Whirlpool decided to build a new plant in Wroclaw instead of in Slovakia.

Gillette announced that it will invest in a production facility in Lodz, which will also manage the firm's entire European packaging and distribution for blade and razor products. French insurance giant AXA is considering entry into the market despite its unsuccessful bid for Polish-state-owned insurer PZU last year and the on-going legal dispute over the company's privatization between the government and Dutch-based Eureko.

RUSSIA

Russia tumbles from eighth place—an all time high—down to 11th most attractive market globally. The events surrounding the Yukos affair, violent terrorist attacks over the past year as well as limited progress on reforms have likely played a role in investors' diminished confidence in the Russian market. Russian FDI jumped from \$3.5 billion in 2002 to \$6.7 billion in 2003, largely driven by oil and gas transactions. In 2004 oil and gas investors ranked Russia their second most attractive market in the world—behind Australia. Earlier this year the French oil company Total decided to take a \$1 billion equity stake in Russia's largest independent

gas producer, Novatek, following a similar move by BP last year which signed a multi-billion dollar deal with Siberian oil firm TNK. ConocoPhillips is linking up with Lukoil.

A 1,000 consumers bloom in Moscow. With one of the fastest growth rates in the region Russia has lured wholesale and retail investors who bumped Russia up from 13th to their fifth most attractive FDI location worldwide. Russia's consumer goods market is booming. Retail trade, catering and selected food and beverage markets are making advances, while shopping centers are rapidly sprouting up around Moscow. Among global investors making a first-time investment over the next three years, 12% identified Russia as a preferred location.

The diversification of Russian FDI inflows and the economy more broadly would help reduce the economy's exposure to violent swings in oil prices. Russia's positive growth and healthy public finances are largely a function of high oil prices. If oil prices were to tumble, the country's increasingly wealthy consumers that investors seek to tap into could quickly vanish. Given the country's aging population and the severe impact of AIDS and other public health challenges, new dynamic industries will have to emerge to drive productivity and offset the shrinking workforce.

THE CZECH REPUBLIC

The Czech Republic dropped just one notch from 13th to 14th most attractive market in the world and continues to gain impressively high levels of confidence among European investors. French investors ranked it second, German investors sixth, Austrian investors

eight, Dutch investors 10th and Belgian investors 11th most attractive markets in the world. Last year the Czech Republic's FDI inflows dropped sharply from \$8.5 billion in 2002 to \$2.6 billion in 2003, however the previous year's spike was heavily attributed to the privatization of the state gas monopoly Transgas for \$4.1 billion.

Wholesale and retail investors ranked the Czech Republic their seventh most attractive market — up from eighth place last year. Light and heavy manufacturing investors sectors ranked the country 13th place last year, but now view it as their eighth and 10th most attractive markets, respectively. Peugeot-Citroen and Toyota have jointly announced the largest greenfield investment in the Czech Republic to date — a \$1.3 billion automobile plant expected to come on line by 2005.

Bolstered by the country's relatively low-cost and technically-trained skill base, electronic equipment investors ranked the country their fourth most attractive market worldwide. Electronic heavyweights Siemens, Matsushita and LG Philips are leading investors in the Czech Republic. As of 2003 Czech operations of First International Computer and Hon Hai (through its subsidiary Foxconn CZ) — both Taiwanese firms — were responsible for 40% of European PC production.

HUNGARY

Hungary slipped from 17th to 19th place, however French, Austrian and German investors remain bullish, ranking the country their fifth, sixth and seventh most attractive market, respectively. Real currency appreciation has negatively impacted unit labor costs for foreign investors and competitiveness

gains made through rapid reforms, industrial restructuring and privatization over the last decade are at risk. About 41% of global investors noted that macroeconomic instability poses a serious risk to the new EU members.

Light manufacturing investors are less inclined to commit FDI to the Hungarian market downgrading it from 12th to 22nd place. However, the country scored well among wholesale and retail investors who ranked it their second most attractive market globally.

SOUTH AMERICA

South America faces growing competition from Asia and Central and Eastern Europe. During the 1990s South America's FDI inflows expanded significantly supported by deregulation, privatization and the opening of markets. However, privatization has wound down and emerging opportunities in Asia and Central and Eastern Europe have had a dampening effect on investor confidence levels in South America.

While the region's absolute FDI Confidence Index score rose by 5% this year, Asia's score rose three times faster. As a result nearly all South American countries declined in relative rankings. For a third year in a row Central and Eastern Europe is considered a more attractive FDI region than South America. Last year FDI inflows to South America fell to \$21 billion from \$27 billion in 2002. From 1999 to 2003, the region's share of developing world FDI nose-dived from a high of 27% to 11%. Over this same period Central and Eastern Europe's share of developing world FDI rose from

10% to 13% and developing Asia's share rose from 44% to 54%.

South America's most dynamic investments have hit hard times. During the 1990s U.S. and European firms bought up privatized assets and entered deregulated telecommunications, financial and utility sectors. These investments generally have had a positive impact—improving coverage, service quality, and competitiveness. But, these service sector investments—among the most dynamic and strongest in the region—have suffered from ill-defined regulatory frameworks and macroeconomic instability.

A return to growth provides an opportunity to reverse FDI declines. After years of languishing growth and macroeconomic instability, this year South America is expected to reach its highest economic growth level since 1997. China's voracious appetite for commodities, which has served to increase prices, is driving an export-led recovery—spawning the first current account surplus in the region in nearly four decades.

Yet, South American income inequality undermines competitiveness and limits FDI potential. High levels of unemployment, poverty and social discontent loom over the region. Economic liberalization of the 1990s has not fulfilled the promise of prosperity or reduced income disparity, which is worse in South America than in any other developing region. Income inequality limits the development of a broad and vibrant consumer market attractive to foreign investors and blunts the impact of growth on reducing poverty, boosting unemployment and

upgrading human capital.

BRAZIL

Brazil drops to its lowest ranking since the first FDI Confidence Index in 1998. This year Brazil was ranked the 17th most attractive market in the world, down from ninth place in 2003 and its lowest recorded FDI Confidence Index ranking. Last year Brazilian FDI inflows fell by 39% from \$16.6 billion in 2002 to \$10 billion in 2003—its lowest level since 1995. Greater economic stability, a resumption of growth, and improved investor views on profitability and risk could help turn around the country's FDI slump, but regulatory concerns as well as opportunities in other parts of the developing world may limit the country's ability to boost FDI.

Foreign telecom and utilities investors face steep challenges. Telecom and utility executives have soured on the Brazilian market—as it dropped from the 10th most attractive market to below the top 25 among these investors. Many cash-strapped investors failed to deliver promised infrastructure development, and currency devaluations magnified debt levels. Changes in the regulatory environment are discouraging utility investors and limiting much needed investment in the electrical power infrastructure. U.S.-based Duke Energy Corp. announced in August 2004 it would plan no new investments in Brazil citing concerns over transparency and unexpected policy shifts.

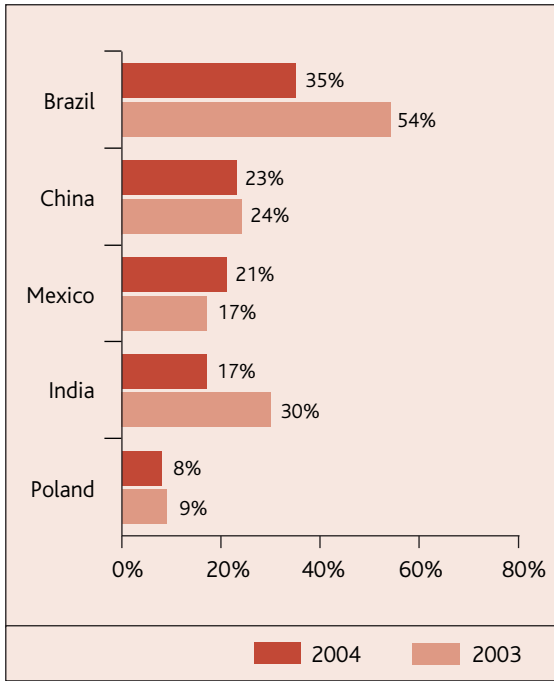
Financial service investors express lower levels of confidence in the Brazilian market. Unlike the late 1990s, when foreign banks were aggressively entering the market, many

are holding steady or outright withdrawing from the market. Spanish bank Bilbao Vizcaya Argentaria, U.S.-based JP Morgan, and Assurances Générales de France sold subsidiary operations to local Brazilian banks. Global bankers appear to be focusing on high-quality assets in the European and U.S. markets and see brighter prospects in China whose banking sector has yet to be fully liberalized.

While service sector investors are downbeat, an array of manufacturing investors are keen on Brazil. Transportation equipment investors consider Brazil their fifth most attractive market in the world. Although down from third place last year, Brazil remains attractive to major auto manufacturers and suppliers. Through the first half of 2004 auto production and sales saw double-digit growth and exports soared by 13%. Mercedes-Benz and Continental AG of Germany as well as Renault of France have announced new Brazilian investments. Chemicals, petroleum and refining investors sector ranked Brazil their ninth most attractive investment destination—up from 13th place last year. Electronics investors are also upbeat on Brazil—ranking it sixth—up from eighth place in 2003.

Primary sector CEOs see natural resource opportunities in Brazil. Primary sector investors ranked Brazil 10th this year—up from 17th last year. Likely driven by the commodity export-led recovery in Brazil, these investors are eager to tap into Brazil's natural resource base. Agriculture exports for the first half of 2004 rose by 36%. Agribusiness giants Archer Daniels Midland Company, Cargill and Louis Dreyfus Group are pouring investments into Brazilian soy-

Figure 10: Percentage of investors who consider these countries "High" risk FDI locations



Source: A.T. Kearney

bean facilities to meet growing global demand. An example of strong emerging market outward investment, China's Minmetals Group is expected to invest \$2 billion in Brazilian mineral production.

Growth and macro policy improve investor outlook, but Brazil trails other emerging markets. Nearly one in four investors hold a more positive outlook on Brazil compared to just one in six last year. Nearly two-thirds of global investors stated that their profitability targets were being met compared to fewer than half of them last year. The government has steered the economy toward exchange rate and inflation stability. Despite a lower risk profile among global investors, Brazil is still viewed as more risky than other big emerging markets (see

figure 10). Nearly twice as many global investors are upbeat about China and India compared to Brazil. The Polish and Czech markets are also viewed more positively than Brazil, and more investors expect to achieve profit targets in China and Poland than in Brazil.

ARGENTINA

Argentina continues to suffer from the effects of the financial collapse. Argentine FDI inflows declined for a fourth-straight year reaching a paltry \$478 million in 2003—less FDI than Panama or Trinidad and Tobago clocked in 2003. Once among the 10 most attractive investment locations globally, on-going financial, political and regulatory instability have largely kept investors out of the Argentine market.

Despite signs of growth and a trade surplus, Argentine sovereign debt remains near the bottom of speculative grade rankings by the three major ratings agencies. Since announcing the largest sovereign debt default in history in December 2001, South America's second largest economy remains unable to tap into international capital markets. Financial disruptions and instability have undermined profitability causing investors to remain wary of the Argentine market.

Financial and utility service investors face a labyrinth of risks. While among the most aggressive investors over the 1990s, financial and utility investors have had to contend with stiff local competition, currency volatility, debt-overhang and a politicized and capricious regulatory environment, conditions which have driven many investors out of the

market. Many foreign banks have been unable to forge a brand and compete against well-established local banks, while others have lost confidence after the peso devaluation of 2002. Scotiabank (Canada), Crédit Agricole (France), MassLife (U.S.), ING (Netherlands) and Principal Financial Services (U.S.) have left the market.

Interventions in the utility market have left few incentives for producers to maintain their operations let alone make new investments. Much of the difficulties in both the financial and utility sectors can be traced to overhang of the peso-dollar peg. That monetary framework left the regulatory authorities ill-prepared for the turmoil that the devaluation reaped.

Buoyed by oil and agro-exports, primary sector investors show signs of warming to Argentina, and manufacturing investors are returning to the market. Along with the rest of the region, Argentina is enjoying strong agro-export growth. French-owned Louis Dreyfus announced plans to invest \$65 million in a new port and soybean crushing facility. One in four primary sector investors have increased optimism about the Argentine market and ranked it their ninth most attractive investment destination globally. The Spanish oil giant Repsol YPF—the largest foreign investor in Argentina—has announced it would invest \$6 billion in Argentina through 2007.

Fiat announced plans to return to the market after a two-year leave and Peugeot Citroen expects to make further investments in its local subsidiary. Yet, most of these investments are targeting the export market, while local-market-seeking FDI has yet to

return to what remains the wealthiest country in the region on an income per capita basis.

THE ANDEAN REGION

Booming commodity markets hoist growth and investors key in on primary sector. With international petroleum, natural gas, copper and gold prices fairly high and strong demand, the Andean countries have enjoyed fairly stable FDI flows in the primary sector. However, more broadly-based growth is needed for sustainable and dynamic growth to emerge. Given the small market size and commodity-dependency of these countries, innovative policies will be required to diversify FDI inflows.

ASIA

Five of the six largest jumps in the Index were registered by Asian markets, with Hong Kong, Australia, Singapore, Malaysia and New Zealand enjoying the strongest improvements in investor confidence. Their robust performances were in part driven by North American and European investors seeking to diversify their operations across Asia and anticipating growth opportunities in these markets. Hong Kong, Malaysia and New Zealand received higher confidence nods from Asian investors.

Executives overwhelmingly consider China to be the undisputed top FDI destination for the third year in a row. India displaced Mexico to become the third most attractive FDI destination worldwide and is increasingly perceived as an R&D hub for a wide range of industries. Japan entered the top ten most attractive investment destina-

tions for the first time in the Index rankings, moving from 15th to 10th place.

Invasion of the telecoms. Telecom & utility investors are anxious to buy up privatized state utilities, build networks, offshore IT services, penetrate the non-urban populations of Asia, and establish R&D facilities that leverage pockets of high-skilled, low-cost labor. At the same time, these investors seek to design innovative products tailored to Asian consumer tastes. Asian countries dominated the top ten most attractive telecom investment locations—with China, India, Hong Kong, and Malaysia taking the top rankings (first-fourth places), Singapore assuming sixth place, and Thailand, Vietnam and Indonesia taking eighth, ninth and tenth place among telecom and utility investors, respectively.

CHINA

China surges ahead in the Index as profitability targets are being met. China takes the number one spot for the third consecutive year and increases its raw score lead over the United States. China was the largest FDI destination in the world in 2003, overtaking the United States for the first time (given the revisions to U.S. FDI data this did not occur in 2002, as was previously reported by UNCTAD). Total FDI inflows in 2003 hit \$53.5 billion as compared to \$29.8 billion for the United States. More investors expect to achieve their profit targets in China than do investors in other big emerging markets (see figure 11).

New investors are expected to forge into China. China is the top FDI location globally for anticipated first-time investments—

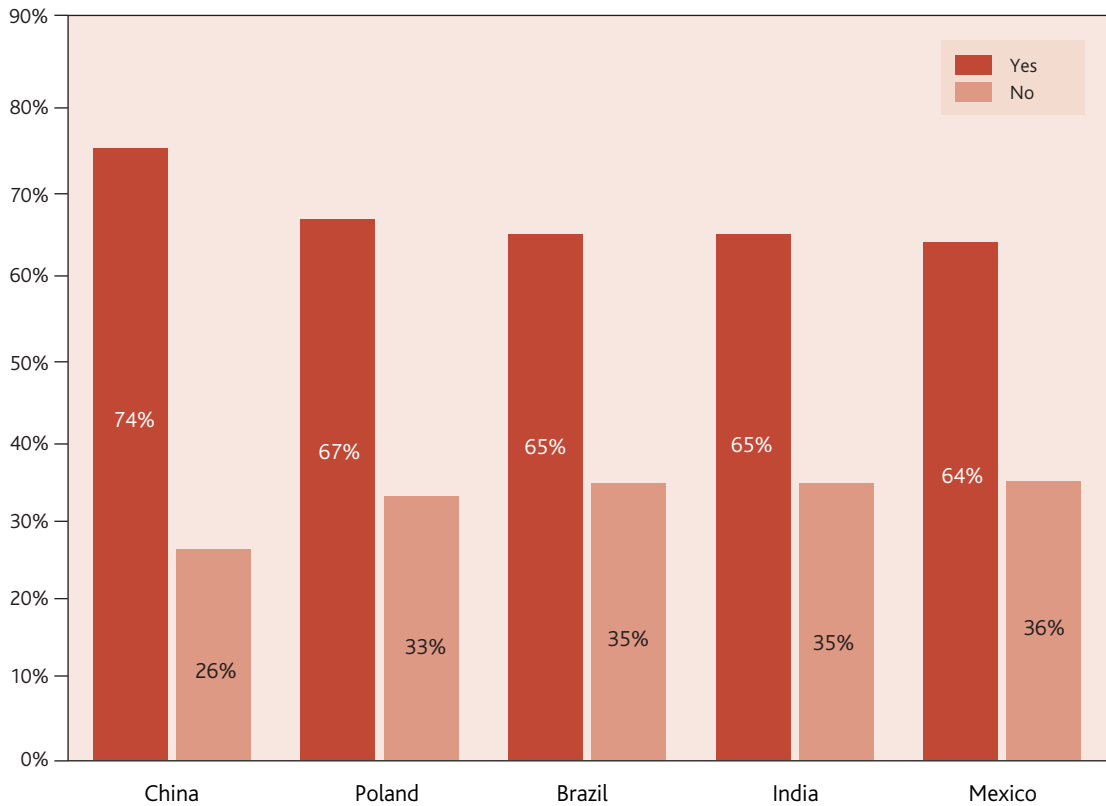
nearly half (43%) of global investors are expected to make a first-time investment in China over the next three years. About 40% of global investors expressed a more positive outlook on China's economy, four times the number of executives who had a dimmer view of China. While leading corporate executives consider the overheating of the Chinese economy to be the third most important factor influencing their FDI decisions, investors still consider the upside benefits to outweigh the risks in China.

Asian investors are most sensitive to the overheating of the Chinese economy. Unlike other global investors, Asian investors cited the prospect of an overheating of the Chinese economy as the second most important factor potentially impacting their FDI decisions. Only 28% of Asian investors said that their outlook on China was positive compared to 38% and 45% of North American and European investors, respectively. Given their deeper economic ties with China, Asian investors are evidently more concerned about an immediate and direct negative impact of an overheated Chinese economy.

Corporate strategies aimed at lowering costs (efficiency-seeking FDI) as well as improving top-line growth (market-seeking FDI) largely point to China. The country's vast low-cost labor pool and consumer market expansion have helped drive inward FDI.

Both services and manufacturing investors are keen on China. After wholesale and retail investors, heavy and light manufacturing investors expressed the highest levels of optimism about the Chinese market—GM, Toyota and VW have all

Figure 11: If invested, are profitability targets met?



Source: A.T. Kearney

(Percentage of Total Respondents)

announced new investments in China. GM alone expects to pour \$3 billion into China over the next three years, boosting production, developing new engines, and supporting R&D activities in Shanghai.

Given the expected WTO-mandated opening of the Chinese banking sector, financial service investors fervently await liberalization. Despite concerns over high debt levels and weak governance, nearly 40% of financial service investors are more positive on the Chinese market. HSBC is leading the way, taking a 20% stake in China's fifth-largest bank, Bank of Communications, in a \$1.75 billion deal.

Smokestack and textile industries see

bright prospects in China. With the end of quotas for textile imports to the United States and EU, China is expected to take an even larger share of the global textile market and leave countries which have benefited from the quota system—like Mexico, the Philippines and Malaysia—in the dust. Steel companies are positioning themselves for the consolidation of the Chinese steel industry. Dutch steel company LNM is making a first-time investment in China and ThyssenKrupp is also further positioning itself in this market.

While most confident in China, investors are aware of risks. Investors cite the regulatory climate, corruption, intellectual proper-

The Shifting Geography of FDI in China

The rapid transformation of China is having a significant impact at the micro level. Last year, the Pearl River delta, the industrial heartland of China, received \$13.7 billion of FDI, while Yangtze area cities (around Shanghai) took nearly twice that amount. Enticed by better working conditions and higher wages, these northern cities are attracting workers from the Pearl Delta.

Economic activity to the north is leading to labor shortages (by about 2 million) in the Pearl delta area, which defies the notion that China enjoys an inexhaustible labor supply. The city of Suzhou in the Yangtze area now attracts more FDI than any other Chinese city—recently displacing nearby Shanghai. Lower production costs and less congestion are drawing investors to hinterland areas away from traditional FDI locations.

ty rights, and foreign exchange and capital controls as the most serious risks to doing business in China. While global investors are less concerned with basic labor skills and education, a quarter of them consider the lack of managerial talent as a critical risk to doing business in China (see figure 12).

INDIA

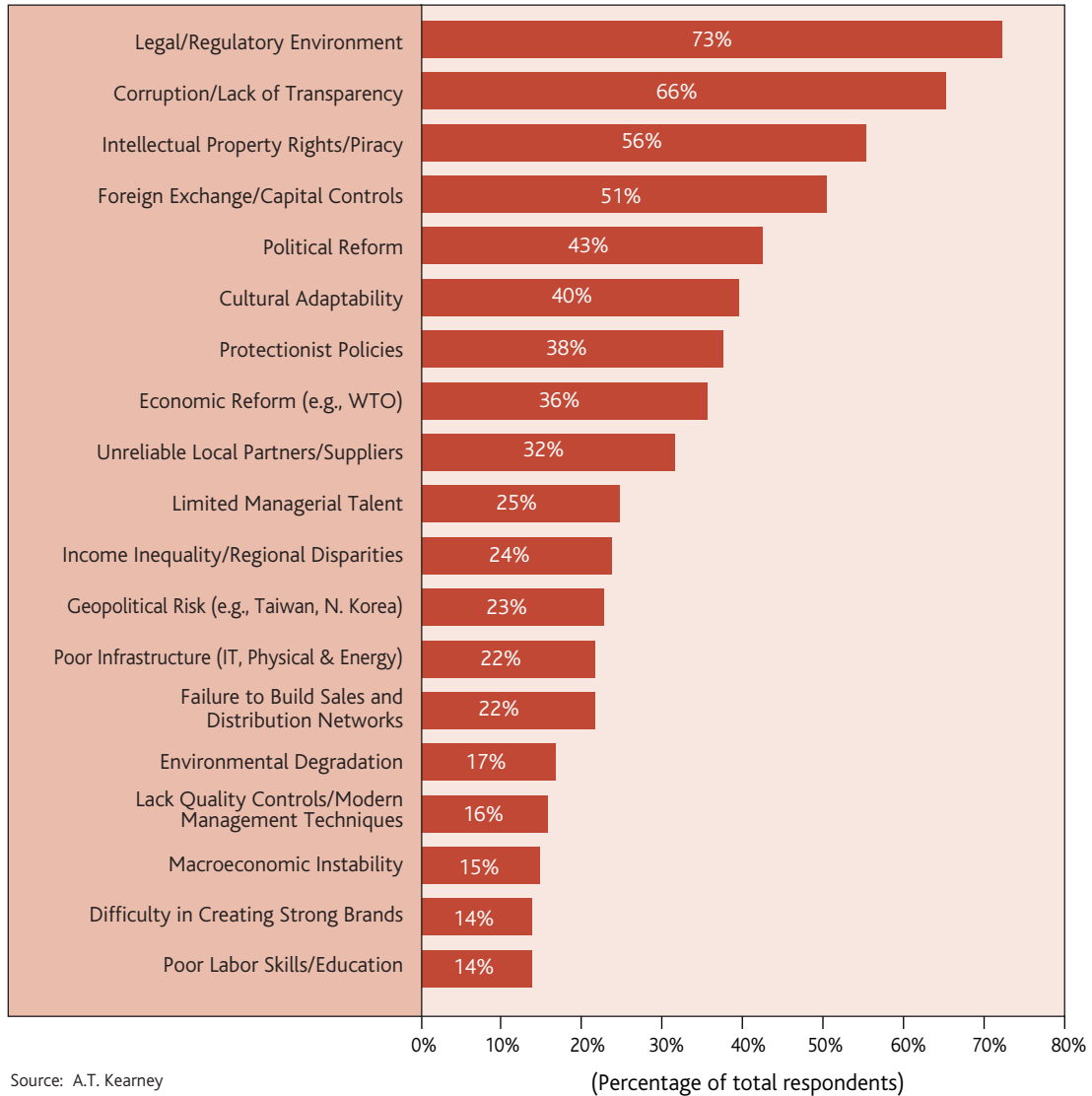
India climbs to become the third most attractive FDI location, up from sixth place last year, reaching its highest ranking ever. India's rise is accompanied by an improved outlook with 38% of global investors taking a more positive view on India compared to a year ago. No other country, except China, received such high marks in terms of investor optimism. The country's service-oriented

development path is helping it bypass obstacles like weak infrastructure. A "wired" India has played to its strong suit—a well-educated, IT-savvy workforce with English-language proficiency.

India emerges as an R&D hub. Manufacturing and communication services are the most bullish on India, ranking it the second most attractive market globally. The companies in these industries represented mostly knowledge-intensive segments such as semiconductor manufacturers, pharmaceuticals and scientific instruments. About 35% of global investors consider intellectual property rights as a growing challenge to India's future competitiveness. Nevertheless, they are eager to tap into India's powerful knowledge base and few see limitations vis-à-vis the country's skill level or education—with only 10% noting that these factors would pose a challenge to India's competitiveness (see figure 13).

Communication service investors ranked India their second and chemical investors ranked it their fifth most attractive market in the world. After China, India has the fastest-growing mobile market. Finnish Nokia and Chinese Huawei Technologies have established R&D centers in India this year. Implementation of WTO rules covering intellectual property rights (TRIPS), combined with a highly-talented pool of pharmaceutical scientists could position India to become an R&D player in the drug development field. As innovation is protected, more room for cross-border investments and technological spillovers will be created. U.S.-based Bristol-Myers Squibb recently invested \$10.6 million in an R&D facility and formed

Figure 12: The greatest perceived risks to doing business in China

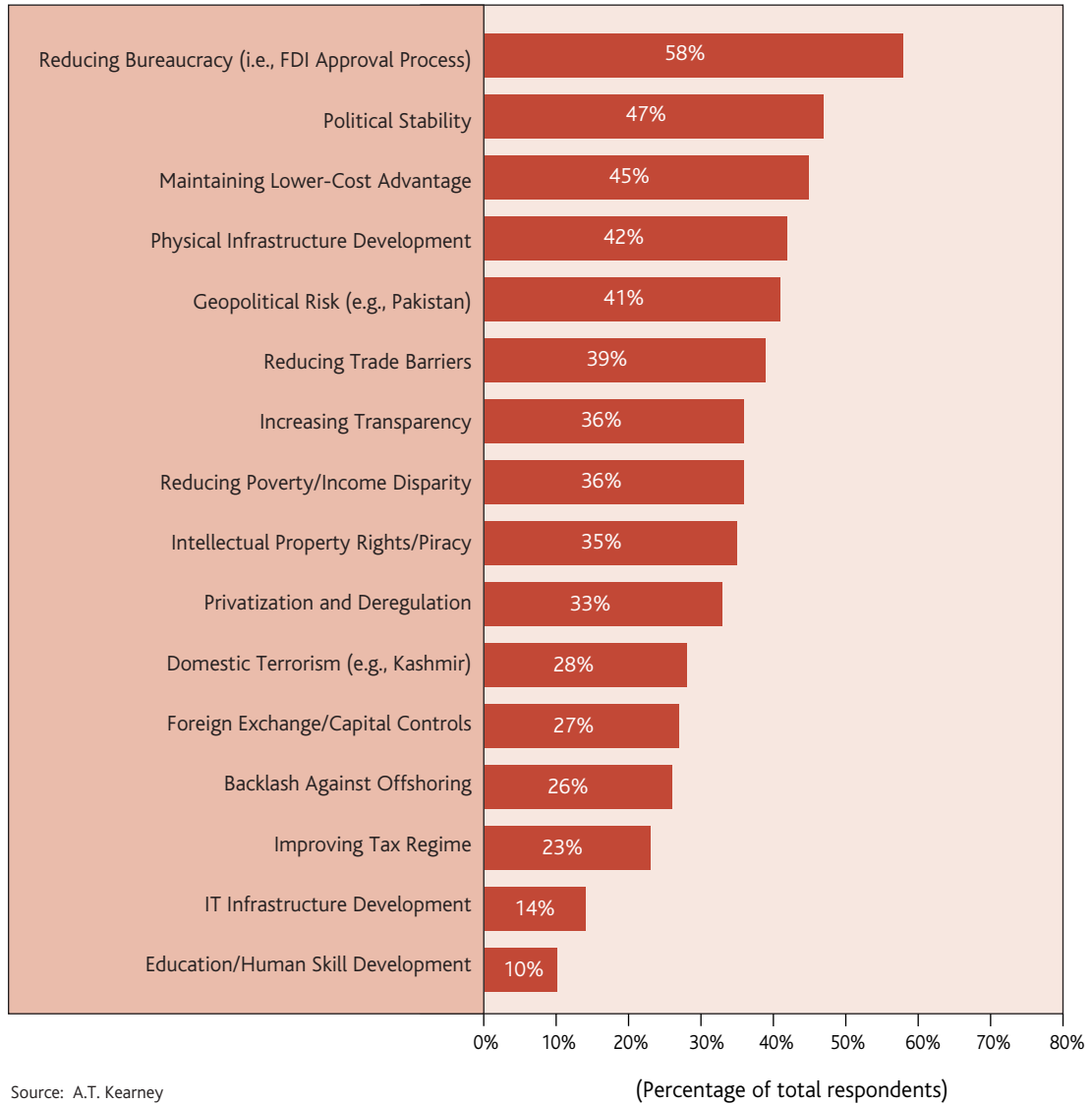


a research partnership with the India drug company Ranbaxy.

Bureaucracy and political instability could undermine India's future competitiveness. Although investors view India as an increasingly attractive investment location, the investment climate is not without problems. Investors are especially worried about cumbersome bureaucracy and political insta-

bility. The second most frequently cited concern regarding India's competitiveness was political stability, or the lack thereof. Despite the recent rapprochement between New Delhi and Islamabad, geopolitical risks loom over the investment climate. Global investors noted geopolitical risk as a more important factor in determining India's prospects than transparency and intellectual

Figure 13: Factors judged most seriously to impact India's competitiveness



property rights (see figure 13).

The third most frequently cited factor impacting India's competitiveness was concern over the erosion of India's low-cost advantage. About 45% of investors consider the emergence of higher costs as likely to impact India's competitiveness. India's pre-eminence as the offshoring destination of

choice has been largely driven by the country's incredible low-cost labor advantage. Over a quarter of global investors believe that a backlash against offshoring would impinge on the country's future competitiveness.

Stronger investor enthusiasm, yet the FDI boom has yet to arrive. Indian FDI

inflows have grown nearly eight-fold over the last decade, and despite rising last year by 24%, foreign investment remains relatively low—only \$4.3 billion compared to China’s \$53.5 billion in 2003. China opened its market to FDI in 1979, while India did not openly welcome foreign investors until the early 1990s. China’s decade-long head-start helps, in part, explain its relatively stronger FDI inflows. China’s export-manufacturing FDI framework brought capital-intensive industries, while India’s import-substitution regime led to higher-technology-oriented FDI.

China’s WTO-entry continues to foster FDI in a wide array of sectors as the economy further liberalizes. India’s previously restrictive FDI regime limited foreign participation in the economy to mostly licensing and other contractual agreements—not FDI. This explains why when foreign companies outsource to India, they may choose to purchase the services of a third-party provider in India rather than invest in a call center, as such.

AUSTRALIA

Australia moves up from the 19th to seventh most attractive market worldwide, aided by strong interest among British and American investors. Historically important players in the Australian market, British companies rank Australia their fourth most attractive market worldwide. Americans, the largest contributors to the country’s FDI stock, are more likely to invest in the Australian market. U.S. investors ranked the country their eighth most attractive environment, up from 21st last year. Strong export-led growth, the

liberalization in the media industry and tax reform are likely helping boost global investor views on Australia. The country’s natural resource industry remains one of the most attractive in the world with Australia taking second place among primary sector investors.

Australia jockeys for a position in the global FTA game. A flurry of free trade agreements have been completed or initiated over the past few years, with Australia determined not to sit on the sidelines. Expected to be implemented as early as January 2005, the Australia-United States Free Trade Agreement (AUSFTA) is likely spurring U.S. investor interest since it will create greater market access for U.S. firms. As Australia improves its trade links with ASEAN, confidence among Singaporean investors is strong, ranking Australia their seventh most attractive FDI destination.

The M&A market down under heats up, with bankers eager to be dealmakers. Global bankers rank Australia their fourth most preferred FDI location in the world. The Australian real-estate industry is restructuring and turning overseas to pick up new assets. Power companies that entered the market in 1990s are now divesting their assets after disappointing returns. Assets being shed in the industry are luring regional players into the fray as Singapore Power Limited bought U.S.-based TXU’s Australian assets for \$5.1 billion. For the first three quarters of 2004, Australia was the fifth-largest M&A market in the world and investment bankers are looking to capture a larger share of advisory business.

HONG KONG

Supported by a strong economic recovery, Hong Kong shows the highest jump in the Index in 2004—leaping 14 spots to become the eighth most attractive FDI location in the world. Hong Kong's robust performance is driven largely by Asian investors who consider Hong Kong their top FDI choice—after mainland China—up from sixth place last year. European investors are more likely to invest in Hong Kong and ranked it 16th place—up from below the top 25 last year. FDI flows to Hong Kong rose from \$9.7 billion in 2002 to \$13.6 billion in 2003. The city continues to be the second largest FDI recipient in Asia after mainland China.

After suffering from SARS and an economic recession, a return to rapid growth is welcomed by investors. Hong Kong's economy grew by 12% in the second quarter of 2004, a rate not seen since early 2000. Deflation also came to an end after six years of falling prices. Relatively low taxes, a strong legal system and excellent infrastructure in close proximity to mainland China have provided Hong Kong competitive advantages. Moreover, the 2003 Closer Economic Partnership Arrangement (CEPA) agreement between Hong Kong and mainland China will improve market access and could boost foreign investments into Hong Kong that would flow on to mainland China.

The revival of the economy and real estate market lifts financial service investors' expectations. Financial service investors ranked Hong Kong their fifth most attractive FDI destination, up from 14th place last year. With improved macroeconomic conditions and the real estate market returning to

health, financial service investors see better prospects. Since the Asian financial crisis and the mortgage market collapse, banks have been focusing on insurance, wealth management and mutual funds. This strategy has begun to reap returns, but with the mortgage volumes picking up, banks will likely gain even greater earnings momentum. Financial service-related provisions in the Hong Kong-China CEPA agreement could help position Hong Kong to benefit from the opening of mainland China's banking sector.

Telecom & utility investors are showing stronger interest in Hong Kong, ranking it as the third most attractive market in the world, up from eighth place last year. The recent wave of initial public offerings combined with the easing of restrictions on foreign ownership have helped pique telecom investors' interest. With higher growth expected from 3G services, Japanese and Taiwanese firms are moving in to establish the next generation of networks. Driven by electrical and electronic manufacturing, the light industry sector upgraded Hong Kong five spots to their sixth most preferred market in the world.

JAPAN

Japan enters the top ten most attractive destinations in the world for the first time, as the long-suffering Japanese economy recovers. Japan jumped from 15th to 10th place in 2004. So far this year Japan has been one of the fastest-growing economies in the developed world, achieving rates not seen since the 1980s. Unlike previous recoveries, Japanese households are leading the way as traditionally reserved Japanese consumers

open their wallets and further support U.S.-China-driven export growth. About 30% of global investors are more optimistic about Japan compared to a year ago.

Bankers are eyeing Japan's enormous assets. Banking executives are eager to gain access to Japan's prized financial assets and consider the Japanese market their ninth most attractive market in the world. Deflation has tapered off and non-performing loans are down. Despite enduring financial difficulties over the past few years, Japan's banks are among the largest with significant global reach. On the retail side, Japan remains the second-largest high-net-worth client market in the world.

After overhauling the banking system, the government now boldly seeks to privatize the postal system, Japan Post, which is effectively the world's largest bank, managing \$3.2 trillion worth of national retirement savings and insurance deposits. This could unleash a massive amount of capital into the private sector that would otherwise have been channeled to inefficient semi-public projects. The fierce takeover battle between Japan's second and third largest banks for UFJ could represent a shift toward a more competitive culture in Japanese banking, a break with the past.

The chemicals, petroleum, and refining sector remains focused on Japan—ranking it sixth place—down one spot. While slightly lower this year among these investors, pharmaceutical and biotech companies remain bullish on Japan. The country's large and aging population has made Japan the second-largest pharmaceuticals market in the world, accounting for one-fifth of global

sales and the biotech industry is one of fastest-growing sectors in the economy. Australia-based CSL bought Aventis Behring Japan earlier this year for nearly \$1 billion.

The Japanese market has plenty of room for FDI development. Foreign companies still face a complicated regulatory environment, high costs and residual hostility to foreign ownership in Japan. FDI plays a small role in the Japanese economy—representing only 0.6% of gross fixed investment compared to 1.5% in the U.S., 5% in the UK and 14% in France. The Japanese market has had relatively little cross-border M&A inflows given its enormous size. The government's moves to reduce domestic cross-share holdings and reform M&A rules governing stock swaps could help stimulate greater FDI flows.

MALAYSIA

Malaysia jumped from the 23rd to 15th most attractive market driven by Australian and Singaporean investors. The government is expected to tackle corruption and improve transparency and its broad reform agenda has already wooed portfolio investors back into the market—lifting the stock market. First quarter 2004 growth showed the best performance in three years and the country enjoys a robust current account surplus, high reserves and low inflation.

Malaysia scores well among manufacturing and IT investors. Heavy and light manufacturing investors upgraded the country from 18th to 16th and 21st to ninth, respectively. In particular, electronics investors ranked Malaysia their seventh most attractive market, up from 13th place. This bodes well for the country given that industry's

important role in the economy. Malaysia is also a hot spot for communication service investors, who ranked Malaysia fourth most attractive, and fabricated metal, industrial machinery and computer equipment investors who ranked Malaysia their fifth most attractive FDI location.

The country's buoyed stock market and M&A activity have likely helped improve banking investors' outlook on the country—who this year ranked it 14th most attractive, up from below the top 25. Aside from Singapore Stock Exchange, the Kuala Lumpur Stock Exchange is one of the largest exchanges in Southeast Asia. Stronger growth, higher liquidity, and an improving business climate are likely helping spur cross-border M&A activity—particularly for Malaysian firms making outward investments. While HSBC (UK), Standard Chartered (UK) and Citibank (U.S.) have been the dominant foreign banks in Malaysia, two Singapore banks have recently made inroads in the Malaysian market—Overseas Chinese Banking Corp and United Overseas Bank. The removal of limitations on foreign ownership in financial services is expected next year.

Thai terrorists and skilled-labor shortage could spell trouble for Malaysia. As Malaysia seeks to move up the value chain to R&D and knowledge-based activities, it is encountering a lack of skilled labor. Foreign investors are having difficulties staffing in advanced manufacturing and IT operations and Malaysian graduates are migrating to higher-paid positions in Singapore or Western countries. The Islamic opposition did not perform well in the March 2004 elections at the federal level. However, militant

Islamist groups fomenting violence in neighboring Thai provinces could lead to increased perceptions of political instability which the government is actively working to dispel.

SINGAPORE

Singapore returns to the top 25, aided by Australian and French investors. Singapore became the 18th most attractive market in the world in 2004—up from ranking below the top 25 destinations last year. About 5% of global investors are expected to enter the Singaporean market for the first time over the next three years. Encouraged by the U.S.-Singapore Free Trade Agreement, U.S. companies also expressed stronger levels of confidence in the Singaporean market in 2004. Despite its relatively small market, Singapore is already the U.S.'s 12th largest trade partner. Helped by the turnaround in the global electronics industry, Singapore's FDI inflows doubled in 2003 reaching \$11.4 billion.

Telecom investors see advanced technology growth and offshore opportunities. Communication services investors view the city-state as their sixth most promising market in the world. Singapore's rising mobile phone and internet penetration and IT infrastructure development over the last decade have brought the market close to a saturation point. However, Singapore offers advanced technology opportunities, such as G3 phone and broadband services. One in three Singaporeans shop or bank on-line. The country's strong skill-base will reinforce its evolution from IT hardware toward IT services. Security-minded IT firms established in India are locating backup facilities in Singapore.

A tale of two cities. Having once been a backwater of the British empire, Singapore has evolved into a modern, IT-enabled and financial hub for Asia. Financial service investors ranked the city-state their 12th most preferred FDI location. The market capitalization of the Singapore Exchange represents about 260% of GDP—fairly high by global standards. Foreign banks dominate the country’s massive cross-border capital flows in the Asian dollar market. Singaporeans are both wealthy and eager to invest in the stock market, while Singaporean firms—some of the largest globally within their industries based on foreign assets—are actively listed. Overseas firms are also eager to list given the exchange’s strong reputation and high standards. Singapore is also an attractive offshore location for financial service call centers and high-end activities. Last year ten banks centralized their regional and global processing operations in Singapore.

THAILAND

Thailand falls four spots from 16th to 20th place. Manufacturing investors have entered Thailand in order to diversify their FDI portfolios rather than relying exclusively on China. The eruption of violence in January 2004 in the Muslim-dominated south as well as reports of the terrorist organization Jemaah Islamiah being active in the country have likely lowered investors’ confidence in the Thai market. Thailand’s less than stable legal and regulatory environment and corruption continue to present difficulties for foreign investors.

For a second year in a row, Thailand is

the third most attractive investment location worldwide for Asian investors. The country is negotiating or has completed free trade agreements with India, China, Australia and the U.S., fostering deeper trade and investment linkages and helping Thailand integrate with the global economy. Asian investors are particularly keen to take advantage of these new economic arrangements. Indian investors were the most confident in the Thai market—ranking it their second most attractive market globally. For Indian firms, the FTA between these two countries will make Thailand a gateway to the wider ASEAN market. Progress towards ASEAN economic integration is also spurring Singaporean confidence in the Thai market—as these investors rank it their fifth most preferred investment location. United Overseas Bank of Singapore acquired Thai Bank of Asia earlier this year. Australian investors ranked Singapore their 11th most attractive market.

Food & beverages and telecom investors optimistic on Thailand. Food and beverage companies are more likely to invest in the Thai market—ranking it their sixth most attractive market up from 19th place. Nestlé and Unilever are introducing new product lines in the Thai market. Last year Japanese brewer Asahi announced that it will consolidate its Southeast Asian and Australasian production in Thailand. Pushing it up two notches to fifth place this year, telecom & utility investors anticipate the privatization of the country’s state-owned telecom companies TOT Corporation and CAT Telecom. The government is ready to establish a national regulator to simplify and manage

the country's complicated telecom industry. Despite the rapid growth and high penetration rates, mobile operators see opportunities in the provinces and among younger Thais willing to try new technologies.

SOUTH KOREA

South Korea falls from 18th to 21st most attractive environment. Having previously ranked South Korea their 18th most attractive market, European investors ranked it their 24th most preferred market this year. North American investors expressed a stronger interest in the South Korean market though, ranking it their 11th most attractive FDI location, up from 15th place. Asian investors ranked South Korea in 14th place, just down one spot from last year. Australians and Americans are most keen on South Korea—ranking it their eighth and 10th most attractive markets, respectively. UK and Singaporean investors also view South Korea favorably, both ranking it their 13th most favorable market.

Heavy manufacturing investors downgrade South Korea 8 spots to 22nd place. South Korean labor productivity is only half of the OECD average and the move by the government to reduce the work week without corresponding wage cuts could worsen the country's competitiveness position. Foreign investors largely regard the country's higher costs as justifiable given its highly-educated and productive workforce. Yet, policy changes negatively impacting productivity gains could undermine South Korea's FDI potential.

Financial services upgraded South Korea two spots to 10th place. As the world's sixth-largest insurance market, South Korea is an

attractive market for insurance carriers, one in five of whom are more upbeat on the South Korean market. Citigroup has taken the lead as the first foreign firm to enter the South Korean banking sector. For \$2.7 billion it acquired a majority stake in Korean bank KorAm—the largest ever single foreign investment into South Korea.

Further fuelling financial service investor enthusiasm, the government plans to sell a \$1.2 billion stake in Woori Financial Group, accelerating the privatization of the last major state-controlled bank in the country. South Korean FDI inflows rose from \$2.9 billion in 2002 to \$3.8 billion in 2003, largely attributed to the U.S.-based Lone Star Fund taking a majority stake in the Korean Exchange Bank for \$1.2 billion.

INDONESIA

Led by primary sector investor confidence, Indonesia recorded a slight improvement from 25th to 23rd place in 2004. Since the financial crisis, Indonesia has suffered a protracted period of divestment—from 1998 to 2001. In 2002 Indonesian FDI inflows entered positive territory reaching \$145 million, but turned negative again, dropping to negative \$597 million last year. Although approvals of new foreign investment reached \$5.1 billion in 2003, the country's difficult bureaucracy and inadequate infrastructure helped keep these investments from maturing.

Tough oil and gas executives venture into Indonesia. Given its challenging business climate, few investors are prepared to bear the risks of venturing into the Indonesian market. With oil prices breaking the psychological barrier of \$50/barrel and China's insa-

tiable demand for energy, oil and gas investors are eager to tap global energy deposits even in the toughest of business environments. Primary sector investors ranked Indonesia their fourth most attractive country globally, an increase from last year's eighth position.

Indonesia is a member of OPEC and the world's leading exporter of liquefied natural gas. China National Offshore Oil Corporation (CNOOC), Italian-based ENI, and U.S.-based firms like Unocal and ExxonMobil are in exploration and production plays in Indonesia. Giants like Rio Tinto of Australia and BP are producing coal as well. The state-owned oil firm, Pertamina, is expected to be privatized in 2006.

Indonesia remains a risky place to do business. While the government privatized several state-owned banks last year, the shaky financial system remains debilitated by a high debt burden. Peaceful elections project a return to a more stable democratic process, but the political situation remains fragile and corruption is widespread. The Bali bombings and terrorist attack against the Australian embassy in Jakarta, combined with on-going separatist violence have undermined the country's attempt to restore security. Piracy attacks on international shipping in the Straits of Malacca highlight the government's tenuous control over its vast territory.

TAIWAN

Taiwan falls five notches from 20th to 25th place in the Index in 2004. Restrictions on economic interaction with mainland China could be discouraging foreign investors. Taiwan is being overtaken by a growing web of new trade relations among Asian coun-

tries and between Asian countries and the rest of the world. Other than the possible FTA with the United States, Taiwan has been largely on the sidelines. While North American and European investors expressed diminished levels of confidence in the Taiwanese market, Asian investors continue to be attracted to the island's highly innovative and technology-oriented market.

Taiwan is still a popular investment destination for light manufacturing investors—particularly electronics and computer companies. Foreign investment in Taiwan has been concentrated in the electronics industry. Electronics executives ranked Taiwan their ninth most attractive investment location in 2004. Taiwanese companies such as Quanta Computer and Compal Electronics, although not household names, are the world's two largest notebook computer producers.

AFRICA, NEAR EAST, AND MIDDLE EAST

South Africa's FDI profile is raised among UK, Swiss, Italian, French, and Australian investors. Transportation equipment manufacturers expressed the highest level of confidence in the South African market—ranking it their sixth most attractive market globally. Supported by a progressive national automotive policy and regional programs like the Durban Automotive Cluster (DAC), car exports have grown nine-fold over the past decade and vehicle investment is expected to reach \$2.3 billion over the next five years.

Despite the country's progress on macroeconomic policies, investment grade ratings, and solid infrastructure, FDI inflows on average are well below levels achieved by

China, India, Mexico and Brazil. Endemic crime is likely inhibiting new investment. HIV/AIDS prevalence in South Africa is among the highest on the continent and will likely undermine the country's long-term competitiveness. With the appropriate policy mix though, South Africa has an opportunity to capitalize on global investors' elevated interest revealed in this year's Index.

Turkey leaves the top 25 rankings in 2004. After taking 24th place last year, Turkey falls out of the top 25 most attractive markets globally. FDI flows to Turkey fell by nearly half from \$1 billion in 2002 to \$575 million in 2003. Concerns over the pace of reform, security and lingering macroeconomic instability could be in part behind the country's lower ranking this year.

Turkey is a preferred FDI destination among wholesale & retail investors, who

ranked it their ninth most attractive FDI location this year. U.S.-based Starbucks opened its first two outlets in Ankara in September. Lower interest rates combined with greater credit card use are helping fuel consumer growth. Department stores and retail chains are expanding along with urban growth. Turkey took 21st place again among European investors this year and is the ninth most attractive FDI location for German investors.

Conclusion

Cross-border corporate investment could be reaching a tipping point as global investors express the highest levels of optimism in years, view traditional operational risks as less ominous, and expect to more aggressively offshore. Corporate investors revealed an increased willingness to make overseas investments compared to last year—the first positive year-to-year increase in overall FDI confidence in global investment locations since 2001. The largest emerging markets in the world are perceived as more profitable and generally less risky compared to a year ago.

Nonetheless, dangers still loom. Risk management strategies and scenario planning will be necessary for firms to effectively maneuver the potential hazards to come during the next wave of overseas business expansion. Corporate governance concerns still linger, complicating cross-border business transactions. Investors have increased anxiety over theft of intellectual property, terrorism, and threats to employees and assets. A rigorous assessment of current and potential corporate “blind spots” or unknowns will no doubt be critical during the next period of overseas investment.

As the top two most attractive emerging markets and preferred IT and business process offshore locations, China and India will continue to exert significant competitive pressures on the rest of the world and reshape the global business landscape. The U.S. economy will also continue to undergo structural adjustment resulting from the Sino-Indian dynamo, but given its preeminent status in the global economy, will continue to attract large volumes of FDI. Rising investor confidence in Australia, Hong Kong, Japan, Malaysia, and Singapore could add further momentum, helping increase Asia’s share of global FDI flows.

This year U.S. and European investors expressed robust confidence in one another’s markets. The European investor outlook on the U.S. economy was considerably more bullish and U.S. investors expressed stronger confidence in Europe’s major markets. With the transatlantic economy accounting for more than 80% of global FDI outflows, U.S. and European investors could help spur a return to positive FDI growth worldwide. Much will depend on the deepening of the economic recovery in Europe for this to occur. Central and Eastern Europe’s FDI prospects will also hinge on that recovery, as the countries of the region rely heavily on their more wealthy neighbors for corporate investments. Political leadership among Central and Eastern European countries will also be essential for these countries to smartly manage the risks and opportunities presented by EU accession process.

Unfulfilled reforms in key areas such as telecom, infrastructure, and energy, and the lure of China pose serious challenges to the future FDI competitiveness of Mexico. The loss of maquiladora manufacturing to lower-cost locations needs to be offset by investments in high-end manufacturing and services. Mexico may not be able to make the kind of big FDI gains as in the past since the financial sector is becoming saturated. Brazil, along with Mexico, faces strong competition from China, India and Poland. As the largest market in South America and with a return to macroeconomic stability, Brazil could reverse its FDI recession. Nevertheless, while China has the WTO, India IT, and Poland the EU, Brazil, for the moment, lacks a similar dynamism that could foster FDI — except for China's appetite for acquiring access to natural resources.

Methodology

The FDI Confidence Index was designed to gauge the likelihood of investment in specific markets in order to gain insights into likely trends in future global FDI flows. Since the inception of the FDI Confidence Index rankings in 1998, the top 10 most attractive FDI destinations have consistently received 40% or more of global FDI inflows roughly one year after the administration of the survey. Over the same period, on average the top 5 countries captured 37 percent, while the top 25 captured 72 percent of global FDI inflows one year after the release of survey results.

There is a strong positive correlation between the FDI Confidence Index country rankings and relative performance of countries accordingly to FDI inflows one year later. There is an even more robust relationship between the Index rankings and future bricks-and-mortar FDI once tax-haven-driven anomalies are accounted for.

The survey was constructed using primary data from a proprietary survey administered to senior executives of the world's 1,000 largest corporations. The population of companies was selected from the Global 1,000, as determined by 2003 revenues and represent 38 countries and 23 different industries (as categorized by three-digit SIC codes). Furthermore, the combined corporate revenues of these firms amount to US\$20 trillion. The countries represented in the survey account for more than 90 percent of total global FDI flows.

The participating executives include CEOs, CFOs, Board Members, and senior corporate strategists from 35 countries and 20 specific industries. The participating companies closely approximate the country and sector coverage of the Global 1,000 population, generate US\$3.3 trillion in annual sales and hold more than US\$14 trillion total global assets. Fieldwork for this survey was conducted between June and August 2004.

The Index was computed as a weighed average of the number of high, medium, low and "no interest" responses to a question about the likelihood of direct investment in a market over the next one to three year period. Index values are based on non-source country responses about various markets. For example, the Index ranking for the United States reflects all non-U.S. company responses about the U.S. market. All Index values have been calculated on a scale of zero to three, with three representing highly attractive and zero not attractive.

FDI Confidence Index

The main secondary sources used in this analysis are UNCTAD, the World Bank, the International Monetary Fund, the OECD, the EBRD, the UN-ECLAC and the Economist Intelligence Unit. Additional sources used include: country investment promotion agencies, country central banks, country ministries of finance and trade, as well as major newspapers and magazines.

	October 2004	September 2003	September 2002	February 2001	January 2000	June 1999	December 1998	June 1998
Rank	Country	Country	Country	Country	Country	Country	Country	Country
1.	China	China	China	United States	United States	United States	United States	United States
2.	United States	United States	United States	China	United Kingdom	China	Brazil	Brazil
3.	India	Mexico	United Kingdom	Brazil	China	United Kingdom	China	China
4.	United Kingdom	Poland	Germany	United Kingdom	Brazil	Brazil	United Kingdom	United Kingdom
5.	Germany	Germany	France	Mexico	Poland	Mexico	Germany	India
6.	France	India	Italy	Germany	Germany	India	Poland	Mexico
7.	Australia	United Kingdom	Spain	India	Mexico	Australia	India	Poland
8.	Hong Kong	Russia	Canada	Italy	Italy	Poland	Mexico	Argentina
9.	Italy	Brazil	Mexico	Spain	Spain	Germany	Spain	Australia
10.	Japan	Spain	Australia	France	Australia	France	France	Germany
11.	Russia	France	Poland	Poland	India	Italy	Italy	Spain
12.	Poland	Italy	Japan	Canada	France	Canada	Argentina	Italy
13.	Spain	Czech Republic	Brazil	Singapore	Canada	Spain	Netherlands	Russia
14.	Czech Republic	Canada	Czech Republic	Thailand	Thailand	Argentina	Australia	Hungary
15.	Malaysia	Japan	India	Australia	South Korea	Thailand	Thailand	Thailand
16.	Canada	Thailand	Hungary	Czech Republic	Japan	Czech Republic	South Korea	Czech Republic
17.	Brazil	Hungary	Russia	South Korea	Netherlands	South Korea	Canada	Canada
18.	Singapore	South Korea	Hong Kong	Netherlands	Czech Republic	Hungary	Czech Republic	Indonesia
19.	Hungary	Australia	Netherlands	Taiwan	Argentina	Netherlands	Japan	France
20.	Thailand	Taiwan	Thailand	Japan	Hungary	Singapore	Ireland	Chile
21.	South Korea	Vietnam	South Korea	Hungary	Singapore	Japan	Hungary	South Korea
22.	Mexico	Hong Kong	Singapore	Malaysia	Malaysia	Malaysia	Singapore	Malaysia
23.	Indonesia	Malaysia	Belgium	Turkey	Taiwan	Taiwan	Chile	Japan
24.	Netherlands	Turkey	Taiwan	Argentina	Belgium	Philippines	Belgium	Singapore
25.	Taiwan	Indonesia	Austria	Hong Kong	Ireland	Hong Kong	Taiwan	Philippines

Source: A.T. Kearney

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A.T. Kearney, Inc.
Marketing & Communications
222 West Adams Street
Chicago, Illinois 60606 U.S.A.
1 312 648 0111
fax: 1 312 223 6759
email: insight@atkearney.com
www.atkearney.com

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