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**Global FDI Recovery Clouded By Savings Glut Overhang, Say Global Executives in New A.T. Kearney Study**

*China maintains first place in annual ranking; India rises to second as U.S. falls to third  
Turkey achieves its highest position ever, placing 13<sup>th</sup> on the overall Index and ranking  
8<sup>th</sup> in terms of investor optimism.*

*Corporate R&D investments expected to shift from North America and Western Europe  
to developing Asia and Eastern Europe*

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Washington, D.C. – China, India, and Eastern Europe have reached new heights of attractiveness as foreign direct investment destinations and increasingly will challenge traditional R&D locations in the industrialized world, according to the latest Foreign Direct Investment Confidence Index<sup>®</sup>, an annual survey of executives from the world's largest companies, conducted by global management consulting firm A.T. Kearney. Quite noteworthy, investor confidence in Turkey has soared, placing the country among the top 15 investment destinations. European investors are especially bullish on Turkey while the optimism expressed about future flows shows that its performance is not a one-time phenomenon but could be the beginning of a trend.

**Turkey reaps the benefits of a stable economic environment and positive attitudes towards foreign investment**

While China and India are the top two most attractive destination for FDI flows, Turkey jumps up to 13th place – entering the top 20 most attractive countries for the first time. The potential for EU accession – although still uncertain - and reforms under the IMF sponsored stabilization program have helped push the country up in the Index. In January 2006 the central bank will formally adopt inflation targeting, part of the last phase in the four year process of reforming the country's monetary policy in the wake of the 2001

financial crisis. Although initiatives such as significant reductions in corporate taxes will likely aid this trend, sustained commitment to improving the business environment for foreign investors will be necessary for Turkey to leverage investor interest into sustained, robust increases in FDI flows.

“Growing investor enthusiasm for Turkey underscores the fact that the ‘fundamentals’ of an investment environment are the principal drivers of investment decision-making. The size and relative vibrancy of the Turkish economy has put the country on the foreign investors radar screen. Whether or not Turkey will be able to leverage this interest into sustained investment capital flows will be a function of how successfully Turkey can sustain its reform agenda and continue to improve investment conditions,” said Paul Laudicina, managing director of A.T. Kearney’s Global Business Policy Council, the sponsor of this research.

Turkey ranked 7th in the list of countries in which investors are considering first time investments over the next 3 years. Inflows of FDI in 2004 were at \$2.7 billion, a 56% increase over the previous year. The government reports that as of October, \$3.7 billion in FDI flows had been recorded in the country for the year 2005.

European investors are the most optimistic on Turkey. Turkey moved to 7th place in the European ranking, up from 21st last year, aided by highly favorable views from Italian investors who ranked Turkey as their number one FDI location, ahead of China and India.

Accelerated privatization attracts investors in increasing numbers, but protests by employees and legal challenges may cause delays. Turkey vaulted up to 11th place from 20th in the banking sector, with more than one in four sector investors saying that their outlook on Turkey was more positive. Investor interest in telecommunications is especially high. Turkey jumped from below top 25 to being the 12th most attractive destination for telecom and utilities investors. Manufacturing investors are more bullish. Turkey jumped from below 20 in both light and heavy manufacturing to 9th and 12th

places respectively. In the automobile sector, companies are increasingly looking to Turkey as an export platform for Europe with an intent to take advantage of the lower labor costs.

**Investors express less optimism about the global economy yet choose to invest overseas for top-line growth**

Optimism concerning the global economy among executives surveyed has waned since last year. This year just over a third of respondents (36%) are more optimistic about the global economy compared to 31% who are more negative. Last year nearly 70% were more bullish on the global economy and only 12% were more negative.

U.S. companies alone have reported accumulations in the last four years of more than \$1 trillion in cash, and a gloomier investor outlook could mean continued cash stockpiling. Global executives cite the need to improve their balance sheets, lingering fears of another economic downturn, shareholder pressures, and new interdependent business risks, as among the leading reasons for having accumulated record stores of cash.

However, the top-line growth imperative is pushing companies overseas again. This year 54 percent of executives say they are planning foreign investment increases, the largest number since 2000. Global FDI inflows rose by 2% to \$648 billion in 2004, the first positive change in FDI since 2000. As cross-border mergers and acquisitions resuscitate and competition intensifies, pressures to expand overseas are conflicting with the rationale for holding cash.

“Global executives face a series of conflicting pressures that may well moderate the FDI recovery,” said Paul Laudicina. “The top-line growth imperative and revival of cross-border M&A activity will run up against investor interest in maintaining cash cushions in a risk-laden world. These lingering fears may act as a drag on FDI. However those companies that fail to position themselves globally with strategic investments will be the most vulnerable to competitive pressure,” said Laudicina.

Global executives are more eager to commit FDI in China, India and Eastern Europe than at any time since 1998, while investor confidence in Brazil and Mexico rebounded.

For the fourth year in a row, China is the most preferred FDI location worldwide, while India rose from third to become the second most likely FDI destination for the first time. The United States dropped from second to third most attractive FDI location and the United Kingdom maintained its spot as the fourth most attractive FDI destination.

Along with Eastern European markets – nearly all of which rose in the rankings – China and India are increasingly seen as sources of innovation and attractive R&D locations. As R&D – the least globalized corporate activity – becomes more mobile, North America and Western Europe will be challenged by gradually maturing knowledge centers in the developing world.

**Corporate war chests have yet to be unleashed amid savings glut overhang**

Since September 11, 2001, more than half (65 percent) of global investors from the world's largest firms indicate that they have been building up significant cash reserves. U.S. companies alone accumulated more than \$1 trillion during that period.

According to global investors, the desire to improve corporate balance sheets has been the top reason for piling-up cash during this time. Creating a cushion for the next economic downturn was the second most frequently cited reason for building up cash, cited by 38 percent of global investors. Just as many investors consider limited investment opportunities as their reason for stockpiling cash. More than a third noted shareholder pressure (e.g. for dividends and buybacks) as their primary reason for increasing corporate savings. About 30 percent of investors cited increased perceived investment risks and nearly one in five said difficulty in evaluating FDI risk was their top reason for accumulating cash.

However, healthy profits and corporate restructuring have fueled cross-border merger and acquisition activity, a leading component of FDI, with the value of such deals increasing by 28 percent, reaching \$381 billion last year.

With large cash positions, companies are at risk of losing market position or at worst face a hostile takeover in an expansionary climate. Nearly half of investors who volunteered responses said they were building war chests for future investment opportunities, which if unleashed could lead to an FDI surge. But, the number of investors indicating planned investment increases rose modestly from 52 percent to 54 percent in 2005.

“The need to hold cash surpluses to weather the lean years and maintain shareholder confidence must be weighed carefully against the potential gains reaped from higher return investments overseas. Given the moderate rise in global FDI and continued cash hoarding, it would appear that these corporate war chests have yet to be fully unleashed,” said Jonathan White, manager of the FDI Confidence Index.

### **Corporate R&D will shift to developing Asia and Eastern Europe**

Nearly half of global investors plan to increase R&D spending and only 3 percent will decrease it over the next three years. Almost three-quarters of these increases will be allocated to developing Asia and Eastern Europe.

About one in five global investors indicate plans to increase R&D in North America and Western Europe, with virtually the same number of global investors indicating planned decreases in R&D investments in these locations, respectively.

Overseas migration of R&D spending is expected to rise. Global investors from North America and Western Europe said their most significant R&D spending reductions will occur in their home territories.

### **Cost and quality drive R&D investment location decision-making**

The three most important location attributes driving global R&D investments are lower R&D costs, availability and quality of local R&D labor, and intellectual property protection – with just over half of global investors citing these as the most important location attributes. The quality of universities and research centers and IT infrastructure were the fourth and fifth most important R&D investment location factors, with 46 percent and 42 percent of investors noting these factors, respectively.

About one third of investors believe that regulatory environment, reputation for creativity and innovation and ability to tailor products and services are most important R&D investment location attributes. Roughly 28 percent consider market size, while 26 percent view government R&D incentives as critical R&D location attributes.

**Globalization of R&D will be a balancing act, not a “zero-sum” event**

China and India are the most preferred countries for future R&D investments, according to the A.T. Kearney study, with slightly more than 40 percent of CEOs indicating they will likely make such investments in these markets over the next three years.

Almost one third of global investors cited Eastern European locations for R&D activities – with Poland and Russia leading the way. Investor preference for these slowly maturing R&D locations says much about their views on their future potential talent base, intellectual property protection, the quality of educational and research communities and infrastructure.

The United States, the United Kingdom, Japan and Germany trail China and India as the most preferred future R&D investment locations. As of 2003, these four industrialized countries’ combined gross domestic expenditure on R&D amounted to approximately \$520 billion, compared with an estimated \$26 billion spent in China and India combined. The U.S. and these other developed countries likely will remain on the frontier of innovation in most fields, but certain components of the corporate R&D process will benefit increasingly from support of developing world locations.

### **India joins China at the center of the FDI radar screen**

For the first time in the history of the Index, which began tracking the FDI intentions of global executives in 1998, emerging market countries are ranked first and second as the most attractive FDI locations in the world. Roughly 45% of global investors more upbeat on China and India compared to last year – nearly twice the number recorded for the next three most positively viewed markets, Brazil, Poland, and Russia. Investor enthusiasm for China and India is at an all-time high. China achieved the highest country Index raw score ever, while India hit a raw score surpassed only by China and the U.S. in previous years. China and India took the first and second spots across nearly all broad sector categories.

While China has held the first spot since 2002, a strong increase in investor interest in India is a more recent development. Despite India's successful positioning as a business processing and information technology outsourcing hub, these activities often translate into Indian service sector exports via third party transactions – not FDI. Last year, Indian FDI inflows reached \$5.3 billion, compared with China's \$60.6 billion. India has yet to build a critical mass in FDI, having only initiated investment-attracting reforms in 1991. China's pro-FDI regime has been in place since 1979. India's technology and IT-oriented economy has received fewer capital-intensive FDI flows relative to China, whose entire manufacturing base has been, in large part, established by foreign multinational companies.

“India is on the cusp of an FDI take-off. However, for India to harness manufacturing investor interest and evolve into an FDI capital-intensive hub, the government must maintain its reform orientation and overcome narrow business interests, consistently addressing the country's infrastructure, logistics, and regulatory barriers”, said Paul Laudicina.

### **The U.S. drops to 3<sup>rd</sup> place for the first time**

The U.S. dropped from second to third most attractive future FDI location for the first time, losing ground mainly in the light manufacturing and financial services sector.

Although FDI in the U.S. financial sector has been high in recent years, financial service investors ranked the U.S. their 6<sup>th</sup> most attractive market, down from second place globally in 2004. More than a third of global insurance carriers are more negative on the U.S. market, likely the result of the \$70 billion plus costs resulting from the country's destructive hurricane season.

Investors from highly competitive light manufacturing segments such as electronics, food and textiles are less likely to commit FDI in U.S. and instead prefer low-cost, fast-growing emerging markets. China, India, Brazil, Russia, Poland, Mexico and Hungary take the first seven spots in the light manufacturing rankings, with the U.S. ranked eighth – down from third place.

In 2004, the U.S. was the largest FDI recipient in the world – capturing \$96 billion, a strong rebound from the \$56.8 billion received in 2003. Based on estimates for the first half of 2005, the U.S. could achieve similar levels of FDI in 2005.

Producing \$12.5 trillion in GDP, three times the next largest market, Japan, and having weathered unprecedented current-account deficits and multiple and massive natural disasters, the U.S. economy remains unparalleled in history. Primary sector, telecom and utility and heavy manufacturing investors – specifically in high-technology and computer equipment firms - rank the U.S. among their top five most attractive FDI locations. Underlying the strength of the U.S. economy are U.S. companies, which last year directed more investments overseas than ever before, approximately \$229 billion, reinforcing the U.S. role as a primary source of FDI.

With U.S. companies apparently taking advantage of the tax break on repatriated earnings under the Homeland Investment Act, U.S. FDI outflows are estimated to be nearly \$60 billion for the first half of 2005 down from \$108 billion over the same period in 2004. “Since the U.S. accounts for nearly one-third of total global FDI outflows, these U.S. tax-

driven repatriations could have a moderating effect on global FDI in 2005”, said Jonathan White.

### **Western Europe’s FDI prospects dim**

Not since 1999 have so few Western European countries been represented in the top ten most attractive FDI locations. Between 2000 and 2004, Western Europe took between three to five spots in the top ten. However, this year only two remained – the U.K. and Germany.

While the United Kingdom maintained fourth place, Germany declined from fifth to ninth, France from sixth to 14<sup>th</sup>, Italy from ninth to 19<sup>th</sup> and Spain from 13<sup>th</sup> to 17<sup>th</sup> place. The decline of attractiveness of Western European markets was most strongly reported by manufacturing investors, who instead favor China, India, Brazil, Russia, Poland, and Mexico. “These results further underscore many other indices reflecting fundamental declines in Western European competitiveness,” said Laudicina.

In 2004, the EU15 countries experienced a 40 percent decline in FDI inflows – hitting \$196 billion, a six-year low. Sluggish growth, disinvestments and substantial repayments of intra-firm credits by foreign affiliates to their parent firms overseas have contributed to the FDI declines. The rejection of the EU constitution by the electorates of France and the Netherlands, two founding members of the EU, as well as the shifting political scene in Germany – Europe’s largest economy – have likely added to this shift in investor sentiment.

### **Investment confidence soars for Eastern European and Turkish markets**

Eastern European markets experienced a sharp increase in FDI confidence levels – with Poland (fifth), Russia (sixth), Hungary (11<sup>th</sup>), the Czech Republic (12<sup>th</sup>), Turkey (13<sup>th</sup>) and Romania (25<sup>th</sup>) all rising in the rankings and all achieving record highs save Poland.

Poland, Russia, Turkey, the Baltic States and the Czech Republic rank among the top ten countries with the most upbeat outlooks among investors. EU entry has created greater

market access, reduced trade and investment barriers and increased market stability. The anticipation of EU entry has extended investor confidence to aspirant countries such as Romania and even Turkey – both of which were ranked among the top 25 most attractive markets for the first time ever. Relatively faster growth rates, lower corporate taxes, and favorable productivity levels, helping offset rising costs, are likely adding to stronger investor interest in the region.

Communications investors are the most bullish on Eastern Europe and Turkey – ranking Poland first, Hungary second, the Baltic states fourth, the Czech Republic fifth, Slovakia seventh, Turkey ninth and Croatia 15<sup>th</sup>. Telecom liberalization and deregulation, low mobile phone penetration rates and growing dynamic, adaptive consumer markets are bolstering the region’s telecom FDI prospects. “Though suffering some declines in cost competitiveness vis-à-vis other developing regions of the world, Eastern European locations score well as FDI moves up the value chain to more knowledge-intensive investments,” said Laudicina.

Eastern Europe is viewed positively as a R&D location as well – offering both low-costs and scientific and engineering capabilities. Nearly a third of global investors said they planned R&D-oriented FDI in Eastern Europe over the next three years.

### **Brazil and Mexico regain lost ground among investors**

Brazilian FDI inflows jumped by nearly 80 percent, reaching \$18.2 billion in 2004. This FDI momentum could continue, as Brazil reentered the ten most attractive markets, taking seventh place in 2005 (up from 17<sup>th</sup>).

Brazil’s economic recovery and rising income levels have fueled interest from wholesale and retail investors, who ranked it their third most preferred destination globally.

Financial service and telecommunication and utility investors, who previously soured on the market in the face of macroeconomic and regulatory instability, are now rethinking the Brazilian market. With debt and inflation under control, financial services investors ranked Brazil 14<sup>th</sup> and telecommunication and utility investors ranked it their 16<sup>th</sup> most

attractive foreign investment destination. Investors from these industries ranked Brazil below their top 25 markets in 2004.

Electronics manufacturers, who ranked Brazil sixth in 2004, consider the country the third most attractive market this year – just behind China and India. Automotive companies maintain a robust interest in Brazil, ranking it sixth globally – down one notch from fifth place in 2004. Chemicals, fabricated metal, industrial machinery, and computer equipment, mining and raw material manufacturers eager to meet global demand for a wide range of commodities also showed stronger confidence in the Brazilian market.

Mexico climbed to 16<sup>th</sup> place this year after ranking 22<sup>nd</sup> in 2004 – a rise primarily attributed to increased manufacturing investor attractiveness. Heavy and light manufacturers considered Mexico their 15<sup>th</sup> and 21<sup>st</sup> most preferred FDI location, respectively, in 2004, but ranked it their eight and sixth most attractive FDI location in 2005. Mexico is also benefiting from the surge in global commodity demand, as raw material investors ranked Mexico their eighth most preferred FDI location.

The most notable improvement was in the electronics sector, where Mexico soared from 21<sup>st</sup> to fourth most attractive FDI location. Over the course of 2005, global electronics manufacturing firms have been acquiring facilities and land along the U.S. border, suggesting that the improvement in FDI into the *maquiladora* sector recorded in 2004 could continue. Overall Mexican FDI inflows increased from \$11.3 billion in 2003 to \$16.6 billion in 2004.

Oil and gas investors ranked Mexico in 16<sup>th</sup> place, down from seventh place in 2004. As the country prepares for the July 2006 Presidential election, future reform in the energy sector will be less likely – possibly delaying further the much-needed infrastructure and technology investments necessary to upgrade the oil, gas and electricity sectors and help reduce business costs. Without additional resources and technical support, much of Mexico's reserves may remain untapped and the country may soon become a net oil importer.

Japanese investors expressed the highest levels of interest in the Mexican market, ranking it their fifth most attractive FDI location worldwide, likely the result of new opportunities emerging from the recently enacted free trade agreement between Mexico and Japan.

**The offshoring pace intensifies, but the FDI impact will vary**

The urge to offshore continues to grow, as nearly 80 percent of global investors plan to locate corporate functions overseas over the next three years, compared to 66 percent in 2004 and 50 percent in 2003. Corporate investors will pursue offshoring opportunities more aggressively across all major functions – information technology, call centers, business processing, distribution, knowledge management, R&D, and manufacturing.

Information technology and call center functions will see the highest levels of offshoring activity, with 67 percent and 50 percent of global investors expecting to offshore these functions, respectively. For the first time in three years, just as many global investors expect to offshore their business process functions as will offshore R&D – 41 percent.

However, operating models used to offshore corporate functions will vary between captive and joint venture modes (which result in FDI) and third-party outsourcing and other non-FDI business transactions.

Given concerns over intellectual property and quality control issues, R&D, knowledge management and analytic functions will primarily occur through FDI (i.e. captive or joint venture). Nearly 70 percent of future R&D offshoring will be through FDI, while the remaining offshore R&D activity will occur through third-party outsourcing or other non-FDI channels. “Intellectual property protection will be central to whether the developing world will be able to lure the R&D investment it is capable of attracting,” said Jonathan White.

However, for information technology, call centers and distribution and logistics, global investors prefer to rely on third-party outsourcing contacts and other non-FDI operating

models. About 55 percent of global investors plan to work with an IT provider when offshoring this function. Despite the rapidly growing business process outsourcing (BPO) market, only 28 percent of global investors expect to turn to outside service providers to handle their BPO functions, such as HR, finance, and accounting. Nearly 60 percent favor a captive or JV operating model instead.

According to global investors who have offshored, 60 percent believe their expectations have either been met or exceeded. About 17% believe that their expectations have not been met. Nearly one in four are not sure if their offshore expectations were met. This explains why about 75 percent of investors said establishing and monitoring performance measures was most critical to the success of their offshore migration process.

For these same investors, the two other most important actions critical to the success of the offshore migration process are gaining commitment from senior levels of the organization and rigorously researching and selecting the offshore location or vendor. Roughly three-quarters of global investors cited these activities as extremely important to the success of their offshoring strategy. Laudicina notes “offshoring is not a simple site/provider selection process as some may have imagined, particularly for increasingly sophisticated and sensitive functions.” The next most important offshoring task noted by global investors is empowering and holding accountable the program management team.

### **The Dearth of African FDI could be ending**

Although burdened with some of the highest business costs in the world along with weak governance and poor growth, Africa is viewed more positively by global investors. About 17 percent of senior executives are more upbeat on Africa’s outlook, while only 11 percent are more negative on the continent’s investment prospects compared to a year ago.

The international donor community is increasingly focused on debt relief and more effective development assistance, while leading global companies are exploring new

business models where economic and social development issues intersect profitable growth strategies in Africa. “If the current momentum for reform and building stronger ties with the global business community continues, the continent may see this higher level of investor interest translate into greater FDI flows,” notes Jonathan White.

Among the leading African nations expected to attract future FDI are South Africa, Nigeria, Egypt, Morocco and Kenya. The bulk of African FDI remains concentrated in resources-based industries. FDI flows and corporate investor interest are limited to just a few key markets.

Average FDI inflows to Africa have risen to \$17 billion between 2001 to 2004, compared with \$10 billion during the preceding four years. However, the continent barely captures 3 percent of total global FDI compared with developing Asia, which receives nearly one in every four FDI dollars. FDI remains more a lagging than a leading factor in growth and development in the region. Targeted public and private sector initiatives that link industry, education, human capital and institutional capacity-building will be required in order for greater FDI to assist in a virtuous cycle of economic growth, job creation and rising incomes.

### **About A.T. Kearney**

A.T. Kearney is one of the world’s largest management consulting firms. With a global presence that includes offices in 34 countries, A.T. Kearney provides consulting services in the areas of strategic operations management, transformation and organization, and technology strategy to leading private and public sector clients around the world.

Over the past three years, A.T. Kearney has provided management consulting services to 69 companies out of the *Fortune* 100 in North America and to 73 of the *Fortune* Global 100 worldwide.

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