

*FDI Confidence Index®*  
*Global Business Policy Council*



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GLOBAL BUSINESS



POLICY COUNCIL

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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](http://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.

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# Introduction

Top corporate decision-makers around the world remain skeptical about the revival of the U.S. economy in 2002. Despite the fitful signs of a nascent economic recovery in the United States, the excesses of the economic boom of the 1990s continue to unravel and dampen corporate investors' outlook. Revelations of corporate fraud, the ripple effects of a deflated bubble economy, the increased costs of security as well as the threat of terrorism have further complicated the business environment—both in the United States and elsewhere. Moreover, the future of globalization remains uncertain as senior executives express concern over the prospects for future trade expansion as well as brewing anti-corporate and anti-brand public sentiments.

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

Over the past five years, we have surveyed CEOs, CFOs and other top decision-makers from the world's largest 1,000 firms about their opinions of various FDI destinations and their intentions for future cross-border corporate investments. Responses from participating firms about their views of 60 countries, which receive 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 US\$18 trillion in annual sales. These companies represent all regions and all sectors.

*\*Foreign direct investment includes investment 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.*



show more interest in Japan as an investment destination. However, growing confidence in China and Japan and a return of economic and political stability to the region have not bolstered investor sentiment elsewhere in Asia.

Despite an uneven economic recovery in Europe, investors continue to place European countries among the most attractive worldwide. Central European countries also hold promise as they aggressively transition to market economies. Further east, new leadership and a reviving economy are positive developments for Russia, which achieved the highest individual improvement in investor attractiveness worldwide.

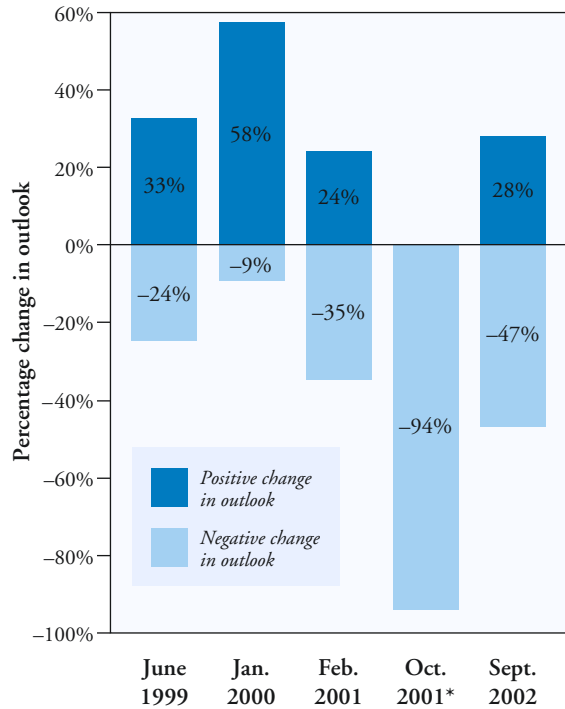
The perceived backtracking of political and economic reforms and the fear of social unrest have likely undermined FDI prospects for Latin America. As the Argentine crisis continues unabated and Brazil faces economic and political uncertainty, the region's investment prospects have deteriorated.

**GLOBAL 1,000 FOREIGN INVESTMENT PROSPECTS DIM**

With economic indicators pointing toward a slow and fitful recovery for the U.S. economy, nearly half of decision-makers from the world's largest firms indicate a more negative outlook for the global economy. Investors have become increasingly more pessimistic since last year's Index, when one-third of investors expressed this sentiment. However, in the immediate aftermath of the September 11 terrorist attacks, 94 percent of investors cited a more pessimistic outlook. So, although the outlook remains somber, there are still signs of improvement (see figure 2).

More than half—roughly 60 percent—of corporate investors indicated that they would

Figure 2: Corporate investor outlook on the global economy compared to one year ago



\*Note: Post-September 11th FDI Flash Survey  
Source: A.T. Kearney

maintain steady levels of investment abroad in line with last year's results. However, the number of planned investment increases fell, and planned decreases rose, thereby reducing net planned investment forecast among the world's largest global investors. In line with this, investors expressed less confidence in investment destinations worldwide, as revealed by a lower world Index score—a GDP-weighted proxy for the likelihood of foreign direct investment—which fell from 1.43 to 1.38. In other words, for the first time since the Asian financial crisis, the likelihood to invest abroad has declined.

Over half of U.S. investors harbor a more negative view of the global economy, up from

only one-third a year ago. Almost one-quarter of American investors indicated plans to decrease their number of investments, although three-quarters are expected to increase or maintain last year's investment levels. This "wait and see" attitude has slightly eroded since 2001, when 88 percent of investors expressed this view. Our FDI Flash Survey revealed that immediately after September 11, American investors decided to sit tight. But since then, the unusual pace and nature of the recovery, sagging equity markets and revelations about corporate accounting have dampened CEO willingness to make investments abroad.

European executives have the most negative outlook on the global economy and have expressed the greatest increase in pessimism, with 53 percent citing a more negative outlook compared with only one-third in last year's Index. Only one of 10 European investors plans to increase investments, while more than twice as many North Americans and three times as many Asian investors plan to increase investments this year. Italian and German executives hold the most negative outlook on the global economy: Twice as many executives from these countries adopted a dim view of the global economy compared with last year. It's no surprise then, that nearly one-third of Italian and German firms plan to decrease their foreign investments. However, 60 percent of French executives will maintain investment levels, and as many as 93 percent of British executives plan to do likewise.

As with last year's results, Asian investors have the most positive outlook toward the global economy. Roughly half of North American and European investors are downbeat on the global economy; less than one-third of Asian executives

offer this view. Unlike other global executives, more Asian investors express their intention to increase than decrease their investments.

#### **INVESTORS' PRINCIPAL CONCERN IS THE U.S. ECONOMY**

Investors in all regions and sectors ranked the state of the U.S. economy as their primary source of unease and biggest likely driver of future investment decisions. Many indicators, however, suggest that the United States is emerging from what has been characterized as the mildest recession on record. Contrary to initial fears that the September 11 terrorist attacks would intensify the U.S. recession, they actually seem to have coincided with the beginning of its recovery. Despite a weakening dollar and a growing current account deficit, productivity rates continue to improve and inflation seems very much under control. The U.S. economy was the principal concern of CEOs last year, with just over three-quarters indicating it was most critical to their investment decisions. This year an unprecedented nine out of 10 CEOs expressed concern over the recovery of the world's leading economy, with more than half listing it as most important to their future FDI decisions (*see figure 3*).

#### **TRADE ISSUES ARE IMPORTANT TO FDI DECISION-MAKING**

Although U.S. economic woes prompted investor anxiety over the past year, trade emerged for the first time as a potentially distressing issue for future FDI flows. Nearly two-thirds of top executives singled out global or regional trade initiatives, or lack thereof, as likely affecting their investment decisions this year.

Figure 3: Global developments most likely to influence FDI decisions



Source: A.T. Kearney

In a volatile global environment, it is not surprising that investors are becoming more apprehensive about the prospect of slowing global economic integration. As most of the world's major economies have collectively stalled, trade and investment flows have consequently suffered. With roughly one-third of all global trade occurring within firms—between subsidiaries and between subsidiaries and headquarters—trade openness directly affects corporate operations. There is a sense that without government commitment to maintain open trade and capital flows, the pace of globalization may falter. In singling out trade initiatives, CEOs likely view the lack of momentum on the trade front as an obstacle to a friendly cross-border investment climate and consider depressed trade flows as narrowing their investment opportunities abroad.

Trade growth, a principal indicator of integration, stalled in 2001 after steady annual

increases averaging 7 percent throughout the 1990s. With terrorism and corporate governance issues taking center stage, trade liberalization talks at the WTO appear to lack needed momentum. Protectionist U.S. actions on steel and agricultural goods help explain why 43 percent of global decision-makers cited trade policy as potentially adversely affecting the attractiveness of the American market. Although the U.S. Trade Promotion Authority Act was approved since this survey was conducted, it remains uncertain whether the United States will find common ground with its major trade partners.

As a further setback, trade relations between the United States and the European Union, which represent more than half of global trade, have grown increasingly strained, with European trade officials threatening retaliatory action against the United States. Europe, however, is not immune to protectionist tendencies:

The EU is under pressure to reform its Common Agricultural Policy as Central and East European farmers seek preferential market access through community enlargement.

Given the increasing importance of trade initiatives to FDI decisions, regional trade agreements surfaced as decisive for Latin America, with a majority of CEOs citing a Free Trade Area of the Americas (FTAA) agreement as critical to increasing the region's attractiveness. The prospect of an FTAA ranked particularly high for Japanese and U.S. investors (63 percent and 67 percent respectively) in assessing the region as an investment destination. Much to the disadvantage of Latin America, hopes for an FTAA agreement have weakened amidst the economic crisis in Argentina and investor concerns about the outlook for Brazil, leading some even to pronounce Mercosur is dead. Only one third of global executives now cite Mercosur as a trade arrangement likely to bolster Latin America's attractiveness. Trade liberalization in Asia looks even less likely, as the ASEAN countries have made little progress in further lowering intra-regional trade barriers.

The frail nature of the current trade environment not only poses specific problems for policymakers, it also poses a general threat to the continued growth of foreign direct investment and to the globalization process itself. Inasmuch as a principle impetus of foreign investment is to globalize the various stages of production, FDI cannot prosper when the arteries of trade are blocked by protectionist policies. Whether multinationals decide to move production abroad to lower labor costs, optimize export platforms or harness other country-specific resources or capabilities, their

options are inherently limited in an unfavorable trade environment.

Despite the somewhat pessimistic outlook for further trade integration, it is expected that trade volumes will accelerate as the global economy recovers. In fact, forecasts by the Economist Intelligence Unit suggest that world trade will grow, on average, 7.4 percent annually between 2003 to 2006, with developing countries reaping most of the gains from the increased trade volume.

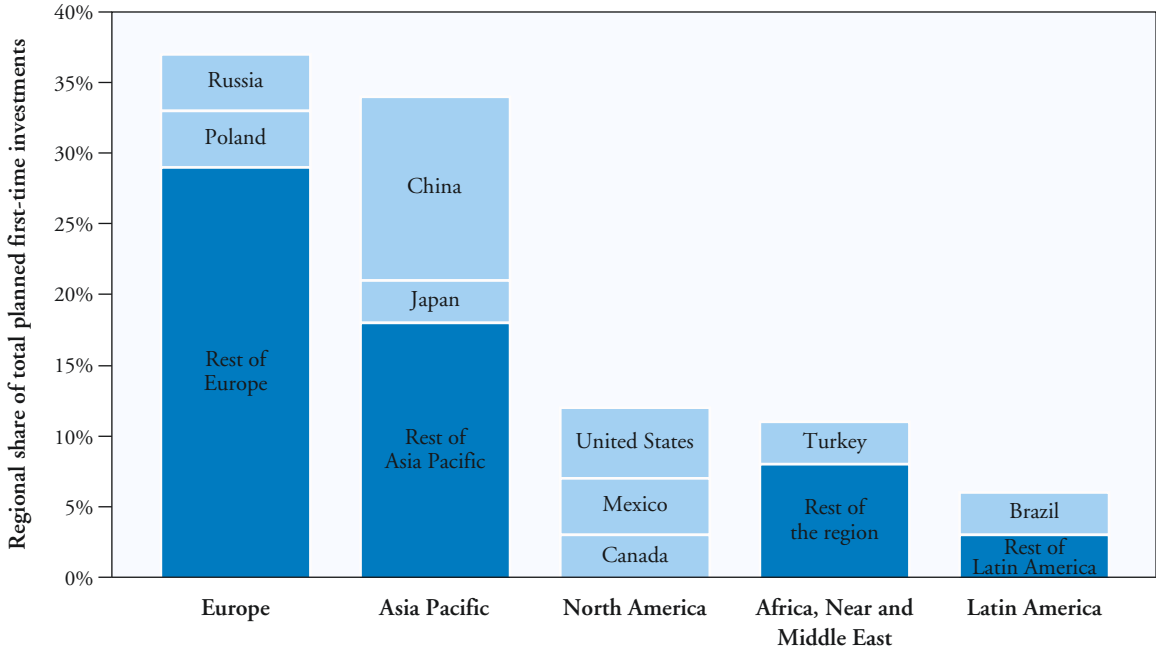
#### INVESTORS STRIKE A BALANCE BETWEEN INDUSTRIAL AND EMERGING ECONOMIES

Unlike last year, when many first-time investments gravitated to a few big emerging markets—Mexico, India, China and Brazil—investors this year have become more intent on balancing their FDI portfolios of first-time investment between a few select emerging markets and developed economies. Nearly one in three global executives cited China as a preferred first-time investment destination, more often than any other market. The United States was mentioned second most often as a first-time investment location. Russia followed close behind, and could well to be a target for almost as many first-time investments as the United States (*see figure 4*).

Roughly three-quarters of all first-time investment over the next three years will likely be made in developing economies, with China, Russia, Mexico and Poland topping the list. Combined, these countries are expected to accumulate about one-quarter of all proposed new investment commitments during this time period.

Among industrialized economies, the United States and Japan rank among the preferred

Figure 4: Planned new market entry by region



Source: A.T. Kearney

first-time investment destinations. Although investors are this year slightly less attracted to the U.S. market, many global investors who have previously not operated in the United States plan to invest there. Clearly, the lure of the world's largest market, which remains twice the size of Japan's and one-third larger than the eurozone, is strong.

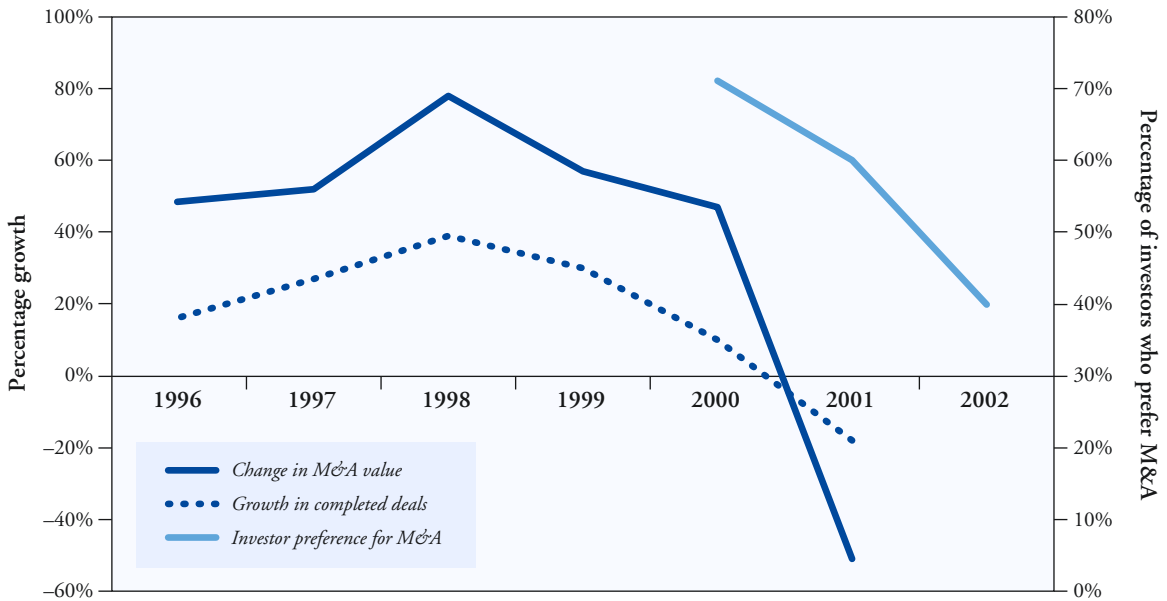
In regional terms, Europe has become the most attractive destination for first-time investments: More than one-third of global executives are expected to commit investments for the first time in Europe over the next three years. Among the top first-time investment destinations cited in the region were Russia, Poland and the Czech Republic. However, executives indicate that first-time investment in Europe is nearly evenly divided between industrial and emerging markets: Italy, France, Ireland,

Germany, the United Kingdom and Austria are expected to receive nearly one-quarter of all first-time European investment.

#### M&A LOSES ITS FLAVOR

For the first time in three years, mergers and acquisitions are not the preferred mode of foreign market entry for the majority of corporate decision-makers. In 2002 only 40 percent of global investors preferred M&A to other modes of entry, compared with 60 percent in 2001 and 71 percent in 2000. After the extraordinary M&A boom of the late 1990s, the era of megadeals appears to be over—or at least on hold. The value of cross-border M&A deals in 2001 fell to roughly US\$600 billion, down from US\$1.1 trillion in 2000. In the first half of 2002, M&A outflows from countries in the Organization for Economic Cooperation and

Figure 5: Investor preference for mergers and acquisitions (M&amp;A) as FDI mode of entry



Source: A.T. Kearney, KPMG, Thompson Financial

Development (OECD)—which are responsible for the majority of M&A flows—reached just US\$185 billion, according to the OECD. If this diminished pace continues, it would represent a 20 percent decline in cross-border merger and acquisition flows for 2002, consistent with the decrease evident in our findings (see figure 5).

The light manufacturing, financial services and primary sectors reveal the strongest shifts in preference away from M&A. Although the financial services sector experienced some of the greatest M&A activity in 2001, further consolidation has left fewer M&A opportunities. Within the primary sector, mining companies experienced notably high levels of M&A activity in 2001. The US\$11.9 billion merger between Billiton of the United Kingdom and BHP of Australia created the world's largest resource conglomerate. However, in 2002, investors within

the primary sector are 26 percent less likely to make foreign direct investments—the greatest decrease among global executives over the next one to three years.

Still, a majority of telecom and utility firms continued to favor M&As, with 60 percent expressing a preference for this mode of market entry. Although the telecom sector experienced the largest drop in M&A flows in 2001, it continued to be the dominant sector for M&A transactions, with deals such as the acquisition of VoiceStream Wireless of the United States by Deutsche Telekom of Germany for US\$24.6 billion. So far this year the utilities sector has also seen significant M&A action. Duke Energy Corporation of the United States acquiring Westcoast Energy of Canada for US\$3.4 billion and RWE of Germany acquiring Innogy Holdings of the United Kingdom for US\$7.8 billion are examples.

# International Business Strategy

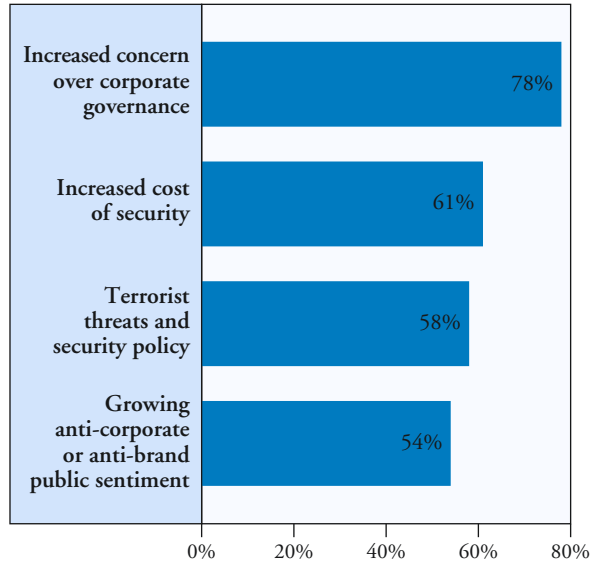
## CHANGES IN CORPORATE GOVERNANCE WILL INFLUENCE STRATEGIC PLANNING

According to global executives, corporate governance issues are the most important business environment factors likely to affect firm strategy. The demise of Enron and executive shakeups at other corporate giants such as Global Crossing, Tyco and WorldCom help explain why nearly 80 percent of CEOs cited corporate governance as their top concern.

In the United States, legislators, stock exchanges, institutional investors, ratings agencies and corporate watchdogs, as well as numerous business and professional associations, are seeking to influence the outcome of the corporate governance debate. Top executives are rightfully concerned about how their corporate strategies will be affected. New listing requirements could affect access to capital, accounting changes could alter entire business models, more rigorous rating systems could transform the way firms are valued, and new oversight—from boards as well as regulators—could fundamentally change business strategy development.

This unease has stretched beyond the United States. Executives from Germany voiced their concern as loudly as their American counterparts, with roughly 90 percent of executives from both countries ranking corporate governance as the most important factor affecting business strategy. Eighty percent of French and Italian executives expressed similar apprehension. Although Asian executives ranked this concern second, after the costs of security, more than two-thirds cited

Figure 6: Business environment factors most likely to affect corporate strategy



Source: A.T. Kearney

it as a vital factor to their business strategy (see figure 6).

## SECURITY ISSUES CONCERN INVESTORS

The increased cost of security and ongoing terrorist threats also ranked high as business environment factors affecting firm strategy. Overall, nearly two-thirds of investors are worried about increased security costs influencing firm strategy. More than 80 percent of Asian investors were disquieted by the prospect of increased security costs, with Japanese executives citing it as their top concern. In North America about 60 percent, and in Europe, roughly 50 percent of executives are troubled by the financial burden associated with the need for tighter security.

The heightened concerns expressed by Asian investors over security costs are evident from

the deliberations of APEC (the Asia-Pacific Economic Cooperation forum), which is examining the prospect of a multilateral military security arrangement for the region. Given the extraordinary strategic importance of the supply lines of Southeast Asia, this is a positive step.

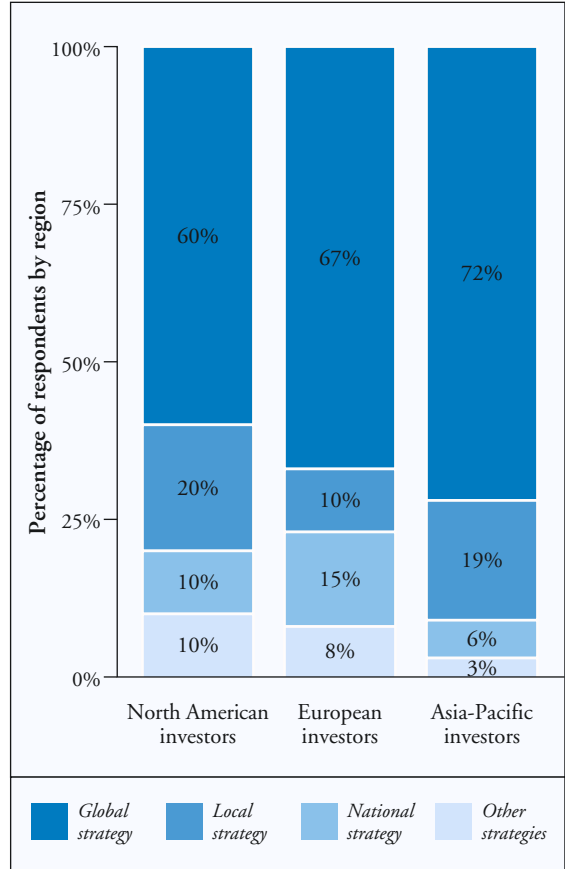
Security costs for airfreight alone have increased an estimated 15 percent since September 11. Given the potential impact to global supply chain systems, it is no surprise that 70 percent of senior executives in heavy manufacturing and 74 percent in the light manufacturing singled out this factor as chief among their concerns. Institutionally, the traditional mechanisms for ensuring security to the corporate operations infrastructure—physical and virtual—will require both new attention and increased investment.

**THE BRANDING CONUNDRUM**

Global executives recognize that success not only hinges on investing in plants, technology and people, but also brands. When pursuing a foreign direct investment opportunity aimed at capturing market share, two-thirds of investors prefer a marketing strategy that promotes their products and company under a global rather than local or national brand name. Yet more than half of investors consider growing anti-corporate or anti-brand public sentiment to be an important factor affecting their firm’s strategy. One in five executives views this as the most important factor underlying the increasingly negative corporate environment.

Still, investors believe that greater market-share is more likely to be gained by marketing a product or a corporate identity under a global name, despite the anti-business and anti-brand backlash. Executives are not altering their

Figure 7: Preferred market strategies for capturing local market share

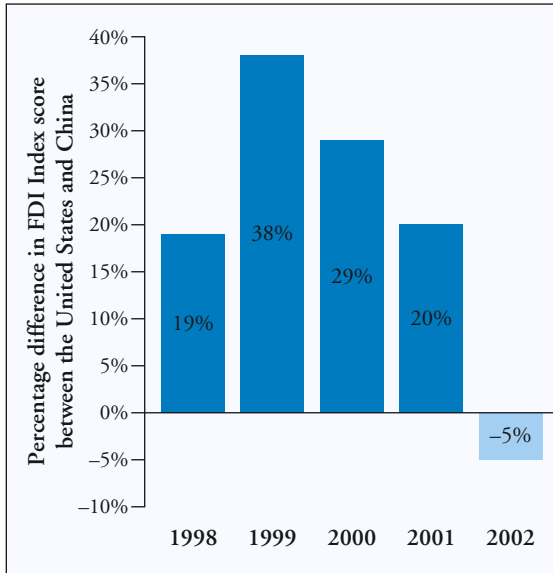


Source: A.T. Kearney

strategies in the face of this threat: Nearly 90 percent of respondents confirm that the marketing strategies they prefer do not reflect any change in their normal method of doing business.

Asian investors are the most aggressive in adopting global strategies, with 72 percent preferring this approach (see figure 7). In Europe, this number drops to 67 percent, and stands at 60 for North American investors. Despite the general preference for global marketing strategies, more than one-quarter of all investors pursue local or national marketing strategies. German and Italian executives are most keen on

Figure 8: U.S. lead over China  
in relative investment attractiveness declines



Source: A.T. Kearney

promoting their products and companies under a national banner, with about 20 percent and 30 percent respectively believing this is the best way to gain brand loyalty. French firms stand out as an exception, with a full 100 percent preferring the global approach exclusively. One-fifth of British, Italian, American and Canadian firms believe that to achieve greater market share they must appeal to local tastes when developing a marketing strategy.

In terms of sectors, more than 80 percent of heavy manufacturing firms believe that global brands will achieve higher marketshare results—more than any other sector—while less than half of financial services firms put their faith in this strategy. More firms from the financial services sector pursue either local or national branding strategies compared with other sectors, except for the primary sector, which took the lead in adopting local strategies.

## Regional Analysis

### NORTH AMERICA

*The United States loses its lead in the FDI attractiveness race to China.* For the first time in five years, the United States was knocked out of the top spot as the number one foreign investment destination for global investors from the world's largest 1,000 corporations. After lagging behind the United States, by as much as 38 percent in relative investor attractiveness in 1999, China claimed the lead position, with investors giving it a 5 percent edge over the United States (see figure 8). Decreasing investor interest in the U.S. market is reflected in the unanimous reduction in the likelihood of investment across all sectors, with investors from the non-financial services and wholesale and retail sectors showing the greatest decline in investor interest. Although British investors are the most confident in the U.S. market, their likelihood of investing is also diminishing this year.

*Investor outlook for the United States turns highly volatile.* A slow and uncertain economic recovery, stock market uncertainty, corporate scandals and continuing concerns about homeland security fueled volatility in investors' sentiment toward the U.S. market. Concerns about the medium-term effects of a moderate recovery—such as the risks posed by the combination of a large U.S. current account deficit (now reaching 5 percent of GDP) with a dramatic reduction in capital inflows from abroad—contribute to changing investor perspectives. Estimates indicate that foreign investment flows into the United States in 2001 declined by nearly 60 percent compared with 2000. This year, volatility—measured as the percent of executives whose outlook for the market has

changed over the past year—peaked at nearly 40 percent, placing the United States third in outlook volatility after China and Argentina.

However, investor sentiment toward the United States has rebounded somewhat from the lows recorded immediately after September 11, according to A.T. Kearney's FDI Confidence Index Flash Survey 2001. Then, nearly one-third of global investors indicated a worsening of their outlook on the U.S. market, while only 17 percent expressed the same sentiment this year. Moreover, the United States continues to be the number one foreign investment destination for British, Canadian and German investors.

*China and Japan shine as sole targets for increased U.S. investment.* American investors

When questioned about the principal factors that can ensure U.S. attractiveness relative to other markets, economic recovery still ranks highest among investors' concerns. Almost every corporate executive noted economic recovery as a vital factor, with more than four-fifths of investors citing it as the single most important aspect for retaining U.S. market attractiveness. Global investors consider competition and trade policy, labor market flexibility and productivity rates the most important attractive attributes of the U.S. market. Despite increased threats of terrorism and impending legislation aimed at improving corporate governance, these concerns were judged less likely to hinder U.S. attractiveness than the economic

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*Japan, a market that was nearly off the U.S. investor radar screen last year, shines in 2002.*

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ranked China as the most attractive destination for their foreign investment, expressing a 21 percent higher likelihood of investing in the Chinese market than they did last year. Forty-three percent of U.S. investors have a more positive outlook of the Chinese market today, while none indicated having a more negative perspective. Japan, a market that was nearly off the U.S. investor radar screen last year, shines in 2002 with 22 percent of investors expressing a greater probability of investing in the Japanese market. Mexico dropped to second place after having been the number one investment destination for U.S. executives last year, while Brazil fell from third to seventh position in the eyes of U.S. investors.

*The United States' relative attractiveness for investment still depends on economic fundamentals.*

fundamentals according to global investors.

*Canada joins the top 10 for the first time.* Making a slow but steady climb from 17th position in 1998 to eighth position in 2002, Canada has joined the ranks of the 10 most attractive destinations for foreign investment. Canada receives its highest ranking from Swiss investors, who place it third after China and the United States in their list of most attractive near-future investment locations. Likewise, U.S., British, Dutch and Australian investors indicate the greatest likelihood of investing in Canada over the next one to three years. From an industrial perspective, Canada ranks high this year for investors from the primary sector who ranked it fourth after Australia, Chile and Brazil, and for investors from the financial

services sector who ranked it the eighth most attractive destination worldwide. Canada also performed particularly well in the mining, stone, glass and concrete, and banking sub-sectors.

*Canadian executives diversify their portfolio of preferred investment targets with a radical shift away from Asia.* While nine out of the top 10 most attractive destinations for Canadian executives were in Asia last year, only two countries—Australia and China—remain so in 2002. Canadian investors are taking a more diversified approach and now find the United Kingdom, Australia, France, Mexico, Chile and Hungary to be among the most attractive foreign investment locations. Unchanged, though, is the Canadian executives' strong preference for the U.S. market, which again ranked as the most attractive destination for Canadian investors.

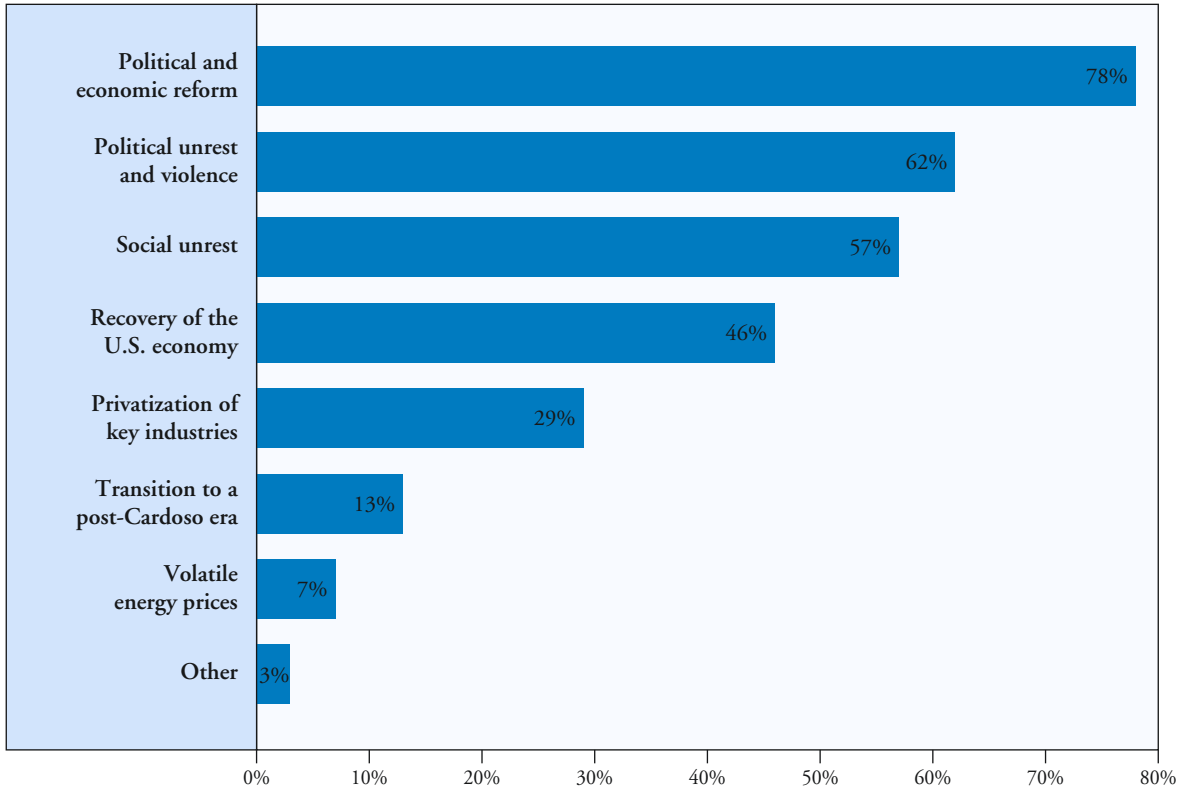
*Mexico's investment attractiveness declines for the first time.* Mexico's economic performance is beset by the economic recession in the United States, its most important trading partner and main foreign investor. As Mexico's FDI fortunes rose with those of the United States—especially post-NAFTA—so, too, have they fallen. Global senior executives indicate a decreasing likelihood of investing in Mexico, thereby diminishing its ranking from fifth to ninth place among preferred investment destinations. This is the lowest position the country has held in the FDI Confidence Index tracking since 1998. Expressions of diminishing interest in the Mexican market are led by European investors and investors worldwide in the non-financial services, telecommunications and utilities sectors.

In 2001, President Vicente Fox reached his goal of doubling foreign direct investment in Mexico, an impressive achievement boosted mainly by the purchase of Banamex-Accival

(Banacci) by Citigroup, which accounted for roughly half of the year's total FDI flows. High investor confidence and attendant capital flows appreciated the value of the peso enough to make it the world's strongest currency last year. But the strong peso also diminished low labor cost advantages that had attracted many investors in the past. A slower than expected recovery from the recession, the lack of significant movement on promised structural reforms in the electricity and telecommunications sectors, and increased tax and labor costs are likely the primary causes for the eroded market attractiveness. In 2001, one-third of senior executives indicated having an improved outlook for Mexico, giving it the highest outlook-improvement score for the year; in 2002, half as many executives are bullish on Mexico.

*NAFTA continues to underpin FDI in Mexico.* NAFTA partners remain the most positive on Mexico over the next three years, with U.S. and Canadian investors ranking it the 2nd and 6th most attractive investment destination worldwide, respectively. Notably, Japanese investors also rank Mexico among their five most preferred investment destinations over the next three years. From an industry perspective, Mexico remains among the most preferred investment targets for heavy and light manufacturing industries and the financial services sector. Mexico is also attractive to investors from the electronics, transportation equipment and banking sub-sectors. Moreover, Mexico ranks high among senior executives considering investing there for the first time: One in 10 investors said they will likely commit first-time investments in Mexico over the next three years, rendering it the fourth most preferred destination for first-time investment worldwide.

Figure 9: Factors judged most likely to affect the relative attractiveness of Latin America over the next one to three years



Source: A.T. Kearney

#### LATIN AMERICA

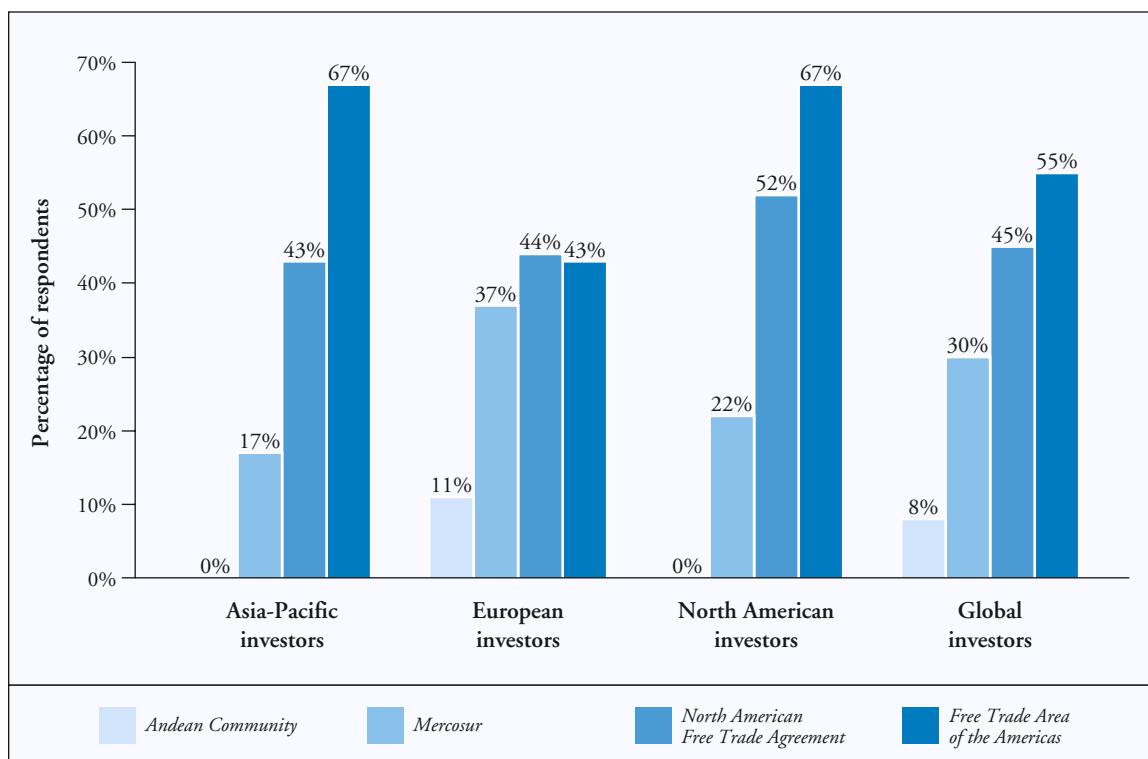
*Latin America loses its swing.* Global executive intentions of investing in the region decreased by 40 percent compared with 2001, making it the least attractive region after Africa and the Middle East. The Argentine crisis and its repercussions for all of Latin America have left Brazil as the region's sole representative among the top 25 investment destinations. This year also marks Argentina's fall from the top 25, completing a devastating slide from 1998 when it stood as the eighth most-preferred destination.

A majority of global investors indicate that an initiation of the Free Trade Area of the Americas trade arrangement would enhance

Latin America's investment attractiveness. However, FTAA's future is uncertain and investors express apprehension about political stability, social unrest and the continuity of reform across the region.

*Reform fatigue could severely undermine the region's attractiveness.* Executives cited political and economic reform as the most important issue that would affect the region's relative attractiveness over the medium term (*see figure 9*). Concerns about possible social and political unrest followed closely behind. Latin American governments are faced with a quandary: Political and social unrest is in part driven by growing resistance to the very reforms that would attract

Figure 10: Regional trade arrangements judged most likely to affect Latin American investment attractiveness



Source: A.T. Kearney

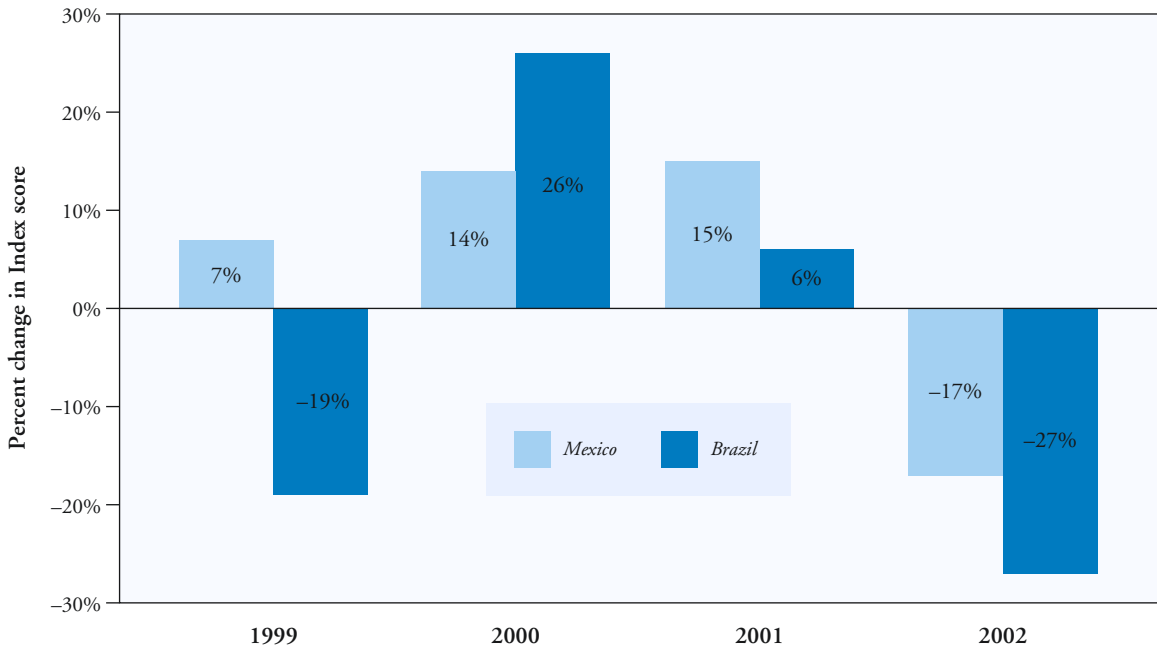
investors. How effectively these governments are able to balance the need for continued reform with managing domestic reform fatigue will likely determine the prospects for future flows of foreign investment into the region.

The dynamics of the region’s attractiveness have changed over the past five years. For example, for the first time, the fate of the U.S. economy is not central to the region’s attractiveness. In fact, the recovery of the U.S. economy was cited by less than half of the respondents as central to ensuring the region’s attractiveness. North American executives show more concern about Latin America’s political and economic reform, with more than half ranking it as the number one factor. Investors

from Asia Pacific, on the other hand, ranked political unrest and violence most often as their number one concern, while European investors were evenly split on the two issues.

*Future of FTAA crucial to investment.* The consolidation of the Free Trade Area of the Americas will be more important to increasing the region’s appeal to investors than other existing trade arrangements (see figure 10). Mercosur might be struggling—though not dead—in the minds of investors, with one-third of senior executives citing it as important to their investment decision-making in the region. The Andean Community, on the other hand, ranked lowest, with fewer than one in 10 investors considering it significant for the region’s attractiveness.

Figure 11: Changes in investment attractiveness of Mexico and Brazil (1999 to 2002)



Source: A.T. Kearney

*Decline of the emerging giant.* After holding a steady position among the top five global destinations for investment, senior executives' confidence in Brazil tumbled, leaving the country in the 13th position in the Index rankings (see figure 11). European investors reveal the most dramatic loss of confidence in the Brazilian market compared with last year. British investors, most bearish, indicate half the likelihood of investing in the Brazilian market compared with last year. Canadian investors indicate a similar loss of confidence. For American investors, the likelihood of investing in Brazil dropped by one-quarter compared with 2001.

From an industry perspective, executives from the financial services sector downgraded their investment intentions in the market by half. Only 5 percent indicated an improved

outlook compared with more than 30 percent in 2001. Investors from the telecommunication and utilities sector are 44 percent less likely to invest in Brazil. The only investors that state an increased propensity to invest in Brazil compared with last year were those from the light manufacturing sector—more specifically, electronics firms and investors from the food, tobacco and textile industries count Brazil among their top three investment destinations.

*Uncertainty over election outcomes has contributed to Brazil's diminished attractiveness.* Although executives expressed significantly less concern about the transition in Brazil after President Cardoso than they did about issues of the continuity of reform and social unrest for the future attractiveness of Latin America, uncertainty over the outcome of the upcoming

Brazilian presidential elections has likely contributed to undermining investor confidence. Senior executives have increasingly become less optimistic about Brazil: Only 14 percent now offer a more positive view of the economy, half as many as last year.

*Argentine crisis erases any remaining investor confidence.* The darling of the foreign investment community in the aftermath of the Asian financial crisis, Argentina dropped almost completely from investors' radar screens in 2002. Foreign investors in Argentina suffered through the pains of the crisis in late 2001, and the subsequent effects of the government's imposition of capital controls. Capital flows into Argentina have virtually stopped since the government defaulted on its debt in December 2001. For the second year in a row, corporate executives ranked Argentina first among those countries for which investment prospects have deteriorated most. In 2002, almost twice as many executives indicated a more negative outlook on Argentina than they did in 2001.

*Venezuela and Andean countries continue to lag in investment attractiveness.* Executives ranked Venezuela—a country wracked by political unrest in the last year—third in their assessment of the countries for which prospects have deteriorated most since 2001. The Andean countries failed again in attracting the much-needed attention of global investors, with only the mining industry ranking Peru, Venezuela and Colombia among the top 25 preferred investment destinations.

## EUROPE

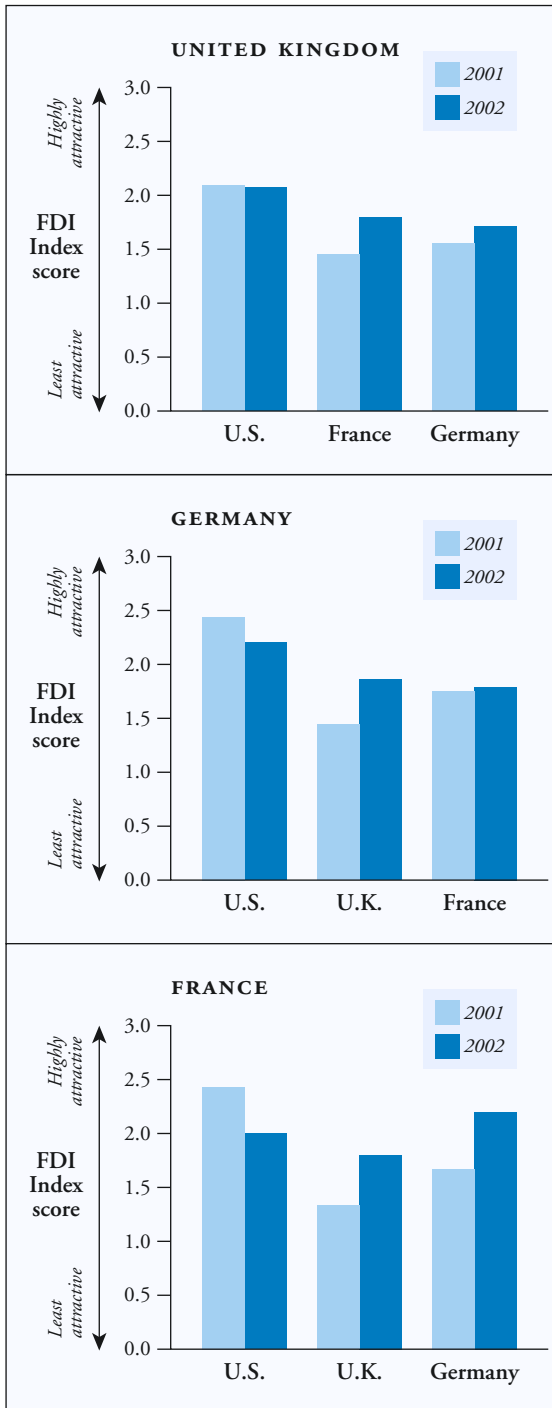
*European destinations account for nearly half of the Index's top 25 destinations.* Investor sentiment toward Europe remained essentially unchanged

from last year—which, when considered within a global context, is quite remarkable. The United Kingdom, Germany, France, Italy and Spain consolidated their hold on the Index's top 10 most attractive markets for FDI, achieving their highest collective ranking behind only China and the United States. At the same time, EU aspirants Poland, the Czech Republic, and Hungary landed in the top 16, with the best overall rankings in recent years for Central European countries. The most favorable change in position, however, was registered by Russia, which jumped to 17th place in the Index from its position below the top 25 last year.

Despite internal differences over such vexing issues as budget deficit limits, labor practices, European Union enlargement, and the Common Agricultural Policy (CAP), European economic integration is deepening via intra-European FDI flows. This trend is especially apparent among Britain, Germany and France, which have formed a sort of European triumvirate in which investor confidence toward one another has grown increasingly stronger (*see figure 12 on page 18*).

*Mergers and acquisitions focus less on telecommunications and more on utilities.* A slim majority of European senior executives—51 percent—still prefer M&A as a mode of foreign market entry. (This compares with 30 percent of Asian executives and just 25 percent of North Americans.) Notwithstanding the decrease this represents from last year, when 73 percent of European executives favored this mode of entry, the continued preference for mergers and acquisitions can likely be linked to the largest European economies' growing regional focus and enhanced perception of one another as increasingly viable and attractive markets.

Figure 12: The United Kingdom, Germany and France increasingly view one another as the brightest FDI prospects



Source: A.T. Kearney

The financial services and telecommunications industries continue to favor M&A, 46 and 61 percent respectively, and accounted for most of the largest cross-border European M&A deals in 2001. However, the likelihood of investment by executives from both industries has deteriorated in Europe in 2002. After the high FDI levels of 2000, activity began to wane in 2001, with the largest cross-border deal being the US\$24.6 billion acquisition by Germany's Deutsche Telekom of VoiceStream Wireless Corporation of the United States. As opportunities decreased, European investors within the utilities and energy sectors have become more eager to embark on M&As. In the first quarter of 2002, transactions in the utilities sector accounted for almost one-fifth of total European M&A deal value, including the acquisition by Germany's RWE of the U.K. firm Innogy Holdings. This was the biggest deal of the quarter, valued at US\$7.8 billion. The energy sector, too, figured prominently among the deals reached in the first half of 2002. The largest transaction concluded was the US\$5.6 billion takeover of the German integrated energy operator Veba Oel by BP of the United Kingdom.

Also in June 2002, the European Court of Justice decided to restrict the use of "golden shares" (government shares in privatized companies that allow a government to block a takeover bid under circumstances in which "national interests" justify it). This decision could pave the way for future increases in European mergers and acquisitions.

*European competitiveness hinges on labor market reform and deregulation.* Since the mid 1990s, labor productivity in the United States has grown considerably faster than that of the

European Union due to advantages in labor market flexibility, labor costs and unemployment benefits. The perception of the European labor market as more rigid, and relatively less efficient, has caused concern among senior executives worldwide: The majority of this year's respondents cited labor market reform and deregulation as likely to have the greatest impact on European competitiveness over the next three years.

Following the aggressive deregulation and privatization movement in the 1990s, the plunge in global capital markets in the new millennium has thwarted continued progress on the privatization front and even sparked fears of potential backtracking. The privatizations of several state-run utilities, such as *El lectricit  de France*, have been indefinitely placed on hold. Moreover, in the telecommunications sector, partially privatized firms such as *France Telecom* and *Deutsche Telekom* may not become fully privatized given deflated share prices and heavy corporate debt overhang. Some governments are even considering renationalization. Last year, for example, the British government placed *Railtrack*, the privatized rail infrastructure company, into bankruptcy, effectively renationalizing it.

Nearly half of investors indicated that Europe's fiscal and monetary policies are critical to Europe's competitiveness over the next three years. The 12 member countries of the eurozone are bound by the Stability and Growth Pact, which ensures fiscal rigor. But, several members—even some of the larger economies—are under pressure to cut taxes, increase spending on education, and cover other domestic priorities. Europe's competitiveness may well depend on how European policymakers manage these domestic priorities while ensuring investors

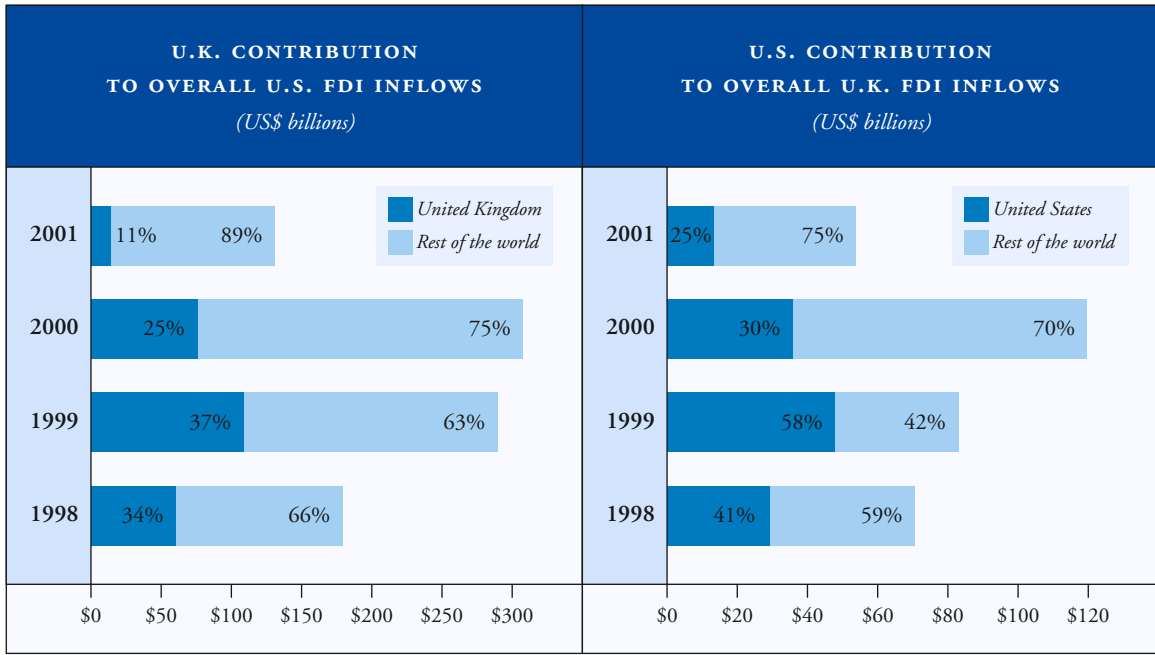
that fiscal discipline remains a cornerstone of the eurozone.

*Upsurge in investor confidence vis- -vis Germany.* Germany rose to fourth place in the Index this year, becoming considerably more attractive to investors, particularly those in Britain and France. This marks the third consecutive year Germany ranks as the second most-attractive Western European market. The stronger upward track it is on has virtually closed the gap with the number-one ranked European market in the Index, the United Kingdom. Although FDI flows into Germany declined significantly in 2001, five of the top 10 major European M&A deals occurred within its borders during the first quarter of 2002.

Germany is the global favorite among telecommunications and utilities firms and performed especially well among investors from the transportation services industry. This increased attractiveness was probably in part an upshot of the Hamburg airport privatization as well as the floating of shares of Frankfurt's airport (*Fraport AG*) on the stock market, which was the first of its kind for Germany. Manufacturers are more attracted to Germany since last year, and stand to benefit from new corporate tax legislation the government implemented at the outset of 2002. The major discordant note is in the financial services industry: Concern over a spate of recent bankruptcies, triggered by bad loans and overcapacity, has tainted banking executives' outlook toward Germany.

*As bilateral FDI flows with the United States wane, the United Kingdom is poised to foray into Europe.* The United Kingdom climbed one notch to third place in the Index, overtaking Brazil while maintaining its status as the most attractive European investment destination

Figure 13: The preferential FDI relationship between the United States and the United Kingdom has declined



Source: Bureau of Economic Analysis, OECD

worldwide. France and Germany are most bullish about the United Kingdom and, for the first time, expressed more confidence than even U.S. investors who are traditionally Britain's biggest source of FDI. Likewise, the United Kingdom is more enthusiastic about French and German investment prospects, and also exhibited a marked increase in confidence vis-à-vis Italy. Although the United States continues to be the number one investment destination among British investors, the gap between the United States and France and Germany is narrowing. British investors slightly downgraded U.S. investment prospects while increasingly favoring French and Germany investment destinations.

The United Kingdom lost its top spot to the United States as the largest source of FDI worldwide. Over the past few years, the United

Kingdom's intense investor interest in the United States has faded somewhat and, this year, U.S. investors reciprocated this trend. The two countries' investment in one another as a percentage of total inflows has declined; at the same time, the United Kingdom continues to bolster its investments in Europe (*see figure 13*).

Last year, British firms—unlike continental European investors—indicated that basic macroeconomic developments were more likely to affect the United Kingdom's ability to attract FDI rather than a decision of whether or not to adopt the euro. This year, British executives again differ from other Europeans on their views of the euro: Only 40 percent of British investors believe that adopting the euro renders a country more attractive for investment in contrast to 77 percent of continental European investors.

In last year's survey, American executives concluded that the United Kingdom's standing as an attractive investment destination was more likely to be affected by basic macro-economic developments than from a decision not to join the euro. Similarly, Americans this year ranked the impact of the euro on Europe's competitiveness significantly behind fiscal and monetary policies. Most importantly, global investors consider the United Kingdom the most competitive European market for business over the next three years.

*France is increasingly a favorite of EU investors.* France jumped five spots to fifth place, improving its score in all industries except financial services, where it declined by 28 percent. Global investors also pegged it as the fourth most competitive European market. After wholesale and retail sector executives, France is viewed most favorably by telecom, utilities and heavy and light manufacturing investors. Similar to other EU countries, French FDI outflows decreased, from approximately US\$170 billion in 2000 to US\$83 billion in 2001. At the same time, inflows into France increased by US\$10 billion to reach more than US\$53 billion in 2001. To stimulate demand, the French government plans to increase tax cuts and government spending, much to the ire of fellow eurozone members, as such actions could violate the Stability and Growth Pact.

*Italy evades the telecom bubble, rising to sixth position.* Italy moved up two spots to sixth place, benefiting from increased investor attractiveness within the non-financial services, and wholesale and retail sectors. Consistent with the wider decline evident in most country scores, Italy's score declined slightly—driven by the more negative views of executives in the financial

services, and telecom and utilities industries. This seems natural given Italy's widespread appeal prior to the bursting of the technology bubble. Telecom Italia, for example, struggles under the weight of its substantial debt burden. Yet, Italy's relative gains in investor confidence among other sectors helped hoist it in the overall Index, and global investors consider Italy the seventh most competitive market in Europe.

*Investors cool to Spain and Portugal.* Although Spain's Index score declined somewhat, it nonetheless jumped two spots in the Index to seventh place this year. This slight deterioration in investor confidence perhaps belies concern over the country's exposure to the financial crisis in Argentina and its potential contamination of the region. As expected, the perceptions vis-à-vis Spain of telecommunications and utilities, and financial services investors—the industries that were previously at the forefront of Spain's investment drive into Latin America—have worsened substantially since last year. Under-scoring this deterioration, Spanish banks Santander Central Hispano and Banco Bilbao Vizcaya Argentaria have suffered from the burden of covering potential write-offs incurred through their Argentine subsidiaries. It is no surprise, then, that both Spain's FDI outflows and inflows declined by almost half to US\$28 billion and US\$22 billion, respectively, between 2000 and 2001.

However, difficulties within the financial sector have not completely undermined investor sentiment toward Spain: One-third of global investors view Spain to be among the most competitive markets in Europe, ranking it the third most competitive after the United Kingdom and Germany. With regard to Spain's Iberian neighbor, investor confidence in

Portugal's market dimmed considerably, and the country once again fell below the top 25 investment destinations.

*Investors are dramatically more bullish on Russian prospects.* Russia recorded the biggest positive investment sentiment shift in the Index, as investor confidence grew by 19 percent, zooming it up to 17th place from its position below the top 25 last year. Behind this striking upgrade were its rankings as 10th and 19th most attractive investment destinations by European and American investors, respectively. As the most compelling evidence of Russia's greatly improved economic fundamentals, the country's debt/GDP ratio fell from 90 percent at end of 1998 to 50 percent at end of 2001. Russia's improving

compared with a year ago, and one in 10 global investors indicated that they will likely commit a first-time investment in Russia over the next three years.

Russia has fared poorly in the race to attract FDI relative to other transitioning countries in the region (*see figure 14*). Perceptions of poor corporate governance, weak commercial law, pervasive corruption and a capricious and high-tax regime have deterred investors. Whereas the fast-reforming Central and East European countries can claim FDI inflows amounting to 5 to 10 percent of GDP, Russia's FDI barely reaches 1 percent of GDP. However, several recent announcements of large investment projects in 2002 have fueled hopes that FDI in Russia may

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*Russia recorded the biggest positive investment sentiment shift in the Index, as investor confidence grew by 19 percent.*

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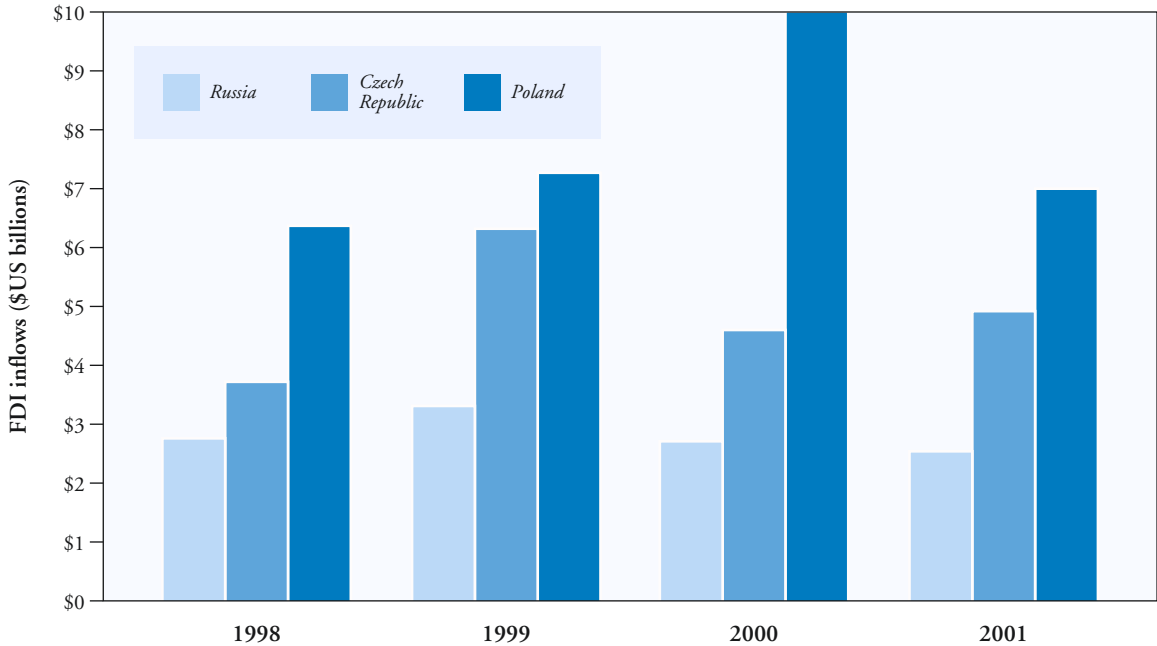
economic situation is also reflected in a sharp narrowing of the spreads on Russian Eurobonds, as well as a series of upgrades from ratings agencies noted in the first half of 2002.

This surge in confidence was likely not only inspired by Russia's rapid and marked improvement in economic fundamentals, but also by reforms enacted by the Putin administration. Investor confidence was no doubt further encouraged by the country's shifting political and economic relations with the West—underscored by the recent designation of Russia as a “market economy” by both the United States and the European Union—a major coup in Russia's bid for entry into the WTO. Aside from China, Russia earned the greatest increase in positive investor outlook

signal an upswing. Ford and Royal Dutch/Shell are making preparations for significant investments. More significantly, BP is returning to the Russian market to increase its stake in Sidanko, an oil company. This is particularly important because BP was the largest foreign investor in Russia in the 1990s, but cooled to the market in the wake of suffering substantial losses after the 1998 crisis.

*Aspiring EU members are catching up.* Investor confidence toward Poland and the Czech Republic also registered slight declines consistent with overall investor sentiment declines this year. However, the Czech Republic moved up two positions to 14th place and Poland maintained 11th place this year. A modest rise in investor confidence vis-à-vis

Figure 14: FDI flows to Russia versus Central Europe



Source: UNCTAD; EIU; Country Central Banks

Hungary boosted its move to 16th place from 21st, giving Central European investment destinations strong representation among the top 25 ranked countries in the Index.

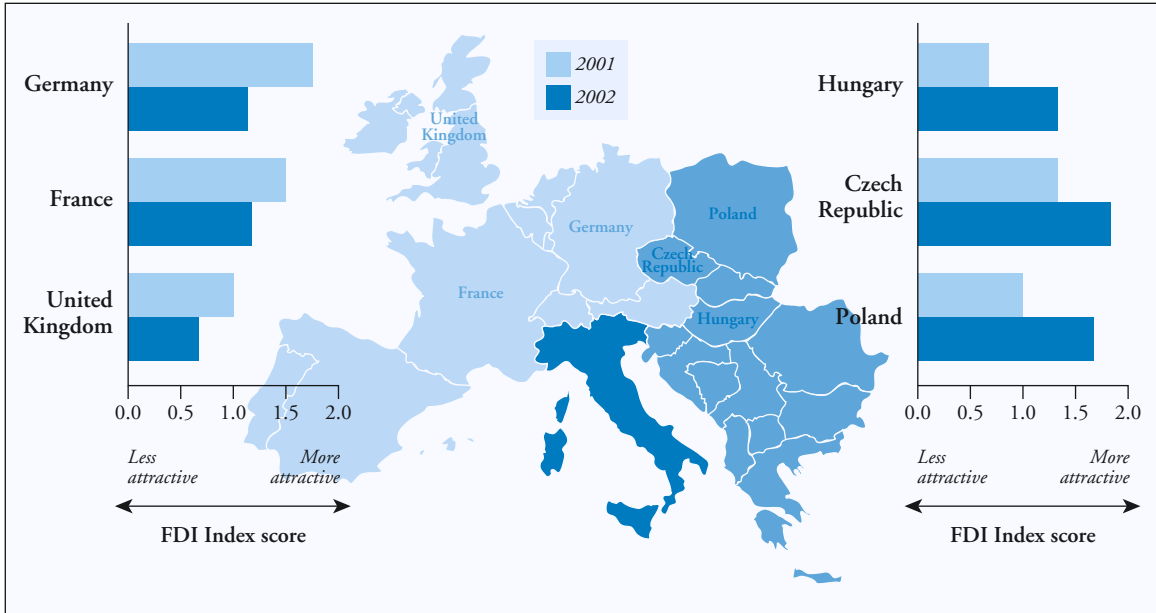
Although these economies were also hit by the global economic downturn, the more favorable outlook in the region can likely be attributed to Central Europe's record of sound economic fundamentals in recent years. This is due, in large part, to the aggressive market reforms and privatizations undertaken, as well as the rigorous development of their industrial export sectors. Among the factors considered most important to the future competitiveness of Europe, Asian investors expressed the greatest concern over the prospects of EU enlargement, while the biggest investors in the Central European economies, other Europeans, placed less importance on the issue.

While expressing less interest in traditional destinations such as the United Kingdom, France, Germany, and Spain, Italian executives unequivocally demonstrated a predilection for investing in Central Europe, expressing the greatest interest in the Czech and Polish economies (*see figure 15 on page 24*). As one of the primary FDI contributors to Central Europe, such an improvement in investor confidence bodes well for the region.

#### ASIA

*Asia overtakes Latin America as the third most attractive region for FDI.* Asia's overall improvement in investment attractiveness in 2002 moves the region into position as the third most attractive destination for FDI following North America and Europe. Of the top 15 countries global executives cited for first-time investments,

Figure 15: Italian investors increasingly favor emerging Central and Eastern European countries over traditional Western European countries



Source: A.T. Kearney

six are in Asia. Furthermore, half of the top 10 countries ranked with the most positive outlook improvement compared with a year ago are in the Asia-Pacific region: China (first); South Korea (fourth); Australia (fifth); Thailand (eighth); and India (ninth).

However, the attractiveness of the region is highly variable. On the one hand, confidence in China is booming and the relative investment attractiveness of Japan, Hong Kong and Australia has improved as well. On the other, the remaining Asian markets at best maintained or even saw deterioration in their overall attractiveness. Although investors have a more optimistic view of many of these Asian economies than they did last year, they are still less likely to commit FDI to these markets—particularly the emerging Asian markets. Among the ASEAN countries, Vietnam is the only

country to improve in relative attractiveness.

*China overtakes the United States.* For the first time in FDI Confidence Index tracking, China surpasses the United States to become the destination most likely to attract investment. More than any other country, investors hold a more positive outlook toward China, with 46 percent more optimistic about the Chinese market today compared with one year ago. They are also expected to commit more first-time investments to China than to any other country: Nearly one-third of senior executives are looking to China for first-time investments over the next three years, three times more than those interested in entering the United States.

Since 1998, Brazil, India, Mexico and China have always ranked among the most attractive markets worldwide. On average, these

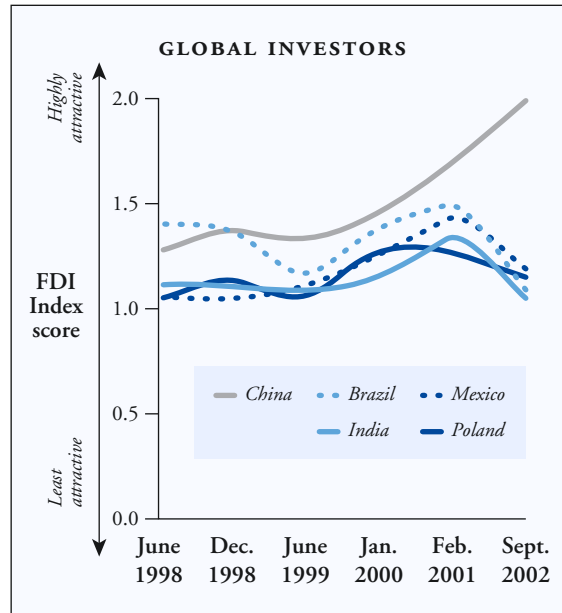
markets have moved in line with each other in terms of relative investment attractiveness. However, investors signal a significant divergence this year as China continues to gain favor among executives, while Brazil, India and Mexico have become less attractive investment destinations (*see figure 16*).

The key factors driving China's impressive boost among investors undoubtedly include its relatively stable political environment, robust economic growth, recent entry into the WTO, and its successful bid for the 2008 Olympics. Concern with China's debatable official growth figures, shaky financial system and huge non-performing loans, troubled state-owned enterprises, and inadequate legal and regulatory regimes, are seemingly outweighed by the positives. Only 6 percent of investors harbor a more negative outlook toward China.

The likelihood of investment in China by non-financial services sector firms increased dramatically, with China's ranking jumping from below the top 25 to first place. Its attractiveness also improved significantly among wholesale and retail as well as financial services investors. More than half of the non-financial services, wholesale and retail, and heavy and light manufacturing investors indicated they are highly likely to invest in China over the next one to three years.

China's accession to the WTO, which is expected to ease market entry for foreign investors, has clearly boosted China's investment attractiveness. Corporate decision-makers also see significant market opportunities from China's growing economy, changing lifestyles, and increasing income levels, seen as positioning China as home to one of the world's fastest growing middle-income populations.

Figure 16: China's investment attractiveness diverges from other large emerging markets



Source: A.T. Kearney

China is the preferred investment destination for Asian investors, nearly three-fourths of whom cited a more positive outlook on the Chinese economy. China is also the most attractive investment destination for senior executives from the United States and Japan, the United States retaining its position as the leading FDI source for China.

*Investors position themselves in key Japanese sectors.* Japan jumped eight positions to 12th place in the overall Index and has become the sixth most attractive destination for first-time investments worldwide. The government's financial reconstructing and regulatory reforms in such sectors as wholesale and retail and telecommunications will likely provide foreign investors with M&A and partnership opportunities. In 2001, the U.K. based acquisition of Japan Telecom Co. Ltd and J-Phone Communications

by Vodafone Group Plc (U.K.) totaled US\$11.5 billion—the biggest M&A deal ever recorded in Japan. In March 2002, Wal-Mart acquired a share of the Japanese retailer, Seiyu.

Japan registered the biggest leap among non-financial services investors worldwide, climbing from below the top 25 to reach the third position among investors from this sector. This is most likely influenced by the optimistic outlook on tourism, attractive commercial property prices, and Japan's co-hosting of the World Cup. Benefiting from its regulatory reforms, Japan's ranking also registers great improvement among telecom and utilities, wholesale and retail, and banking investors. Executives from the fabricated metal, electronics and transportation services

global and regional trade initiatives, senior executives consider a deepening of Japan's recession a critical factor affecting their FDI planning. In fact, nearly half of all global investors cited it as vital to their future FDI decisions.

Corporate investors believe that financial and banking reform will exert the greatest impact on Japan's relative competitiveness, with four out of five indicating that this will affect the country's future prospects as an investment destination. Industrial restructuring and foreign participation in the economy are the second and third most important factors influencing investor perceptions of Japan's competitiveness in the global economy. European and North American executives indicated that foreign

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*Corporate decision-makers also see significant market opportunities from China's growing economy, changing lifestyles, and increasing income levels.*

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sectors also ranked the Japanese market among top investment destinations globally.

After making a risky investment in the troubled Japanese automaker in 1999, the French firm Renault has helped return Nissan to profitability. Other firms are increasingly interested in such alliances, with the goal of leveraging their extensive sales networks throughout Asia and gaining access to the well developed production platforms of Japanese auto firms.

At the same time, global executives express concern over Japan's future. An appreciating yen threatens export growth, and continued weak private consumption and investment undermine prospects for a sustainable economic recovery. Followed by the U.S. economic recovery, and

participation in the economy was the second most important factor influencing Japan's future competitiveness. Among Japanese investors, only one in 10 mentioned this as a critical factor. This stark contrast in views over foreign participation in the economy may reflect residual resistance to FDI, and possibly hamper efforts to increase FDI flows.

*Australia returns to the top 10.* Australia moved from 15th to 10th position in the overall Index rankings. A sound macroeconomic environment, tax reforms, and M&A activity in the primary sector have all supported Australia's return to the upper ranks of the most attractive markets worldwide. Investors in the primary sector rank Australia as the most attractive investment destination globally. This

upsurge in interest is encouraged by big M&A deals, such as the US\$2.4 billion acquisition of Normandy Mining by the U.S.-based Newmont Mining, and Canadian Placer Dome's unsolicited US\$1.3 billion bid for Australian AurionGold.

As more companies relocate their operations to other low-cost Asia-Pacific countries, the attractiveness of Australia's heavy and light manufacturing has waned. However, executives from the wholesale and retail and telecom and utilities sectors are more likely to invest in Australia in the future. Tax reforms such as income tax law amendments and the Double Taxation Protocol with the U.S. have encouraged financial services investors. These investors now rank Australia the 13th most attractive, compared with 25th most attractive last year. American, British and French executives express the greatest interest in Australian investment opportunities.

*Hong Kong's appeal increases.* Hong Kong climbs from 25th to 18th place in overall attractiveness. A stable, investment-friendly environment and proximity to the mainland of China provide great incentives for foreign companies seeking to use Hong Kong as a platform to invest in China. A world-class producer-related service sector strengthens Hong Kong's attractiveness as a service center. Investor sentiment dramatically improved among non-financial services investors who rank Hong Kong as their second most preferred investment destination, after China. Hong Kong's ranking improved most notably among British, French and American investors, but slightly declined among Canadian and Japanese investors.

*India drops from the top 10.* India falls eight spots to 15th position, with a 20 percent decline in the likelihood of receiving FDI.

Estimates suggest India will maintain a 5 percent economic growth rate this year, and that it will open more sectors to foreign investors. However, the simmering conflict with Pakistan over Kashmir undoubtedly deters potential investment. Meanwhile, budget deficits and poor infrastructure have further constrained its attractiveness.

However, India's attractiveness improved significantly among non-financial services, whose investment likelihood increased by 28 percent over 2001. After September 11, India's high-quality and low-cost IT talents have attracted more IT-related outsourcing services such as medical transcription and back-office operations for financial services and airline companies. Telecom and utilities investors consider India as their 25th most attractive investment destination. This is probably stimulated by new policies and regulations, including allowing telecom service providers to carry forward losses and unabsorbed depreciation, measures that facilitated the merger of Birla Tata AT&T and BPL Communications in June 2002.

India's ranking also improved among wholesale and retail executives, who were possibly encouraged by the reduction in foreign corporate tax rates and import duties and easing of restrictions on foreign retailers. Although India's ranking drops among most major investor countries, its position among U.S. and Japanese investors—the second and third most important investors in the Indian market—is holding steady.

*Investors express some hesitancy on South Korea despite positive policy steps.* Despite solid growth rates and aggressive measures to encourage FDI after the 1997 Asian crisis,

South Korea slides four positions to 21st place this year. While seeking to provide opportunities for foreign investors through privatization, South Korea remains a difficult market for investors. Perceptions of hostility toward foreign investors by banks and workers, the influences of the chaebol structure, and questions over unaccounted debts from insolvent domestic companies still discourage investment. Aside from GM's acquisition of Daewoo Motor and a few other exceptions, foreign investors such as HSBC and AIG have failed in reaching M&A deals with South Korean chaebols. The upcoming presidential election in December also casts some doubt about future government policies. Wholesale and retail investors are less attracted

percent in 2002—a strong turnaround from the 1.9 percent contraction last year—Taiwan's over-reliance on exports to the U.S leaves it in a vulnerable position.

The relaxation of laws allowing Taiwanese companies to invest in China has led to a wave of production base shifts from Taiwan to the Mainland. Taiwan's attractiveness falls among light manufacturing and primary sector investors. Weak private consumption and depressed consumer prices have disappointed wholesale and retail executives whose investment confidence in Taiwan has diminished significantly. However, expected reforms and market opportunities preceding the WTO entry have encouraged investors from the non-financial

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*Although electronic component exports have shown improvements in the first half of 2002, ASEAN countries continue to face lackluster prospects.*

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to South Korea, while non-financial services investors rank South Korea as the fifth most attractive market. Chemicals and petroleum investors are also upbeat on South Korea, ranking it the sixth most attractive destination for their industry worldwide. South Korea's very successful co-hosting of the 2002 World Cup and the Asia Games likely helped to boost the interest of the non-financial services sector. Moreover, South Korea continues to be a preferred location for first-time investors, and one in five investors indicated an improved perspective on its economy.

*Taiwan adjusts to post-WTO entry China.* The likelihood of investment in Taiwan dropped as it fell from 19th to 24th place in the Index. Although real GDP is expected to grow by 3.1

services sector, who now rank Taiwan sixth worldwide. Financial services executives are less eager to invest in Taiwan, likely influenced by the fierce competition following the proliferation of banks, the absence of a single regulatory agency, and continuing government intervention.

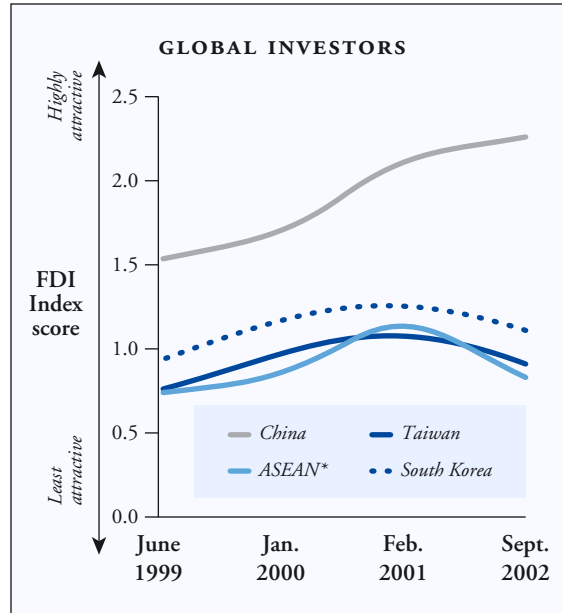
*ASEAN loses its roar.* Although electronic component exports have shown improvements in the first half of 2002, ASEAN countries continue to face lackluster prospects. Major ASEAN countries, including Singapore, Malaysia, Thailand, the Philippines and Indonesia, experienced declines in investor attractiveness. Vietnam is the only exception to this negative trend, moving up one position in the overall ranking. Singapore falls from 13th to 22nd position in the Index. Lack of market opportunities

and higher production costs have diminished Singapore's competitive position in heavy and light manufacturing, and primary sectors. Singapore also moved out of the top-25 list of most attractive markets for American investors.

However, Singapore continues to be a desirable investment location for investors from the electronics sector, who rank it the fifth most attractive market. Investors from non-financial services sectors rank it the 12th most attractive investment destination globally. Singapore also stands out as the preferred regional headquarters destination in Asia for global investors. As a source of foreign direct investment, Singapore has become China's fifth-largest investor in the first quarter of 2002, following the United States, Taiwan, Japan and Hong Kong.

Malaysia experienced a significant drop in this year's country rankings, falling from 22nd position out of the top 25 destinations. Estimated to reach a 4 percent GDP growth rate this year, Malaysia is making progress in banking reform, corporate governance, and is improving its infrastructure. However, uncertainty about its leadership transition, fears of terrorism and the complex relationship between politics and business have taken a toll on Malaysia's investment attractiveness. Malaysia's attractiveness dropped dramatically in the heavy and light manufacturing sectors, which falls in line with the recent shift of production bases from Malaysia to China by such multinationals as NEC and Dell Computer (see figure 17). Despite efforts by the government to stimulate investments in the electronics, chemical and petroleum industries, investors within these sectors indicated they are less likely to invest in Malaysia. A shortage of high-skilled labor and increasing labor costs also put Malaysia at

Figure 17: China attracts manufacturers across Asia



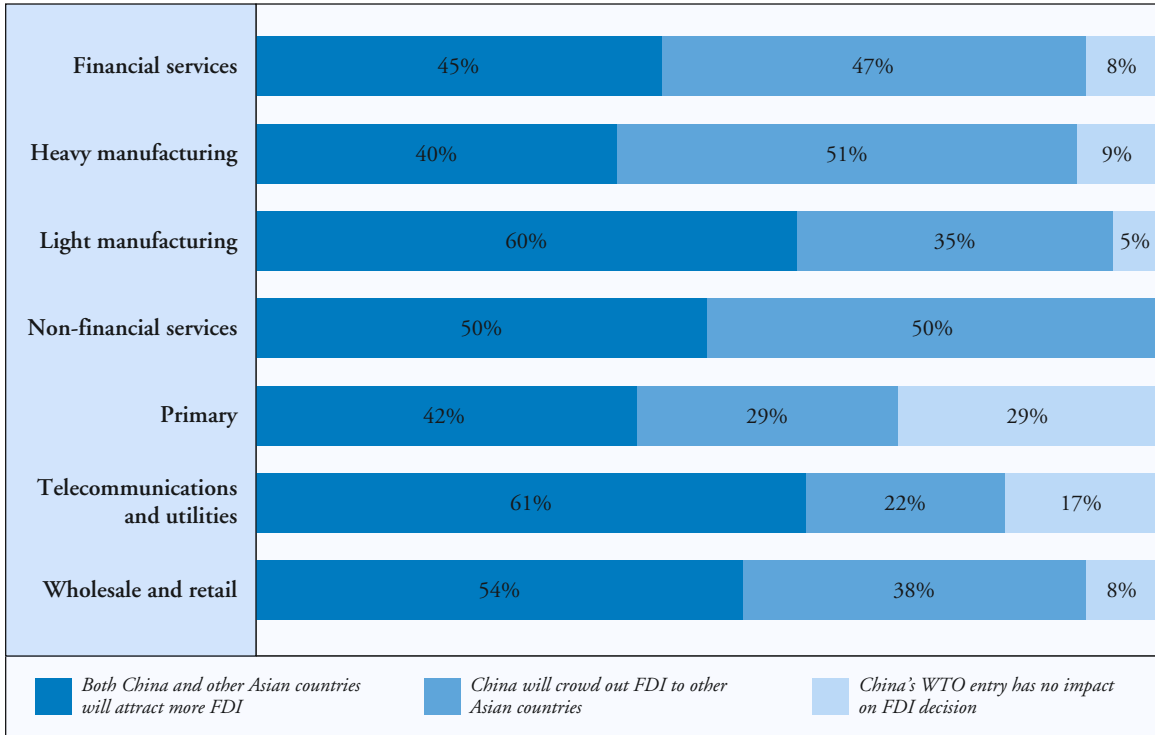
Note: \*Excludes Brunei, Cambodia, Laos and Myanmar

Source: A.T. Kearney

a competitive disadvantage vis-à-vis other regional locations. Competing with Singapore and South Korea in know-how-driven manufacturing is difficult, and Malaysia also loses out to lower cost Asian countries such as Indonesia and Vietnam. Indonesia and Vietnam enter light manufacturing's top-25 list and register substantial increases in the likelihood of investment from light manufacturing executives. American and Japanese investors—two of its principal past sources of FDI—expressed significant diminished interest in the Malaysian market this year.

However, non-financial services investors are relatively upbeat on Malaysia and rank it the 18th most attractive investment destination. This is perhaps a result of the government's promotion efforts within the tourism industry. Malaysia relaxed the limit on foreign

Figure 18: Impact of China’s entry into the WTO on FDI intentions toward Asia—an industry perspective



Source: A.T. Kearney

ownership in telecom companies for a period of five years, which boosts the country’s ranking among telecom investors. The upsurge in investor confidence among insurance and real estate executives may be attributed to the easing of rules concerning real estate acquisition by foreign investors.

*China’s WTO entry is not necessarily bad news for other Asian countries.* ASEAN countries are increasingly concerned that China’s WTO entry will further soak up FDI flows from the rest of Asia. However, 48 percent of global investors indicate that China’s entry to the WTO would make it and other Asian countries more attractive. Conversely, 42 percent believe this will have a crowding-out effect. Only one in 10 global investors expects FDI flows to be

unaffected by China’s WTO entry. For an industry perspective on China’s entry into the WTO, see figure 18.

Not surprisingly, investors from different countries have different perspectives on this issue. American investors prefer a region-wide strategy rather than one that only focuses on China, and more than three-fifths of U.S. investors believe that WTO membership will make China and other Asian countries more attractive. By comparison, three-fifths of Japanese and French investors foresee a crowding-out effect, with China’s WTO entry negatively affecting other Asian countries. For Japanese investors, with operations throughout Asia, China’s entry to the WTO is a good opportunity to shift production bases from

Japan and other Asian countries to China. The anti-terrorism campaign and security concerns in countries such as Malaysia, Indonesia and the Philippines may further lessen their attractiveness to Japanese executives, particularly given the emphasis Japanese investors placed on rising security costs.

*Singapore is the most favored regional headquarters destination in Asia.* Singapore tops the list in five out of the 11 attributes considered to influence the selection of a regional headquarters (see figure 19 on page 32). In May 2002, China established its first overseas Innovation Center for High Technology Enterprises in Singapore. Sydney and Melbourne follow Singapore in rankings based on real estate, rule of law, quality of life and physical security attributes. Hong Kong surpasses other cities in the availability of potential strategic partners and managerial talent. Most recently, Royal Philips Electronics NV consolidated its regional headquarters in Hong Kong to take advantage of these benefits. Global CEOs are not yet seduced by the skyline and colorful lights of Shanghai, which ranked poorly within most categories, except for its second place showing in lower cost structure. Despite the advantage of China's huge market and low labor costs, Shanghai is still constrained by its weak financial structure, underdeveloped legal system and lack of educated workforce.

Investors from different sectors have their own favorites. Singapore inched past Hong Kong and is the leading regional headquarters city for financial services. However, Hong Kong takes first place among financial services investors in the following categories: reputation as a prime location for headquarters, presence of potential partners, availability of managerial talent and the stability of its financial system.

Although Singapore stands out in the eyes of executives from the heavy manufacturing, non-financial services, and telecommunication and utilities sectors, Hong Kong, Sydney and Melbourne could rival Singapore in attracting telecom and utilities, and non-financial services investors. Singapore also shares first place with Sydney and Melbourne among light manufacturing executives.

Combined, Sydney and Melbourne top the list in almost all attributes. Yet, despite the fact that Sydney and Melbourne score highest across virtually all attributes for regional headquarter location, these Australian cities are not viewed by investors as logical regional hubs for their operations, likely because of their geographic location on the periphery of the region. The primary sector's favorite destination is Sydney and Melbourne, and wholesale and retail investors view these cities as having a slight lead over Singapore.


Shanghai holds promise among the heavy manufacturing industry whose investors rank it ahead of other cities regarding the prospects for strategic partnerships, and second in R&D and real estate or other cost attractiveness.

#### **AFRICA, NEAR AND MIDDLE EAST**

*Turkey remains a bright spot despite political and economic instability.* After registering among the top 25 most attractive markets for this first time in 2001, Turkey dropped back below the top 25 FDI destinations in this year's Index. However, it remains the most attractive market among African as well as Near and Middle Eastern countries, and is expected to receive more than one-quarter of all first-time planned investments going to these two regions. The economic turmoil wrought by the February

Figure 19: Singapore is most favorable location in Asia for regional headquarters  
(The most attractive investment destinations by sector)

FACTORS THAT INFLUENCE REGIONAL HEADQUARTERS DECISIONS	CITIES CONSIDERED FOR ASIAN HEADQUARTERS DESTINATIONS			
	HONG KONG	SHANGHAI	SINGAPORE	SYDNEY/ MELBOURNE
Reputation as regional headquarters	FS P		HM LM NFS T&U WRT	
Presence of potential partners	FS LM NFS T&U	HM	NFS WRT	P
Concentration of R&D	NFS	NFS	FS HM LM NFS T&U WRT	P WRT
Availability of management	FS NFS T&U		HM NFS WRT	LM P WRT
Highly educated workforce			FS HM LM NFS P T&U WRT	WRT
Real estate/other costs		LM NFS	NFS	FS HM NFS P T&U WRT
IT infrastructure	NFS T&U		FS HM LM NFS T&U WRT	NFS P
Financial system	FS NFS T&U		HM LM NFS	LM NFS P WRT T&U
Rule of law			FS	FS HM LM NFS P T&U WRT
High international quality of life			NFS	FS HM LM NFS P T&U WRT
Physical security			FS HM NFS T&U	LM NFS P WRT



Source: A.T. Kearney

2001 lira devaluation and the prevailing political uncertainty have undoubtedly deterred investors. However, far-reaching structural reforms and a proposed overhaul of foreign investment procedures could boost Turkey's future FDI prospects.

*South Africa declines in investor attractiveness.* While South Africa continues to be the most attractive market in Africa, its lead over other African nations narrowed, and investors express a diminishing likelihood to invest there compared with 2001. FDI inflows increased

from US\$969 million in 2000 to nearly US\$7.2 billion in 2001, largely attributed to several M&A deals and a 37 percent decline in the value of the rand. On a positive note, the president is helping drive the continent's New Partnership for Africa's Development, which advocates free trade and promotes international investment. However, ongoing opposition to privatization, high crime rates, and a heavily regulated labor market have likely undermined investor confidence.

## Conclusion

Senior executives from the world's largest 1,000 firms have become less optimistic since last year's Index, and for the first time since the Asian crisis the likelihood to invest has declined. Although investors are not as negative about the global economy as they were in the immediate aftermath of September 11, this lingering pessimism is affecting investment strategies since net planned investment will likely decrease among the world's largest investors. The unsteady recovery of the U.S. economy, ongoing corporate governance concerns, the increased costs of security and the threat of terrorism have further complicated the business environment. Apprehension over future trade expansion and anti-corporate and anti-brand public sentiment among global investors bring new uncertainties to the future path of globalization.

For the first time in FDI confidence tracking, China has overtaken the United States to become the most attractive investment destination worldwide, a position consistently held by the United States in the past. Despite its sluggish economy, Japan achieved its highest ranking ever, and its economic woes appear to have helped provide an opening for increased FDI inflows. While Hong Kong, Australia and Vietnam enjoy gains in investor favor, other Asian countries are less likely to reap increasing FDI inflows. Despite the return of political stability and economic growth in the region, Asian economies are struggling to adjust to the post-WTO China era.

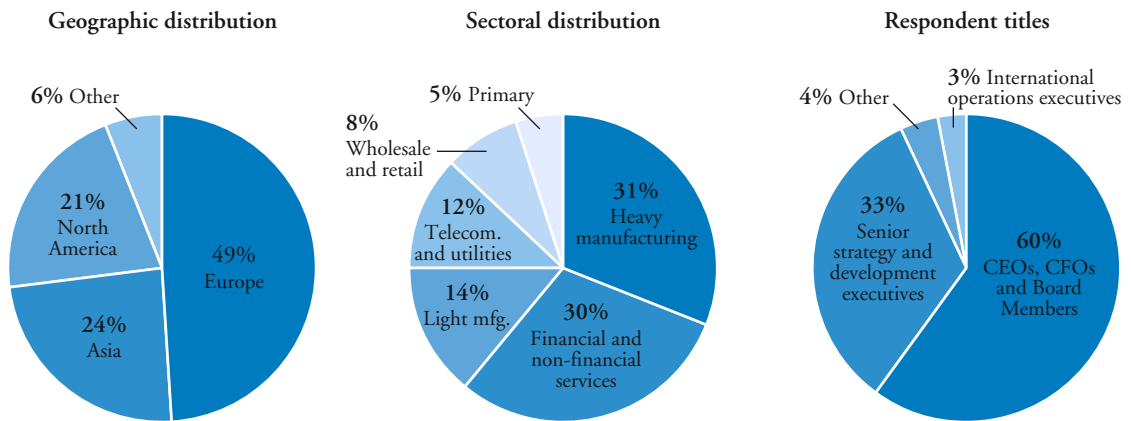
Although investor confidence in the U.S. market has been shaken, executives still consider its vast competitive market in a class of its own. Canada joins the top 10 most attractive markets for the first time, while Mexico's investment prospects dim under the weight of domestic conditions and a weaker U.S. economy. Political and social unrest, coupled with reform fatigue, have heightened challenges to Latin American policymakers as they seek to balance increased foreign investment flows against domestic pressures at home. The Argentine crisis has completely dislodged investor confidence in that market, and Brazil's decline in the rankings marks a dramatic reversal of past fortunes.

The United Kingdom, Germany, France, Italy and Spain consolidated their hold on the Index's top 10 markets for FDI, achieving their highest collective ranking behind only China and the United States. European integration is more evident as European investors remain the most enthusiastic practitioners of M&A, with the United Kingdom, France and Germany increasingly more likely to invest in each other than in other markets. Sound economic fundamentals and progress on EU accession have likely supported strong rankings and positive investor outlooks for countries in Central Europe. Although Russia continues to face a difficult business environment and receives only minimal amounts of FDI, it achieved the greatest increase in investor confidence due to improved economic growth and political stability.

# Methodology

The FDI Confidence Index was constructed using primary data from a proprietary survey administered to senior executives of the world's 1000 largest corporations. The survey was designed to gauge the likelihood of investment in specific markets in order to gain insights into likely trends in global FDI flows over the next one to three years. The population of companies was selected from the Global 1000, as determined by 2000 revenues. The 1000 companies that received surveys represent 41 countries and 24 different industries (as categorized by three-digit SIC codes). Furthermore, these firms' combined corporate revenues amounting to more than US\$18 trillion. The countries represented in the survey account for 90 percent of total global FDI flows in 2001.

Profile of FDI Confidence Index participants



Source: A.T. Kearney

The participating executives include CEOs, CFOs, Board Members, and senior corporate strategists from 30 countries and 19 specific industries. The participating companies closely approximate the country and sector coverage of the Global 1000 population, generate US\$2.55 trillion in annual sales and hold more than US\$10 trillion in total global assets.

The Index was computed as a weighted 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, and major newspapers and magazines.

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

Source: A.T. Kearney

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For more information or additional copies, contact Marketing & Communications at:

A.T. Kearney, Inc.  
 222 West Adams Street  
 Chicago, Illinois 60606 U.S.A.  
 1 312 648 0111  
 fax 1 312 223 6200  
 email: [insight@atkearney.com](mailto:insight@atkearney.com)  
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