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The global economic crisis and FDI flows to emerging markets:
for the first time ever, emerging markets are this year set to attract more than half of global FDI flows

by

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The global economic and financial crisis has had a major impact on foreign direct investment (FDI) flows. After declining in 2008 by 17% to US$1.73trn from US$2.09trn in 2007—the high point of a four-year long boom in cross-border mergers and acquisitions (M&As) and FDI—global FDI inflows are forecast to plunge by 44% to less than US$1trn in 2009.[1] The big drop in 2009 is occurring despite the improvements in the global economy in recent months. A notable feature of trends in 2009 is that, for the first time ever, emerging markets are set to attract more FDI inflows than the developed world.

Global FDI plummets in first half of 2009

Global FDI inflows are estimated to have contracted by 49% in the first half of 2009 compared with the same period in 2008. The estimate is based on data for 54 countries (20 developed countries and 34 emerging markets) that accounted for just under 90% of total global FDI inflows in 2008. For 47 of the countries, FDI inflows in the first half of 2009 were lower than in the first half of 2008; only seven countries recorded growth in inflows over this period. The decline in inflows to developed countries was significantly sharper than the drop for emerging markets--by 54% and 40%, respectively. The declines were especially marked in the US and UK, by 68% and 85% respectively. Among emerging market regions, the sharpest decline, by 55%, was to Eastern Europe. Flows to Latin America and to emerging Asia declined by one third in each case (China, the main emerging market FDI recipient, had a decline of only 18%; FDI flows to Brazil and Mexico dropped by 25%).

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[1] Unless otherwise stated, all FDI estimates and forecasts are from the Economist Intelligence Unit. The data reported here for 2008 are of more recent vintage and, because of that, as well as the use of different sources in some cases, the totals differ slightly from the data reported in UNCTAD, *World Investment Report 2009: Transnational Corporations, Agricultural Production and Development* (Geneva: UNCTAD, 2009. The revised estimates for 2008 and forecasts for 2009 also differ slightly from data that appeared in the Economist Intelligence Unit, “The world economy and plunging FDI”, *Viewswire*, July 29, 2009.

Only a modest improvement is expected in the second half of 2009. In particular, despite improved global economic trends in recent months, a significant recovery in M&As will not happen soon.[2] Rising confidence and a rally in equity markets have failed to boost M&As as corporations remain very cautious and bank financing is constrained. The nine-month 2009 data for M&As were not encouraging. According to data provider Dealogic, the value of M&A deals globally of US$1.62trn in the first nine months of 2009 was down by 37% on the same period in 2008.[3] According to Thomson Reuters data, the value of deals totaled US$369bn globally in the third quarter of 2009, down by 54% on the same quarter in 2008.[4] Furthermore, the numbers would look much worse still were it not for crisis-related financial deals. Since the latter are mainly domestic deals, this means that the decline in cross-border-M&As in 2009 will be significantly sharper than the drop in total deal values.

FDI to emerging markets to surpass 50% of global total

Flows to emerging markets initially proved resilient to the impact of the global crisis. Inflows into the developed world declined by one-third in 2008, whereas flows to emerging markets increased by 11%. FDI flows to emerging markets will decline considerably in 2009, albeit by less than FDI flows to the developed world.[5] In 2009, for the first time ever, emerging markets are likely to attract more FDI than developed countries. The forecast is obviously subject to considerable uncertainty. For example, a few large cross-border deals in the final quarter of 2009 could yet tip the balance back in favor of developed countries. But even should the emerging market share in global FDI inflows fall short of 50%, the share in 2009 will almost certainly be the highest on record. [6]

Practice catches up with theory

The overall decline in global FDI flows is thus being accompanied by a distinct shift in the pattern of FDI. Economic theory tells us that capital should flow from capital-abundant rich countries to capital-scarce poor countries. In practice, that has not been the case as developed countries have consistently attracted the bulk of global FDI flows. High risk in many emerging markets, the benefits of advanced institutions and infrastructure, and a superior overall business environment in developed countries have tended to outweigh the attractions of greater market dynamism and lower costs in emerging markets.

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[2] FDI flows are dominated by trends in cross-border M&As, and the correlation between global FDI inflows and the value of completed cross-border M&A sales is very high. This is not only because cross-border M&As make up a large share of FDI, but also because even non-M&A components of FDI are affected by similar forces that affect M&As.

[3] *Financial Times*, "M&A sector: Too early to call a return to normal," September 25, 2009.

[4] Reuters, "M&A shows signs of life", September 29, 2009.

[5] The Economist Intelligence Unit forecasts that FDI flows to emerging markets will decline by 35% in 2009 compared with 2008 (flows to developed countries are forecast to fall by 52%). See annex for forecasts for FDI inflows in 2009 by subregions. Although the definitions of emerging markets differ considerably, our forecast for the fall in FDI flows to emerging markets is similar to the forecasts made by the World Bank (for a 30% decline in *Global Development Finance*, June 2009, Washington, p. 38) and by the Institute of International Finance for a sample of 30 leading emerging markets (by 33%, in *Capital Flows to Emerging Market Economies*, October 3, 2009, Washington, p. 2).

[6] The definition of what constitutes an emerging market, or the dividing line between developed countries and emerging markets, is rather arbitrary. Under Economist Intelligence Unit definitions, the developed world category is somewhat smaller than under the definition used by UNCTAD, which includes the eight new EU member states from Eastern Europe (all these are considered as emerging markets under most definitions). The emerging market share in global FDI inflows is set to surpass 50% in 2009 on both definitions, although by a narrower margin on the UNCTAD definition. The Economist Intelligence Unit classification is given in Laza Kekic and Karl P. Sauvant, eds., *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk* (London and New York: Economist Intelligence Unit and the Columbia Program on International Investment 2007), p. 195.

This time, practice may be catching up to theory. FDI has tended to rise during recessions as slumps in M&As have hit the developed world disproportionately (and some 80% of cross-border M&A sales are still in developed states). However, other factors are also pushing up the share of emerging markets in global FDI inflows.

FDI flows to emerging markets have held up better because their overall economic performance has been much better than that of the developed world, which has experienced its worst recession since the Second World War. Much of the superior performance of emerging markets is, of course, due to the continued fast growth of China and India. However, even if China and India are taken out of the equation, most emerging markets will have outperformed the developed world in 2009. Emerging markets have thus to some extent "decoupled" from the developed economies.[7]

Globalization and increasing competitive pressure on companies have increased the opportunity cost of not investing in emerging markets.[8] A recent Economist Unit survey provides evidence of a link between investing in emerging markets and corporate financial success. Among surveyed companies from developed countries that derive less than 5% of their revenue from activities in emerging markets, only 24% reported their financial performance as being better than their peers. By contrast, for developed country companies that derived more than 5% of their revenue from emerging markets, the share reporting better performance than their peers was just under 40%.

The trend of improving business environments and liberalization in many emerging markets in recent years has also helped limit the recession-induced fall in FDI inflows. Finally, the increased share of emerging markets in outward investment is increasing the share of emerging markets in inward flows because a disproportionate share of outward investment by emerging markets goes to other emerging markets.

The outlook for 2010 and beyond

Although the global economy is still weak, conditions are now improving in many countries. Global growth resumed in the second half of this year, creating momentum that will carry into 2010. The recovery in 2010 will, however, be sluggish and fragile. Global growth is unlikely to return any time soon to the trend rate of recent years, as it will be constrained by the after-effects of the crisis in 2008-09. As a result, although global FDI inflows are likely to grow in 2010, the recovery will be modest. The growth rates of FDI into the developed world and emerging markets are expected to be similar so that their shares in global FDI are unlikely to change significantly from 2009.

Companies' plans for the next five years, as reflected in the aforementioned Economist Intelligence Unit survey, *Survive and Prosper,* imply that emerging markets will attract considerable FDI and probably more than developed countries. Just under 60% of companies expect to derive more than 20% of their total revenue in emerging markets in five years' time--almost double the present proportion of 31%. This would suggest that the shift in the distribution of global FDI flows in 2009 is a longer-term development and not just a transitory phenomenon.

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[7] The notable exception is Eastern Europe which has suffered very badly and its average output is forecast to contract by 6% in 2009.

[8] Economist Intelligence Unit and UK Trade and Investment, *Survive and Prosper: Emerging Markets in the Global Recession* (London: Economic Intelligence Unit, 2009). The Economist intelligence Unit carried out a survey of 548 companies from 19 business sectors around the world in July and August 2009. Two-fifths of the sample was made up of companies headquartered in emerging markets; the remainder were companies headquartered in developed countries.

Annex

Table 1. FDI inflows (Billions of dollars)

	2007	2008	2009
World total	**2,092.4**	**1,730.9**	**975.2**
% change	44.8	-17.3	-43.7
Developed countries	**1,355.0**	**914.7**	**441.3**
% change	52.3	-32.5	-51.8
Emerging markets	**737.4**	**816.3**	**533.9**
% change	32.9	10.7	-34.6
of which:			
Sub-Saharan Africa	38.0	49.7	30.3
% change	14.2	30.7	-39.1
Middle East & North Africa	81.9	98.1	73.4
% change	13.6	19.8	-25.2
Developing Asia	298.1	323.2	235.5
% change	38.9	8.4	-27.1
Latin America & Caribbean	128.1	140.5	93.8
% change	37.1	9.7	-33.3
Eastern Europe	165.7	183.3	90.4
% change	40.8	10.7	-50.7
% share developed countries	**64.8**	**52.8**	**45.3**
% share emerging markets	**35.2**	**47.2**	**54.7**

Note: Emerging markets according to Economist Intelligence Unit definitions; see text.
Source: IMF; national statistics; UNCTAD; Economist Intelligence Unit forecast for 2009.

Table 2: FDI inflows, % of global FDI inflows

	UNCTAD definitions		Economist Intelligence Unit definitions	
	Developed countries	**Emerging markets**	**Developed countries**	**Emerging markets**
1992	69.4	30.6	67.3	32.7
1993	66.7	33.3	64.3	35.7
1994	59.7	40.3	57.7	42.3
1995	65.5	34.5	61.8	38.2
1996	61.0	39.0	58.3	41.7
1997	59.9	40.1	57.1	42.9
1998	72.0	28.0	69.4	30.6
1999	78.7	21.3	76.9	23.1
2000	81.5	18.5	79.9	20.1
2001	69.7	30.3	67.3	32.7
2002	71.9	28.1	68.0	32.0
2003	66.3	33.7	63.4	36.6
2004	57.8	42.2	52.5	47.5
2005	66.2	33.8	61.6	38.4
2006	65.9	34.1	61.6	38.4
2007	68.3	31.7	64.8	35.2
2008	56.7	43.3	52.8	47.2
2009	48.4	51.6	45.3	54.7

Source: IMF; national statistics; UNCTAD; Economist Intelligence Unit forecast for 2009.

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The Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

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