Economist Intelligence Unit

The Economist

World investment prospects to 2011

Foreign direct investment and the challenge of political risk

Written with the Columbia Program on International Investment

Executive summary

Summary

Global foreign direct investment (FDI) flows over the next five years will be pushed upwards by buoyant growth, competitive pressures and improvements in business environments in most countries. But macroeconomic, regulatory and geopolitical risks will constrain flows. Global FDI recovered strongly in 2004-06 after a deep three-year slump. Following a further increase in FDI inflows in 2007, albeit at a slower rate than annual average growth in 2004-06, a modest and temporary decline in global FDI inflows is expected in 2008. Global FDI inflows are projected to return to steady growth in 2009-11 and to reach US$1.6trn by 2011.

There are a number of reasons to be optimistic about the medium-term prospects for FDI. These include the ongoing global trend towards better business environments, technological change and the search for competitively priced skills; and sharper global competition pushing companies to seek lower-cost destinations. On balance, most host and home governments will continue to encourage FDI. However, downside risks loom large. These range from the risks emanating from global financial turbulence to a host of political risks.

Table 1
Foreign direct investment projections
(US$ bn unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
World FDI inflows	**618.1**	**563.4**	**730.2**	**971.7**	**1,335.1**	**1,474.7**	**1,406.4**	**1,470.3**	**1,536.8**	**1,604.0**
% change, year on year	-27.4	-8.8	29.6	33.1	37.4	10.5	-4.6	4.5	4.5	4.4
% of GDP	1.9	1.5	1.8	2.2	2.8	2.8	2.5	2.5	2.4	2.4
FDI inflows to developed countries	**421.1**	**354.6**	**379.5**	**546.8**	**824.4**	**940.2**	**879.0**	**925.5**	**972.6**	**1017.3**
% change, year on year	-25.2	-15.8	7.0	44.1	50.7	14.0	-6.5	5.3	5.1	4.6
% of GDP	1.7	1.3	1.2	1.7	2.4	2.6	2.3	2.3	2.3	2.4
% of world total	68.1	62.9	52.0	56.3	61.7	63.8	62.5	62.9	63.3	63.4
FDI inflows to emerging markets	**197.0**	**208.9**	**350.7**	**424.9**	**510.7**	**534.6**	**527.4**	**544.8**	**564.2**	**586.7**
% change, year on year	-31.5	6.0	67.9	21.1	20.2	4.7	-1.3	3.3	3.6	4.0
% of GDP	2.5	2.4	3.4	3.5	3.6	3.3	2.9	2.7	2.6	2.4
% of world total	31.9	37.1	48.0	43.7	38.3	36.2	37.5	37.1	36.7	36.6
World stock of inward FDI	**7,185**	**8,615**	**9,981**	**10,455**	**12,216**	**13,622**	**14,955**	**16,347**	**17,796**	**19,307**
% change, year on year	11.4	19.9	15.9	4.7	16.9	11.5	9.8	9.3	8.9	8.5
% of GDP	22.1	23.6	24.3	23.6	25.6	25.9	26.5	27.4	28.3	29.0
Developed country stock of inward FDI	**5,151**	**6,246**	**7,189**	**7,265**	**8,510**	**9,441**	**10,306**	**11,216**	**12,171**	**13,169**
% change, year on year	20.7	21.2	15.1	1.1	17.1	10.9	9.2	8.8	8.5	8.2
% of GDP	20.6	22.2	23.0	22.3	24.9	25.6	26.4	27.8	29.2	30.4
% of world total	71.7	72.5	72.0	69.5	69.7	69.3	68.9	68.6	68.4	68.2
Emerging markets stock of inward FDI	**2,034**	**2,369**	**2,792**	**3,189**	**3,706**	**4,181**	**4,649**	**5,130**	**5,626**	**6,139**
% change, year on year	-6.8	16.5	17.9	14.2	16.2	12.8	11.2	10.4	9.7	9.1
% of GDP	26.2	27.1	27.2	26.3	26.3	25.7	25.6	25.7	25.6	25.3
% of world total	28.3	27.5	28.0	30.5	30.3	30.7	31.1	31.4	31.6	31.8

Sources: National statistics; IMF; OECD; UNCTAD; all forecasts are from the Economist Intelligence Unit.

Key trends

Key expected medium-term trends for FDI include the following.

- After a brief retrenchment, crossborder mergers and acquisitions (M&As) will continue to drive global FDI. The US and the EU15 (inclusive of intra-EU inflows) will continue to dominate as recipients of world FDI.
- Despite growing protectionist sentiment, the US is expected easily to retain its position as the world's leading FDI recipient in 2007-11.
- Among emerging markets, China will remain by far the main recipient, with almost 6% of the global total and 16% of projected inflows into emerging markets.
- There is likely to be some acceleration of the relocation of labour-intensive manufacturing to emerging markets, although this is unlikely to be as dramatic as many observers hope or fear.
- The offshoring of services will accelerate—which will also feed protectionist sentiment, although this form of internationalisation is accompanied by relatively modest capital flows.
- Investment by companies from leading emerging markets is likely to continue to gain in importance.

Benign economic outlook versus heightened political risk

Foreign direct investors are generally a resilient breed and security and related risks should not be exaggerated. However, the risk of protectionism is now appreciable, the global geopolitical climate appears more threatening and the outlook for securing a stable and co-operative international trading and investment environment is worse than in the recent past.

Multinational corporations (MNCs) are generally bullish about the medium-term global investment outlook, and appear to be sanguine about macroeconomic and financial risks, according to a global survey of 602 executives conducted for this report. However, these same executives also foresee a marked heightening of political risks that could undermine the success of their overseas investment strategies.

The survey reveals that political risk has jumped towards the top of corporate agendas. Political risk is seen as posing a considerably greater threat to business over the next five years than in the recent past. This is especially so for emerging markets, where generic political risk is identified as the main investment constraint. All four forms of political risk (risks of political violence, FDI protectionism, and threats associated with geopolitical tensions and governmental instability having a material impact on business) in emerging markets are seen as increasing over the next five years. For developed countries, this is true only of FDI protectionism, but there is widespread concern about the threat of political violence in leading countries such as the US and the UK, and apparent sensitivity to a range of geopolitical risks. The respondents in the survey expressed high rates of agreement with statements pointing to disruptions from key sources of global risk such as conflict between the West and Iran, Islamic radicalism and Russian-Western tensions.

The survey thus reveals an apparent disconnect between bullish sentiment on the investment outlook and heightened perceptions of political risk, especially in emerging markets. Opportunities appear to predominate over political risk concerns, even though these are seen as posing a considerably greater threat to business over the next five years than in the recent past.

Strong growth in 2006

Global FDI inflows climbed to US$1.34trn in 2006, a 37% increase in US dollar terms on the 2005 total and the first time since 2000 that global inflows surpassed the US$1trn mark. This was the third consecutive year of strong growth in global FDI inflows—by 30% or more each year in nominal US dollar terms—although the weakening US dollar has boosted the nominal US dollar-denominated totals. Global FDI inflows had plummeted by a cumulative 60% in US dollar terms in 2001-03. Despite the recovery in 2004-06, FDI inflows as a percentage of the world's GDP, at 2.8% in 2006, were still considerably lower than their peak at the end of the previous decade.

The global environment for FDI has been very favourable in the past few years, and it improved further in 2006. Economic growth remained strong in the US and accelerated in other OECD countries. Most emerging markets performed well, with China's economy continuing to power ahead at exceptionally high rates. This also helped to drive up commodity prices, which in turn fuelled growth in many other emerging markets. Corporate profitability was strong, interest rates were low, equity markets performed well and real estate prices have generally been high. Ample liquidity was available for companies to invest abroad. World trade growth was robust and risk-aversion on the part of international investors low.

The growth in global FDI in 2006, as well as in 2004-05, was in large part the result of very strong M&A activity, including in crossborder deals (which are the main form of FDI in the developed world). The increase in FDI inflows in 2006 was thus especially strong to developed economies—by more than 50%. Growth in FDI flows to emerging markets was more modest—by 20% in 2006, similar to the rate of expansion in 2005. Thus the share of emerging markets in global FDI inflows declined to 38% in 2006 from a peak of 48% in 2004. Nevertheless, FDI inflows to emerging markets reached a record of more than US$500bn in 2006.

FDI inflows increased to record levels in most emerging regions. There were, however, two exceptions—FDI flows in 2006 declined in Sub-Saharan Africa and in Latin America and the Caribbean. Developing Asia received a record US$212bn. China was again far and away the main FDI recipient among emerging markets, with inflows of US$78bn (China's rank dropped from third to fourth globally, behind the US, the UK and France).

Table 2
New FDI projects, top recipient countries

	2005		2006		
	No.	Share in world total (%)	No.	Share in world total (%)	% change, year on year
China	1,237	11.84	1,378	11.66	11.4
India	590	5.65	979	8.29	65.9
US	563	5.39	725	6.14	28.8
UK	633	6.06	668	5.65	5.5
France	489	4.68	582	4.93	19.0
Russia	511	4.89	386	3.27	-24.5
Romania	261	2.50	362	3.06	38.7
Germany	271	2.59	333	2.82	22.9
Poland	271	2.59	324	2.74	19.6
Bulgaria	140	1.34	286	2.42	104.3

Source: Locomonitor.

Growth in new projects

The list of leading destination countries for FDI projects in 2006 differs somewhat from the list of leading recipients by FDI values. This is unsurprising, since FDI values are heavily influenced by crossborder M&As, rather than greenfield investments. China, with 1,378 projects in 2006, is ranked first by the number of new FDI projects, whereas it was fourth by FDI inflows. India jumps to second place—although a distant second behind China—with 979 new projects, ahead of the US with 725 projects, the UK (668) and France (582).

A slowdown and decline before renewed growth

FDI inflows in 2007 should be sustained by a strong global economy and the continued boom in crossborder M&As that occurred in the first half of 2007. However, growth in 2007 in the global FDI total will be modest. Global inflows are projected at US$1.5trn, representing 10% growth on 2006. The high rates of recovery growth in FDI inflows of recent years will thus not be repeated this year, as a result of some slowdown in activity and tighter financing conditions in the light of volatility in financial markets. M&A activity will slow from 2005-06 levels. There will also be fewer privatisation opportunities in emerging markets compared with recent years.

Completed crossborder global M&As surged by more than 50% year on year in the first half of 2007. In particular, private equity funds were willing to inject capital into all kinds of deals. However, volatile financial markets will have a dampening impact on M&A activity in the second half of 2007 and into 2008. Even before the recent global financial turmoil, it was clear that the frenetic activity in global M&As in 2006, which strengthened further in the first half of

Table 3
FDI inflows
(2007-11 average)

	US$ bn	Rank	% of world total		US$ bn	Rank	% of world total
US	250.9	1	16.75	Finland	5.7	42	0.38
UK	112.9	2	7.54	Czech Republic	5.4	43	0.36
China	86.8	3	5.79	Hungary	5.1	44	0.34
France	78.2	4	5.22	New Zealand	5.0	45	0.34
Belgium	71.6	5	4.78	Ukraine	4.9	46	0.33
Germany	66.0	6	4.41	Algeria	4.7	47	0.32
Canada	63.2	7	4.22	Austria	4.0	48	0.27
Hong Kong	48.0	8	3.20	South Africa	3.2	49	0.21
Spain	44.9	9	2.99	Qatar	3.1	50	0.21
Italy	41.6	10	2.77	Pakistan	2.9	51	0.19
Netherlands	38.5	11	2.57	Serbia	2.8	52	0.19
Australia	37.8	12	2.52	Bulgaria	2.6	53	0.17
Russia	31.4	13	2.10	Croatia	2.6	54	0.17
Brazil	27.5	14	1.84	Philippines	2.4	55	0.16
Singapore	27.1	15	1.81	Slovakia	2.2	56	0.15
Sweden	26.1	16	1.74	Jordan	2.1	57	0.14
Mexico	22.7	17	1.51	Nigeria	2.1	58	0.14
India	20.4	18	1.36	Peru	2.0	59	0.14
Ireland	20.3	19	1.35	Angola	1.9	60	0.12
Turkey	20.0	20	1.33	Tunisia	1.8	61	0.12
Switzerland	18.2	21	1.22	Libya	1.6	62	0.11
Japan	13.3	22	0.89	Azerbaijan	1.6	63	0.11
UAE	12.8	23	0.85	Dominican Republic	1.6	64	0.10
Poland	12.6	24	0.84	Morocco	1.5	65	0.10
Chile	10.9	25	0.73	Greece	1.5	66	0.10
Portugal	9.1	26	0.61	Ecuador	1.5	67	0.10
Thailand	8.9	27	0.59	Estonia	1.4	68	0.09
Denmark	8.2	28	0.55	Cyprus	1.3	69	0.08
Saudi Arabia	7.9	29	0.52	Lithuania	1.2	70	0.08
Romania	7.7	30	0.51	Latvia	1.0	71	0.07
South Korea	7.2	31	0.48	Slovenia	1.0	72	0.07
Taiwan	7.1	32	0.47	Venezuela	1.0	73	0.07
Israel	7.0	33	0.47	Costa Rica	1.0	74	0.07
Malaysia	6.8	34	0.45	Bahrain	1.0	75	0.06
Kazakhstan	6.7	35	0.45	Bangladesh	0.7	76	0.05
Indonesia	6.6	36	0.44	El Salvador	0.6	77	0.04
Argentina	6.5	37	0.44	Cuba	0.5	78	0.04
Vietnam	6.5	38	0.44	Kuwait	0.4	79	0.03
Norway	6.4	39	0.43	Iran	0.4	80	0.02
Colombia	6.3	40	0.42	Sri Lanka	0.3	81	0.02
Egypt	6.0	41	0.40	Kenya	0.1	82	0.01

Source: Economist Intelligence Unit.

2007, could not be sustained. The fallout from the US sub-prime loan market will reinforce further the slowdown in M&As that would have occurred in any case. Our global economic forecast assumes that the financial turbulence will be contained, in the light of the continuing healthy fundamentals of the world economy. Much of the M&A activity continues to be undertaken by strategic investors with healthy balance sheets and strong cash flows. The slowdown in M&As, and FDI, is thus likely to be a soft landing, rather than a hard crash like the one that occurred in 2001.

The increase in global FDI in 2007 is expected to be slightly stronger in the developed world (14% growth) than in emerging markets, where FDI inflows are projected to rise by only 5% in 2007, as strong growth in inflows into Latin America (by 20%) is offset by weak growth of flows to Asia and a slight decline of FDI flows to eastern Europe from their 2006 peak. FDI into China is likely to be only slightly up on the 2006 figure; no growth in inflows to India is expected in 2007, and further brisk growth in inflows to Russia and the Commonwealth of Independent States (CIS) will be offset by a decline in flows to other east European subregions, including the EU's new member states.

The deceleration of growth in FDI in 2007 is likely to be followed in 2008 by a modest fall (for the first time since 2003) in nominal global FDI inflows—by a projected 5%. Global inflows are projected to return to steady growth in 2009-11, and to reach US$1.6trn by 2011.

Bullish investors

The survey responses on investment intentions are broadly consistent with our macroeconomic forecast for global FDI flows. We forecast annual average global FDI inflows of US$1.5trn in 2007-11, compared with an annual average of US$843bn in 2002-06. Two-fifths of respondents said that their companies would "substantially increase" investments outside their home markets over the coming five-year period compared with the previous five years, and 52% said that they would increase their foreign investment "moderately". Thus more than 90% expect their investments to increase; fewer than 1% of respondents expect to reduce substantially their foreign investments in 2007-11. These intentions were shared across all major industries we surveyed.

The US will remain the top destination for FDI

The US will remain the main recipient of FDI, accounting for some 17% of the world total in 2007-11. However, FDI into the EU as a whole (including intra-EU flows) will be significantly higher than this. The EU will also continue to outstrip the US as a source region for direct investment. FDI will remain geographically concentrated. The top ten host countries are expected to account for almost 60% of the world total; the top 20 for three-quarters of the world total. Eight of the top 20 are emerging-market recipients.

China will remain the biggest emerging-market destination—

FDI into China is likely to rise slightly in 2007 to some US$80bn and to grow steadily thereafter to surpass US$90bn towards the end of the forecast period. China is still ranked by most international firms as their preferred investment destination, including in the survey conducted for this report. China is committed to meeting its World Trade Organisation (WTO) obligations, which should boost FDI. China's price competitiveness will be maintained over the forecast period. However, despite the range of factors that underpin the expectation of buoyant FDI into China, some factors will keep FDI below potential. Although China will remain open to foreign capital—and in some aspects will liberalise even further—there are signs of unease in China about FDI and of the FDI protectionism that is occurring elsewhere.

—but India will disappoint

Despite the country's dynamism and perceived increasing importance, actual FDI inflows to India will be relatively modest. India's potential to attract FDI is vast and the government has in recent years been adopting measures to encourage FDI. Increased acquisitions by foreign companies will lead to higher FDI inflows. There will be a steady increase in FDI focused on growing domestic market opportunities, especially in consumer goods. FDI in manufacturing will remain limited, although it should increase from a low base on the back of improvements in infrastructure.

FDI inflows are set to increase substantially during the forecast period, but will still remain well below potential because of persistent business environment problems. The government's FDI target of US$25bn for fiscal year 2007/08 (April-March) is unlikely to be met. Political resistance to privatisation, inflexible labour laws and poor infrastructure will also restrict FDI inflows.

Medium-term drivers

Global FDI flows over the forecast period will be influenced by a combination of forces—most of them positive, pushing FDI flows upwards, but also some constraining factors that will keep flows below what they might otherwise be. One of the main factors underpinning our baseline FDI forecast is that the solid world economic recovery is set to continue. We forecast that global growth (at purchasing power parity—PPP—rates) will remain buoyant; it is forecast to average 4.6% a year over 2007-11. The strong global performance reflects in large part the increasing weight of fast-growing emerging markets, especially China and India.

Other reasons to expect continued growth in FDI include the ongoing global trend towards better business environments; technological change and the search for competitively priced skills; and sharper global competition that will push companies to grow through acquisitions or seek lower-cost destinations. The degree of firms' transnationalisation is also clearly linked to their performance, as also illustrated by the results of our survey. Firms that had a high degree of transnationalisation—those with more than 25% of revenue or employees outside their home markets—were more likely to have above-average financial performance than less internationalised firms.

The investment climate

Recent years have brought considerable improvement in the global investment climate. The liberalisation of economies and of policies towards foreign investors has acted as a spur to FDI. Our business environment rankings model provides a quantitative representation of these trends. The business environment rankings paint a relatively optimistic picture of the global operating environment over the next five years. On baseline assumptions, the global trend for liberalisation and deregulation is expected to continue.

A model of FDI determinants shows FDI to be very sensitive to the quality of the business environment. There is scope in almost all countries for still more improvement than we assume will occur over the medium term, with striking implications for FDI. For example, under the assumption that all countries' business environment scores for 2007-11 were a mere 5% higher than we actually assume, our model predicts annual average global FDI flows of US$1.7trn rather than the actual forecast of US$1.5trn. The difference of US$200bn per year, or US$1trn cumulatively over the whole 2007-11 period, is a measure of the huge opportunity cost, in terms of forgone FDI and thus development, of suboptimal policies.

Constraining factors

Several factors will work to dampen FDI flows and keep them below what they would otherwise be. FDI protectionism is one of those factors. Appeals to security threats and fears about the consequences of globalisation have prompted several governments to review and in some cases tighten their FDI regulations. Although instances of protectionism are expected to remain limited, this will nevertheless have some negative impact. At least some large crossborder deals are likely to be prevented. Some firms may be reluctant to engage in a crossborder deal if they feel that opposition from the host government might be an issue. Instances of outward FDI protectionism as well as regulatory restrictions in some emerging markets will also have some adverse impact.

Risks loom large

Our baseline forecast for global FDI flows in 2007-11 assumes that the effects of a host of positive factors for FDI growth will be tempered to an extent by factors such as growing opposition to foreign capital in

Table 4
Business environment ranks and scores

	2007-11 Total score	2007-11 Rank	2002-06 Total score	2002-06 Rank	Change in total score	Change in rank
Denmark	8.76	1	8.69	2	0.06	1
Finland	8.75	2	8.64	3	0.11	1
Singapore	8.72	3	8.71	1	0.01	-2
Switzerland	8.71	4	8.59	7	0.12	3
Canada	8.70	5	8.63	5	0.07	0
Hong Kong	8.68	6	8.57	8	0.11	2
US	8.65	7	8.64	4	0.01	-3
Netherlands	8.64	8	8.53	9	0.11	1
Australia	8.60	9	8.16	12	0.44	3
UK	8.60	10	8.62	6	-0.02	-4
Sweden	8.60	11	8.34	11	0.25	0
Ireland	8.57	12	8.49	10	0.07	-2
Germany	8.46	13	7.97	16	0.48	3
New Zealand	8.31	14	8.15	13	0.16	-1
Belgium	8.30	15	8.07	14	0.23	-1
Austria	8.24	16	7.87	17	0.36	1
Norway	8.14	17	7.99	15	0.15	-2
France	8.12	18	7.87	18	0.25	0
Taiwan	8.11	19	7.66	21	0.45	2
Chile	8.04	20	7.77	19	0.27	-1

Note. The model covers 82 of the largest economies in the world and scores each of these countries on a range of indicators affecting the business environment—for a five-year historical period (currently 2002-06) and a five-year forecast period (2007-11).

some countries and the negative impact of a host of political risks. However, it is possible that negative international political and economic developments could be worse than assumed, with a much more negative impact on global FDI than in our baseline assumptions.

The host of economic risks to our baseline range from overleveraged financial institutions to the impact of commodity price volatility. Turmoil in financial markets could be sharper and more prolonged than is assumed; the slowdown in the US could be steeper than expected; there could be the need for a more aggressive monetary policy stance by central banks in response to higher inflationary pressures. A sharp, sustained downward turn in global equity markets would, for example, put paid to the growth in M&As that underpins much FDI.

A rise in FDI protectionism—

Following decades of liberalisation and openness to FDI, protectionism is on the rise and there is a danger that it will intensify. To the extent that there is a backlash against globalisation and the economic uncertainty it entails, FDI (like free trade) becomes suspect, especially when political and social concerns supplement economic motives. There are also FDI-specific issues that are fuelling protectionist sentiment.

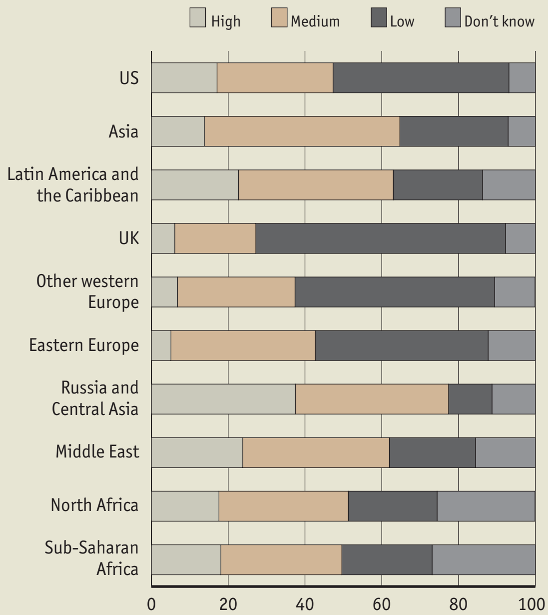
Alongside the continuing dominant trend of liberalisation towards FDI, there has also been a noticeable trend in recent years—in a number of countries and sectors—towards various forms of FDI protectionism. These include moves in several countries to tighten existing investment rules or to enact new rules to regulate foreign investments and protect “strategic sectors” from foreign investors.

Crossborder M&A deals have become a bone of contention in some countries. M&A deals have been blocked in both the developing and the developed world. In many countries, more rigorous screening procedures have been adopted. The growing involvement of private equity funds in crossborder M&As has generated considerable public criticism in some developed countries. The rise of sovereign investment agencies has reinforced calls for restrictive measures.

Several Latin American countries (Bolivia, Ecuador, Argentina, and Venezuela) have been renegotiating contracts with MNCs. Although China's foreign investment regime remains open, acquisitions of Chinese firms by foreign investors are increasingly being questioned. In Russia several oil sector contracts with MNCs have been renegotiated, or MNCs have been forced to sell parts of their stakes, and limits on foreign investment in strategic sectors are being introduced. There has been an increase in disputes between MNCs and host governments in recent years. More than 200 international arbitration cases concerning investment projects have been initiated in the past few years.

A large proportion of our survey respondents reported that they had experienced blocked M&A deals. There is concern that FDI protectionism will increase significantly in most emerging-market regions. There is also concern about FDI protectionism in the US, although investors appear more sanguine about the threat in other developed countries.

How high is the risk of increased FDI protectionism in the following markets during the next five years, in your view?
(% of respondents)



Source: Economist Intelligence Unit survey, June 2007.

—especially in the energy sector

The biggest investment risks are in the energy sector. The political risks of energy investments wax and wane with the tightness of global oil supplies. When markets are tight and oil prices are high, as they are now, existing contracts are renegotiated to the benefit of host countries, and some of the hydrocarbon reserves are re-nationalised. The absence of internationally agreed norms for foreign investment in energy hinders economic development in the host countries, foments aggressive geopolitical competition that threatens global security, and will block the scale of investment and co-operation necessary to overhaul a strained global energy system.

Political risks facing FDI in energy are likely to continue to rise in the coming years. The tensions will reflect the large gaps in income between rich and poor countries, which easily inspire a backlash against foreign investment within poor host countries (such as Bolivia); the growing scramble for natural resources in a fast-growing world economy, especially in view of the rising resource demands of China, and the possible peaking of conventional oil supplies in the coming decade; and the rising environmental threats, which will put many natural-resource-based FDI projects under increased scrutiny.

Outward FDI from emerging markets

Considerable attention is being devoted to increasing outward investment by companies from emerging markets. Outward FDI flows from emerging markets amounted to some US$160bn in 2005. This increased to an estimated US$210bn in 2006—at 17% of the global total, a slight decline from the share in 2005. Rapid economic growth, especially in Asia and oilexporting countries, high prices for raw materials and continuing investment liberalisation in some countries have underpinned strong growth in outflows.

Until relatively recently most FDI flows from emerging markets took the form mainly of so-called South-South investments. But MNCs based in emerging economies have also in more recent years undertaken some large, high-profile acquisitions in developed countries that have attracted considerable attention. The rise of multinationals from the South is an important phenomenon. It is also feeding rising protectionist sentiment in parts of the developed world, which makes it all the more important to keep the development of emerging-market outward FDI in perspective. There are still relatively few companies from the South on the list of the worlds' major MNCs. Despite the increase in FDI outflows from emerging markets in recent years, these are still dwarfed by investments originating in the developed world. Although it is set to increase in the future, the present degree of penetration of developed countries by Southern capital is minuscule.

The US will set the tone

Developments in the US will be of critical importance to overall global trends. Thus, for example, following the September 11th 2001 terrorist attacks, the movement of people and goods in and out of the US is not as free as it was previously. The US is no longer as hospitable to foreign students and migrants. Nor will the US operate an open-door policy with respect to foreign capital: occasionally it will block foreign takeovers of key US companies, which has become more likely following recent legislative changes. All this will make for a constrained globalisation and for less FDI than might otherwise be the case. There is, furthermore, a risk of more intensive protectionism than we assume in our baseline forecast, which would then also spill over to other parts of the world.

The management of political risk

The survey revealed that many firms are not addressing adequately their expectations of increased political risk. Firms that outperformed their competitors paid significantly more attention to assessing and taking measures to manage political risk. Better-performing companies, with better political risk assessment capabilities, also experienced fewer cases of expropriation, government payment default, import/export licence cancellation, or currency transfer restriction than other firms in our survey sample.

The virtuous circle of globalisation

Our survey also demonstrated that firms that exhibited a high degree of transnationalisation—those with more than 25% of revenue or employees outside their home markets—were significantly more bullish in their investment outlook than firms that are comparatively more focused on domestic operations. Of firms with more than one-quarter of their employees working overseas, 45% expect foreign investment to increase substantially in 2007-11, compared with 34% of those with a greater home-market focus. Crucially, there also appears to be a link between the degree of transnationalisation and companies' performance: those firms in our survey with a relatively greater presence in foreign markets were more likely to report better than average financial performance over the past two years (62% compared with 53% for the less internationalised firms).

On most survey questions, the degree of transnationalisation did not appear to be related to significant differences in perceptions of political risk. But there were a few exceptions, suggesting that the experience, and confidence, gained from operating intensively in foreign destinations led to a more sanguine view of some types of political risk. Thus, perhaps ironically, more intensive internationalisation appeared to be associated with less fear of some of the consequences of greater exposure to globalisation.

