

Trends in foreign direct investment and cross border mergers and acquisitions

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Recent trends

World foreign direct investment (FDI) inflows increased to US\$955bn in 2005, a 19% increase in nominal US dollar terms on the 2004 total. This followed a 22% increase in global inflows in 2004 to US\$802bn.¹ In nominal US dollar terms, the 2005 total was the third-highest on record (global inflows reached US\$1.1trn in 1999 and peaked at US\$1.4trn in 2000). The 2004-05 recovery in global FDI flows followed a deep slump in both global FDI inflows and closely related crossborder mergers and acquisitions (M&As) in 2001-03.

As in 2004, emerging markets accounted for the bulk of the increase in FDI inflows in 2005. FDI inflows into emerging markets grew by 26% in 2005 to reach a record high of almost US\$400bn (more than 40% of the global total). By contrast, inflows into the developed world increased by 14%, following a modest recovery by 7% in 2004.

Table 1

FDI inflows

(US\$ bn unless otherwise indicated)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---------------------|--------------|--------------|--------------|----------------|----------------|--------------|--------------|--------------|--------------|--------------|
| World total | 399.0 | 493.8 | 717.7 | 1,122.2 | 1,413.0 | 875.1 | 733.2 | 655.8 | 801.7 | 954.8 |
| Developed countries | 231.9 | 281.2 | 498.4 | 860.3 | 1,131.1 | 586.4 | 539.6 | 453.9 | 485.6 | 555.6 |
| % of world total | 58.1 | 56.9 | 69.4 | 76.7 | 80.0 | 67.0 | 73.6 | 69.2 | 60.6 | 58.2 |
| Emerging markets | 167.1 | 212.6 | 219.3 | 261.9 | 281.9 | 288.7 | 193.7 | 201.9 | 316.1 | 399.2 |
| % of world total | 41.9 | 43.1 | 30.6 | 23.3 | 20.0 | 33.0 | 26.4 | 30.8 | 39.4 | 41.8 |

Source: Economist Intelligence Unit's *World Investment Prospects to 2010*, written with the Columbia Program on International Investment, based on data from National statistics, Economist Intelligence Unit, IMF, UNCTAD.

The global environment for FDI and M&As improved considerably in 2004 and 2005. Economic growth remained strong in the US and accelerated in other OECD countries. Most emerging markets recorded solid growth, with China's economy continuing to power ahead at exceptionally high rates. Other conditions underpinning FDI became more favourable: corporate profitability was strong, interest rates were low and equity markets generally performed well. Ample liquidity was available for companies to invest abroad.

Critical role of crossborder M&As

The pick-up in global FDI in 2005 was in large part the result of a recovery in M&As, including in crossborder deals. Crossborder M&As form the overwhelming part of FDI flows in the developed world, and an increasing share of FDI in emerging markets. In addition, M&As are the component of FDI that responds most quickly to changes in the business environment, financial conditions and macroeconomic performance. Many companies had accumulated large amounts of cash on their balance sheets. Companies have engaged in more restructuring, a trend that has also supported crossborder M&As. Another element is the increase in transactions being undertaken by private equity groups, which are raising ever-larger funds and have concluded a series of multi-billion-dollar deals.

¹ The 2005 global total for FDI inflows was heavily influenced by two large accounting transactions—in an upward direction by US\$115bn for the UK (owing to the reorganisation of the Shell Transport and Trading Company and the Royal Dutch Petroleum Company into Royal Dutch Shell, an essentially accounting operation that was recorded in the UK's balance of payments as an FDI inflow), and in a downward direction for Australia (a net disinvestment of US\$37bn resulting from a reorganisation by News Corporation). Netting out these two accounting transactions, global FDI inflows would have amounted to US\$875bn in 2005, or only 9% more than in 2004. Furthermore, rather than increasing, the 2005 total for the developed world would have been slightly lower than in 2004.

Crossborder mergers and acquisitions and FDI

Crossborder mergers and acquisitions (M&As) make up the overwhelming part of FDI flows. However, there is no one-to-one correspondence between data on FDI flows and crossborder M&As. The latter may be financed by local or international capital market funds that are not reported as FDI, as recorded in balance-of-payments statistics. Data on M&As refer to amounts recorded at the time of closure of deals, and values are not necessarily paid out in a single year. In addition, FDI—the change in inward and outward direct investment assets and liabilities—is reported on a “net” basis: for example, FDI inflows equal inward investment flows minus repatriated capital. M&A data are on a gross basis, and, furthermore, associated payments can be phased over several years. Finally, M&A statistics often record the total amount of capital, whereas FDI refers only to transactions involving more than 10% of the equity capital of firms (if less than 10%, the flows are classified as portfolio investments).

According to data from the company Zephyr, in 2005 the value of completed global crossborder M&As (of “FDI-type”, involving the purchase of more than 10% of the equity of a firm) increased by 35% to an estimated US\$827bn. Crossborder M&As in the developed world made up about three-quarters of the global total in 2005. There was a marked increase in deal activity in Europe. The share of emerging markets in global crossborder M&As has been gradually increasing. However, this trend does not appear to be accelerating. Indeed, the growth in crossborder M&As in 2006 has been heavily concentrated in the developed world.

Table 2 Completed crossborder M&A purchases; OECD countries

| | Values (US\$ bn) | Yr on yr % growth | Deal nos |
|------------|------------------|-------------------|----------|
| Q1 2005 | 99.2 | 1.0 | 1,773 |
| Q2 2005 | 121.5 | 1.1 | 1,867 |
| Q3 2005 | 177.0 | 56.3 | 1,765 |
| Q4 2005 | 252.2 | 50.9 | 2,026 |
| Q1 2006 | 192.2 | 93.8 | 1,912 |
| Q2 2006 | 161.4 | 32.8 | 1,841 |
| Q3 2006 | 139.4 | -21.2 | 1,657 |
| Q1-Q3 2005 | 397.7 | 19.9 | 5,405 |
| Q1-Q3 2006 | 493.0 | 24.0 | 5,410 |

Source: based on data from Zephyr.

Industry consolidation in Europe and the US is fuelling the surge in M&As. A few fundamental changes are supporting the wave of acquisitions. Hedge funds are forcing companies to put themselves up for sale by agitating for corporate changes that would increase stock prices. Private equity funds have been willing to inject capital into all kinds of deals. Private equity transactions represent about 20% of all M&A activity worldwide, in line with a trend that has been building since the end of 2003.

Policy and attitudes towards foreign investment

Recent years have brought considerable improvement in the global investment climate. Policies have been liberalised in many countries across the globe. The liberalisation of economies and of policies towards foreign investors has acted as a spur to FDI. Policy towards foreign investment is a category that is measured in the Economist Intelligence Unit's business environment model (see box). Scores are given both for the historic period (2001-05 average) and are projected over a five-year forecast period (2006-10). Out of the 82 countries covered, in only three (Cyprus, France and Kazakhstan) does the projected score deteriorate in 2006-10 compared with 2001-05; in 29 it stays the same and in 50 it improves. This embodies our expectation that the pattern of liberalisation of policy towards FDI will continue in many countries, despite the signs of a possible backlash in some countries (see below), and will on average not be reversed globally.

The business environment rankings

The Economist Intelligence Unit's business environment rankings model covers 82 of the world's leading economies. The model seeks to measure the quality or attractiveness of the business environment and its key components. The quantitative assessment of the business environment—the opportunities for and obstacles to business—enables a country to be ranked on its overall position and in each of ten categories, on both a global and regional basis. The model uses quantitative data, business surveys and expert assessments to measure the attractiveness of the business environment across the 82 countries. Individual country scores are compiled by a large team of in-house economists and country experts, assisted by a global network of associated contributors and analysts. The framework is designed to reflect the principal criteria used by companies to formulate their global business strategies and investment location decisions. The overall scores (on a scale of 1-10) and rankings are based on scores for 91 indicators, grouped into ten categories of the business environment. Scores and rankings are produced for both a five-year historical period (currently 2001-05) and a five-year forecast period (2006-10).

The enabling framework for FDI, captured by the policy towards foreign investment in the model, consists of the rules and regulations governing entry and operation of FDI, and overall standards of treatment. Although open FDI policies are a necessary condition a wide range of other policies can influence FDI decisions. These are captured in the other categories of our business environment rankings model, and include government measures that influence institutional effectiveness, infrastructure and skill endowments, macroeconomic and political stability. They also involve policies towards private enterprise in general: tax, labour market, financial sector, and foreign trade and exchange-rate policies.

Table 3, which gives data for average FDI flows per head in 2001-2005 and the policy toward foreign investment index in 2001-05 for 65 countries (excluded are countries with abundant natural resources). Although there are many other factors that affect FDI (in addition to natural resource endowments), policy towards foreign investment (or the extent of investment protectionism) is clearly correlated with FDI flows (as suggested by the rankings of the two variables in table 3). The correspondence between country ranks for policy towards foreign investment and FDI flows per head is close for all segments—high-FDI recipient countries, as well as medium and low-FDI recipients. There are, perhaps surprisingly, few exceptions. This illustrates the critical importance of the policy framework, despite the fact that many other factors also drive FDI. Table 4 gives projected data on FDI flows and the policy index for selected countries.

Table 3

| | FDI inflows (US\$ per head), 2001-05 average | | Policy towards foreign investment index, 2001-05 | |
|----------------|--|------|--|------|
| | FDI | Rank | Score | Rank |
| Singapore | 4,148 | 1 | 9.55 | 1 |
| Hong Kong | 3,452 | 2 | 8.65 | 9 |
| Belgium | 2,912 | 3 | 8.65 | 9 |
| Ireland | 2,644 | 4 | 9.55 | 1 |
| Netherlands | 1,767 | 5 | 9.55 | 1 |
| Sweden | 1,209 | 6 | 9.1 | 5 |
| UK | 1,173 | 7 | 9.55 | 1 |
| Switzerland | 1,148 | 8 | 8.7 | 8 |
| Finland | 898 | 9 | 9.1 | 5 |
| Estonia | 834 | 10 | 8.65 | 9 |
| France | 794 | 11 | 8.2 | 18 |
| Spain | 689 | 12 | 8.65 | 9 |
| New Zealand | 685 | 13 | 8.2 | 18 |
| Austria | 641 | 14 | 8.2 | 18 |
| Czech Republic | 627 | 15 | 8.2 | 18 |
| Canada | 605 | 16 | 8.65 | 9 |
| Israel | 516 | 17 | 8.65 | 9 |
| Australia | 429 | 18 | 8.2 | 18 |
| Portugal | 428 | 19 | 7.3 | 27 |
| Denmark | 417 | 20 | 9.1 | 5 |
| Hungary | 405 | 21 | 8.2 | 18 |
| USA | 388 | 22 | 8.65 | 9 |

Table 3

| | FDI inflows (US\$ per head), 2001-05 average | | Policy towards foreign investment index, 2001-05 | |
|--------------------|--|------|--|------|
| | FDI | Rank | Score | Rank |
| Slovenia | 385 | 23 | 6.6 | 42 |
| Slovakia | 349 | 24 | 7.75 | 24 |
| Chile | 337 | 25 | 8.25 | 17 |
| Croatia | 335 | 26 | 6.85 | 34 |
| Germany | 302 | 27 | 8.65 | 9 |
| Italy | 283 | 28 | 6.85 | 34 |
| Bulgaria | 230 | 29 | 6.85 | 34 |
| Mexico | 184 | 30 | 7.75 | 24 |
| Poland | 183 | 31 | 7.75 | 24 |
| Lithuania | 180 | 32 | 6.85 | 34 |
| Romania | 173 | 33 | 6.85 | 34 |
| Latvia | 172 | 34 | 7.3 | 27 |
| Costa Rica | 145 | 35 | 6.4 | 46 |
| Serbia | 118 | 36 | 6.6 | 42 |
| Malaysia | 112 | 37 | 7.3 | 27 |
| Greece | 103 | 38 | 7.3 | 27 |
| Jordan | 99 | 39 | 6.4 | 46 |
| Dominican Republic | 98 | 40 | 6.4 | 46 |
| South Korea | 97 | 41 | 6.85 | 34 |
| Brazil | 95 | 42 | 7.2 | 31 |
| Colombia | 89 | 43 | 6.85 | 34 |
| Taiwan | 85 | 44 | 7.2 | 31 |
| Argentina | 78 | 45 | 5.95 | 51 |
| South Africa | 74 | 46 | 5.95 | 51 |
| Peru | 67 | 47 | 6.4 | 46 |
| Morocco | 62 | 48 | 5.5 | 56 |
| Tunisia | 59 | 49 | 5.5 | 56 |
| El Salvador | 57 | 50 | 6.6 | 42 |
| Ukraine | 52 | 51 | 4.15 | 63 |
| Turkey | 52 | 52 | 6.4 | 46 |
| Japan | 51 | 53 | 5.5 | 56 |
| China | 43 | 54 | 5.95 | 51 |
| Thailand | 37 | 55 | 7.2 | 31 |
| Egypt | 22 | 56 | 6.85 | 34 |
| Vietnam | 20 | 57 | 5.95 | 51 |
| Cuba | 14 | 58 | 2.8 | 65 |
| Philippines | 11 | 59 | 5.95 | 51 |
| Sri Lanka | 10 | 60 | 6.5 | 45 |
| Pakistan | 6 | 61 | 5.5 | 56 |
| India | 5 | 62 | 5.05 | 60 |
| Bangladesh | 2 | 63 | 3.7 | 64 |
| Kenya | 1 | 64 | 5.05 | 60 |
| Indonesia | 0 | 65 | 5.05 | 60 |

The policy toward foreign investment score, on scale of 1 to 10, is a category in the Economist Intelligence Unit's business environment model. It is based on the following 5 indicators: assessment of overall government policy towards foreign capital, openness of national culture to foreign influences, risk of expropriation of foreign assets, availability of investment protection schemes, extent of government favouritism towards domestic firms.

Source: Economist Intelligence Unit.

Table 4 FDI and policy towards FDI, 2006-10, selected countries

| | FDI inflows (US\$ per head), 2006-10 average | | Policy towards foreign investment, 2006-10 | |
|-----------|--|------|--|------|
| | FDI | Rank | Score | Rank |
| Singapore | 5,037 | 1 | 9.55 | 1 |
| UK | 1,480 | 7 | 9.55 | 1 |
| France | 1,144 | 12 | 7.75 | 27 |
| USA | 984 | 14 | 8.65 | 10 |
| Germany | 479 | 23 | 8.65 | 10 |
| Italy | 423 | 25 | 7.75 | 27 |
| Brazil | 98 | 47 | 7.3 | 34 |
| China | 65 | 53 | 6.85 | 47 |
| Japan | 60 | 55 | 6.85 | 47 |
| India | 10 | 62 | 6.4 | 53 |

Source: Economist Intelligence Unit

A possible backlash?

Following decades of liberalisation and openness to FDI, there are, however, also some signs of a possible backlash. The question arises as to whether we may be entering a phase of retrenchment in policies and attitudes towards FDI, with a possible serious negative impact on global FDI flows. Crossborder M&As sometimes involve domestic firms that are regarded by politicians as “national champions”—perceived to be important for national security, cultural identity or economic development. Host-country resistance to such investment is becoming more frequent.

Examples of protectionism have included attempts to block acquisitions that were ultimately successful—the bid of Lenovo (China) to acquire the personal computer (PC) division of IBM (US), and the ultimately also successful bid by the Netherlands-based Mittal Steel for Arcelor (Luxembourg). However, other deals have been impacted because of opposition, including the failed effort by CNOOC (China) to take over Unocal (US); Dubai Ports World's attempt to acquire P&O Steam Navigation Company (UK), which controlled five ports in the US; and a rumoured attempt by Pepsi (US) to take over Danone (France).

Resistance to crossborder M&As was reflected in the European Commission's takeover directive, which was diluted compared with initial drafts. Two bills are at present making their way through the US Congress that would subject potential foreign takeovers to more rigorous scrutiny—relatively limited changes are being considered in the House of Representatives and a far more restrictive bill is before the Senate.

The growing involvement of foreign private equity groups in M&As adds an edge to this mode of entry into foreign markets, as such transactions are typically not seen to be long-term investments, but rather as seeking only quick profits. In Germany, this led a prominent politician to liken such investors to the “biblical plague of locusts”.

In some developed countries there has also been an especially negative reaction to high-profile attempted takeovers by firms from emerging markets. As emerging-market MNCs expand further, seeking to secure natural resources, take over brand names and acquire technology, resistance may increase. Emerging-market MNCs are sometimes (rightly or wrongly) seen as having an unfair advantage (explicit backing and support from their governments) or being more prone than their developed-country counterparts to undesirable behaviour (low standards of governance and less socially responsible behaviour).

The growing unease with FDI has not been limited to developed countries. There are signs that it is spreading to emerging markets. In some countries the terms of existing contracts with MNCs are being questioned. In others there is growing unease with what is seen as excessive dependence on foreign capital. For example, there is now a growing debate within China (by far the largest recipient of FDI among emerging markets) as to the merits of

FDI, especially in the form of M&As (particularly in banking and insurance). Russia is considering rules to protect “strategic sectors” from foreign investors, especially—but not only—in the oil industry.

In their current manifestation, the various developments discussed here do not yet add up to a backlash against FDI; they do not herald an end to FDI liberalisation or presage a marked slowdown in FDI flows. However, they do suggest that there is an increasing ambivalence in attitudes towards FDI and that it cannot be taken for granted that FDI openness will persist.

The baseline forecast

Global FDI flows over the next few years will be influenced by a combination of forces—most of them positive, pushing FDI flows upwards, but there are also some constraining factors. Solid world economic growth is set to continue. Global liquidity also remains high by historical standards. Other reasons to expect continued growth in FDI include the ongoing global trend towards better business environments; some progress in regional integration; 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.

However, several factors will work to dampen FDI flows and keep them below what they would otherwise be. Although instances of FDI protectionism—on security grounds or whatever the excuse—are expected to remain limited, this will nevertheless have some negative impact. At least some large crossborder deals are likely to be prevented. Perhaps as important, manifestations of “economic patriotism” can significantly influence the likelihood of whether a crossborder M&A is even attempted. Some firms may be reluctant to engage in a crossborder deal if they feel that opposition from the host government might be an issue.

Table 5

FDI inflows

(US\$ bn unless otherwise indicated)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|-------|-------|-------|-------|--------|---------|---------|---------|---------|---------|
| World FDI inflows | 875.1 | 733.2 | 655.8 | 801.7 | 954.8 | 1,165.0 | 1,222.5 | 1,285.3 | 1,342.9 | 1,407.3 |
| Rate of growth (%) | -38.1 | -16.2 | -10.6 | 22.2 | 19.1 | 22.0 | 4.9 | 5.1 | 4.5 | 4.8 |
| % of GDP | 2.8 | 2.3 | 1.8 | 2.0 | 2.2 | 2.4 | 2.3 | 2.4 | 2.4 | 2.4 |
| FDI inflows to developed countries | 586.4 | 539.6 | 453.9 | 485.6 | 555.6 | 754.3 | 814.8 | 880.7 | 929.0 | 979.4 |
| Rate of growth (%) | -48.2 | -8.0 | -15.9 | 7.0 | 14.4 | 35.8 | 8.0 | 8.1 | 5.5 | 5.4 |
| % of GDP | 2.4 | 2.2 | 1.6 | 1.6 | 1.7 | 2.2 | 2.2 | 2.3 | 2.3 | 2.4 |
| % of world total | 67.0 | 73.6 | 69.2 | 60.6 | 58.2 | 64.8 | 66.7 | 68.5 | 69.2 | 69.6 |
| FDI inflows to emerging markets | 288.7 | 193.7 | 201.9 | 316.1 | 399.2 | 410.6 | 407.7 | 404.7 | 413.9 | 427.9 |
| Rate of growth (%) | 2.4 | -32.9 | 4.3 | 56.5 | 26.3 | 2.8 | -0.7 | -0.7 | 2.3 | 3.4 |
| % of GDP | 3.9 | 2.5 | 2.3 | 3.1 | 3.4 | 3.0 | 2.8 | 2.6 | 2.4 | 2.3 |
| % of world total | 33.0 | 26.4 | 30.8 | 39.4 | 41.8 | 35.2 | 33.3 | 31.5 | 30.8 | 30.4 |
| World stock of inward FDI | 6,433 | 7,102 | 8,455 | 9,622 | 10,317 | 11,450 | 12,639 | 13,888 | 15,192 | 16,560 |
| Rate of growth (%) | 6.0 | 10.4 | 19.1 | 13.8 | 7.2 | 11.0 | 10.4 | 9.9 | 9.4 | 9.0 |
| % of GDP | 20.5 | 21.8 | 23.2 | 23.5 | 23.4 | 24.1 | 24.2 | 25.5 | 26.7 | 27.8 |

Source: Economist Intelligence Unit's *World Investment Prospects to 2010*, written with the Columbia Program on International Investment, based on data from National statistics, Economist Intelligence Unit, IMF, UNCTAD.

The forecast total global FDI inflows in 2006 of some US\$1.16trn, a 22% increase over 2005, will be the first time since 2000 that global inflows will have surpassed the US\$1trn mark. Economic growth and the delayed impact of crossborder deals will underpin growth in FDI flows, especially in developed countries. The pattern of 2004-05, when emerging markets drove the recovery, will be reversed—inflows into emerging markets in 2006 are expected to increase by only about 3% in US dollar terms, whereas inflows into the developed world are projected to rise by

36%. In part this is because of the delay in the recovery in intra-developed country flows, whereas the bounceback in flows to the emerging markets occurred about two years earlier.

After 2006, global FDI flows will continue to rise, but the rate of growth is expected to slow. In 2006-10 as a whole, global FDI inflows are projected to grow at an average annual rate of around 8%. In the developed world the main part of FDI will continue to originate from M&A activity. A number of the fundamental forces that have underpinned past M&A waves will remain. These factors include relatively low interest rates; the competitive pressures for restructuring and consolidation; and the increasing sophistication of financial markets.

Significant deal-making is expected in Europe's financial sectors. Some recent deals suggest that the traditional reluctance to engage in crossborder mergers in Europe's banking sector may finally be fading, although obstacles that have hampered crossborder mergers in the past still loom large. The European financial services industry is still fairly fragmented, with country-specific taxes, regulations and cultures. However, large mature financial institutions increasingly face more limited growth opportunities in home markets. This has led acquisitive companies to search for crossborder opportunities, a trend that will continue.

Risks

Our baseline forecast for global FDI flows in 2006-10 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 some countries and the negative impact of geopolitical uncertainty. However, there are many downside risks to our baseline forecast. In other words, 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.

Our central forecast implies robust global growth over the next five years. However, important risks stem from large economic imbalances in key countries. A connected threat is another downward turn in global equity markets, which would put paid to any revival in M&As. Three types of, in part inter-related, geopolitical risks pose a threat to our baseline FDI scenario: disruptions and costs to business associated with terrorist attacks and the threat to personal security; the potential adverse impact on global business of the unsettled international political climate; and the threat to globalisation from strengthened protectionist sentiment.

Our baseline scenario of "constrained globalisation" implies a world significantly less open to trade and investment than under the unfettered "super globalisation" scenario that seemed possible in the latter part of the 1990s. At the same time, it is a far cry from a scenario of a retreat from globalisation, with bouts of serious protectionism—still less the "globalisation sunk" scenario, akin to what occurred in the first part of the 20th century.

The main reasons why we assume in our baseline assumptions that a descent into serious protectionism or a backlash against globalisation and FDI will not happen include the following.

- Powerful business interests in the US and Europe will continue to lobby and push for FDI openness, including to companies from the South. Their efforts are already bearing fruit in at least partly defusing the growing demand in the US for FDI protectionism. This example is part of a much broader process—the interest of (most) business is in openness and globalisation.
- The intellectual case is not paramount, but it is not unimportant. General opposition to globalisation—and also with respect to the case against FDI—continues to be hamstrung by the poverty of its intellectual underpinnings. Appealing to fear and emotion can be effective sometimes, but intellectual foundations and respectability are necessary to sustain a general trend.
- Technology and communications developments will continue to be strong countervailing forces undermining moves toward protectionism of all kinds.
- The fast-growing emerging markets, such as China and India, will be a powerful engine sustaining international integration and overcoming protectionist reactions.

Worldwide, economics will continue to trump populism and political concerns—although it would be wrong to ignore the danger that it just might turn out otherwise.

Alternative scenarios

The Economist Intelligence Unit's measure of the quality of the business environment across countries that was discussed, and our cross-section empirical framework for forecasting FDI flows can be employed to yield estimates of FDI flows under alternative scenarios. In our empirical framework, FDI flows are related to a number of determinants, including income levels (market size), GDP growth, natural resource endowments, distances between countries, labour costs adjusted for productivity, as well as our business environment variable (which covers various aspects of the policy, institutional and operating climate).

We construct two alternative scenarios to our baseline forecast for global FDI in 2006-10—"boom" and "backlash" scenarios based on different assumptions about key elements of countries' business environments. Under a boom scenario we simply assume across-the-board improvements across all or most categories of the business environment; we also assume that these are spread across all the 82 countries that are covered.

Boom scenario

We simply posit that all countries' business environment scores for 2006-10 are 10% higher than we actually forecast. Our model predicts annual average FDI flows for the 82 countries that are about 30% higher than under baseline assumptions. This percentage increase is then applied to the US\$1.28trn in global average annual FDI flows under our baseline forecast (the FDI flows for the 82 make up some 90% of the world total). These estimates point to the huge opportunity cost, in terms of foregone FDI, of suboptimal policies (the difference in FDI flows under boom and baseline scenarios is nearly US\$2trn in total over 2006-10).

Table 6 Alternative scenarios for global FDI inflows, 2006-2010 annual average (US\$ bn)

| | Baseline | Boom | Backlash |
|---------------------|----------|-------|----------|
| World total | 1,285 | 1,666 | 1,015 |
| Developed countries | 872 | 1,066 | 682 |
| Emerging markets | 413 | 600 | 333 |

Source: Economist Intelligence Unit's *World Investment Prospects to 2010*, written with the Columbia Program on International Investment, based on data from National statistics, Economist Intelligence Unit, IMF, UNCTAD.

Backlash scenario

For the backlash scenario we make a series of more detailed assumptions about indicators related more specifically to policies towards FDI and related aspects. Thus we assume (again across all 82 countries) a 20% decrease on average in the score for the policy toward FDI category in our business environment rankings (reflecting direct forms of backlash against FDI); lower scores by 10% for the foreign trade and exchange regime (greater protectionism) and policy toward private enterprise and competition categories; and a related downgrading by one point for the indicator scores for the impact of international disputes and tensions and government attitudes to business in the political environment category. The use of the resulting lower average business environment scores in our FDI forecasting model yield the FDI inflows estimates under the "backlash" scenario. Again the impact on FDI would be considerable.