

**Analysis of  
development in the  
field of direct  
investment and M&A**

**Executive Summary**

**EC Internal Market  
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## ***Developments in FDI and M&A in 2007 and the first half of 2008***

### **Economic environment**

The 2007 saw a sharp break from the favourable economic conditions which had characterised the global economic environment for many years.

The sub-prime crisis, which erupted in late summer and fall 2007, and the ensuing credit crunch and the sharp downturn in the housing and construction sector tipped the US economy into a recession by late 2007. Although the consumer fiscal stimulus package of spring 2008 provided temporary relief in the first half of 2008, underlying economic prospects in the USA continued to weaken sharply through 2008.

While the EU economy weathered these adverse developments relatively well through the first quarter 2008, by late spring 2008, a sharp deceleration in economic growth started to be felt in the eurozone and other EU Member States.

Unprecedented increases, in raw material prices in 2007 and early 2008 compounded the problems facing the world economy. These prices have since retreated somewhat from their peaks but remain still much higher than only a few years ago.

Emerging markets appeared until recently to be largely protected from the fall-out of the global credit crunch. But, the most recent events in a number of emerging economies clearly show that the so-called decoupling hypothesis no longer holds.

International capital markets were significantly affected in 2007 and the first half of 2008 by a number of developments, some of which are a direct consequence of the financial turmoil while others reflect more of an ongoing-trend. These factors include the continued large current surpluses run by commodity producing countries and China, a correction in the US current account balance reflecting the weaker US economy, the depreciation of the US dollar on an effective basis through 2007 and through the first half of 2008, the contribution of a number of Sovereign Wealth Funds to the recapitalisation of major financial institutions in 2007, reduced financial sector lending to business, including for M&A activity, and the deleveraging of financial institutions through 2008.

### **International capital flows in 2007**

In 2007, total gross financial inflows (i.e. the current account balance + inward foreign direct investment + inward portfolio investment + other inward investments) world-wide are estimated to reached a new record high of about US \$ 9.5 trillion, up 22% from 2006.

Overall, from 2003 to 2007, annual gross financial inflows increased by 342%, much faster than world GDP growth.. This rapid growth is the result of growing current account imbalances among the various countries and financial globalisation in a context of growing leveraging and product innovation in the financial sector.

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Such gross financial inflows are heavily concentrated within the industrialised countries, although a number of emerging economies, such as China, Russia, Taiwan, Korea, Saudi Arabia, Hong Kong, Kuwait, India, Brazil, and Malaysia, have become major players in international capital flows. In recent years, the share of total gross financial inflows into the emerging economies listed above has been growing, reflecting the very significant current account balance surpluses registered by some of these economies and/or FDI and portfolio investment opportunities.

Total outflows of private capital, defined as the sum of outward foreign direct investment and portfolio investment is estimated to have been broadly stable at almost \$5T in 2007 after having grown rapidly from just \$1.5T in 2002 to almost \$5T by 2006.

The EU27 is by far the largest source of outward private capital flows and accounts typically for between 50% and 60% of total private capital outflows. In contrast, the US typically accounts for between 10% and 15% of total outward private capital movements while the contribution of the euro-zone typically exceeds that of the US by a significant margin. It is important to note that the data referring to the EU27 are gross flows and do not net out intra-EU flows, while the euro-zone data reflect only transactions of euro area residents with non-euro area residents.

### **World-wide FDI in 2007**

The September 2007 UNCTAD figures for 2007 show that inward FDI world-wide reached a new record level of US\$ 1,844 billion (EUR 1,338 billion) in 2007. However, its annual rate of growth decelerated sharply, from 47% in 2006 to 30% in 2007.

Total inward FDI worldwide more than doubled between 2003 (the last trough) and 2007 while world GDP increased by slightly less than 50%

FDI into the developed world in 2007 accounted for about two-thirds of total inward FDI, about the same as in 2006 and 2005. The share of the developed world has fluctuated between a high of 81% in 2000 and a low in 56% in 2004. The European Union<sup>1</sup> accounted 44% of total inward investment.

The developed world is also by far the largest source of outward foreign direct investment, accounting for between 80% and 90% of total outward investment. In 2007, this figure stood at 85%, about the same as for the last five years. The share of total outward foreign direct investment accounted for by the European Union reached 57% in 2007, broadly in line with its trend share since 2000.

Some emerging economies, in particular the oil-producing countries in the Gulf, India and Russia are becoming relatively more important sources of foreign direct investment.

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<sup>1</sup> The European Union FDI data from the UNCTAD refer to inward investment originating from outside and inside the EU27.

## **EU27 inward and outward FDI**

Consistent with the general picture of buoyant inward and outward direct investment flows shown in the previous section, inward and outward investment in the EU showed strong growth in 2007.

While intra-flows within the EU remain the largest component of FDI in the EU27, at EUR 469 billion in 2007, they increased only moderately (Figure 14).

In contrast, outflows from the EU27 rose sharply by 53% and reached almost €420 billion in 2007. Inflows also grew markedly, by 90% to €319 billion in 2007.

Total FDI flows into the ten new Member States from Central and Eastern Europe<sup>2</sup> (CEE) have increased by three-fold in the past seven years, from EUR 24 billion in 2001 to EUR 70 billion in 2007.

Interestingly, the recent increase in inflows does not originate from the EU15 Member States, but rather from non-EU countries. The share of inflows into the CEE countries accounted for by the EU15 fell from 83% in 2005 to 65% in 2006 and remaining at 67% in 2007.

The mix of source countries of inward investment into EU Member States is far from uniform across Member States. Although the United Kingdom receives the greatest inflows, the majority comes from outside of the EU. This is also true for Ireland and Luxembourg. In contrast, most other countries receive a majority of their inward investment flows from other EU Member States.

Cross-border merger and acquisitions activity in 2007 broadly remained at the level observed in 2006 in terms of the aggregate value of the deals and the numbers of deals.

Data available for the first half of 2008 suggest that the pace of cross-border M&A activity is weaker than in 2007 and the year will end very likely below the 2007 level.

In the case of M&A within EU, the largest 10 deal M&A deals accounted for almost 75% of the total deal value of such deals, with the two largest deals being in the power and financial sectors. In the case of EU27 M&A deals originating from outside the EU27, the largest ten such deals accounted for almost 60% of the total deal value of such deals in 2007 and the two largest deals were in the pharmaceutical and insurance sectors.

The latest available data show that, within the service sector, the “financial intermediation” sector is the most important attractor of inward direct investment, accounting for slightly more than 42% of total inward investment (in terms of stock).

The “real estate and business activities” sector is by far the second largest attractor of foreign direct investment, accounting for somewhat less than a 1/4 of total foreign direct investment (in terms of stock).

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<sup>2</sup> Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

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Manufacturing as a whole attracted only about 16% of total foreign direct investment, and the manufacturing sub-sector with the largest share of foreign direct investment, the “petroleum, chemical, rubber, and plastic products” sector accounts for less than 6% of the total stock of foreign direct investment in the EU27 in 2007.

While the sectoral shares of FDI from the EU27 and from outside the EU differ slightly in many cases, there is no sector where the attractiveness to inward foreign direct investment varies markedly between FDI from the within and outside.

There has been very large growth in outward direct investment flows between 2003 and 2007 in several Member States. In nine Member States, the growth has been four-fold. With the exception of Germany, these are new Member States, with Poland showing the strongest growth.

As in the case of inward investment, neighbouring and large economies in the EU have been the main recipients of outward investment (in terms of stocks) from EU Member States.

### *The footprint of foreign-owned companies in the EU economy*

The data from the Amadeus databank, the largest databank containing economic and financial information on European companies, which is published by Bureau Van Dijk, was used for the analysis of the contribution of foreign-owned companies to the EU economy.

As there exist significant differences between the Amadeus data and the limited Eurostat data on foreign-owned companies in the EU, any conclusions drawn from the analysis of the Amadeus data should be considered cautiously. However, until comprehensive and robust Eurostat data are available in the near future, it is impossible to determine a priori to what extent such conclusions are robust.

In general, in 2006, domestic-owned firms accounted for about 2/3 or more of the total value of turnover in 2006, employment in 2006, operating profit in 2006, fixed assets, net investment and value added. Foreign-owned firms with an owner from outside the EU accounted for about 9% to 11% of the value of the different indicators and foreign-owned firms with an owner from another EU Member State for about 9%.

### *Differences in performances between domestic and foreign firms*

A few key facts stand out from an empirical analysis of the effect of foreign ownership (in general or from another EU Member State) on firm economic performance.

First, in the vast majority of cases, differences in the impact of being foreign-owned in general and being foreign-owned by an owner from another EU Member State are nil;

Second, observed differences in economic performance across indicators and Member States vary markedly. There is a great deal of heterogeneity across Member States in terms of the relative economic performance of foreign-owned firms which is hidden when one focuses only on the EU-wide results

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Only in the case of employment growth is there an almost consistent pattern of foreign firms showing stronger employment growth, although the impact is small in absolute terms.

Some indicators show little or no impact of the fact being foreign-owned in the majority of EU Member States. This is the case, for example, of labour productivity.

Regarding the investment indicators, only in very few cases is the impact of being foreign-owned estimated to be positive. In the majority of cases, the impact is either nil or negative (meaning that the foreign-owned firms invest less than their domestic comparators).

The picture regarding profitability is more mixed. While, in a majority of cases, the impact of being foreign owned is positive when profitability is assessed on the basis of the profit margin (ratio of operating profit to turnover), it is mostly negative or nil when profitability is measured as a rate of return defined as operating profit divided by capital (the latter is defined as shareholders' funds + long-term debt).



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