Geoeconomic Realignment and the Reallocation of Foreign Direct Investment in Emerging Markets

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By Bhakti Patel

Abstract

Geopolitical realignment is changing not only how much foreign direct investment flows to emerging markets but where it goes and on what terms. Recent evidence documents systematic sorting of FDI along ideological and geographic lines, investment shifting toward politically aligned partners and geographically proximate hubs, and away from countries perceived as strategically distant. This paper proposes to examine a question that the fragmentation literature has so far treated mostly in aggregate: whether "friendshored" and "connector" FDI behaves differently over the cycle than FDI governed by ordinary commercial motives, and whether that difference amounts to a new source of volatility for the emerging markets that receive it. Using bilateral FDI data across a panel of emerging and frontier economies from 2010 to 2025, matched to indices of geopolitical alignment and to a country-level classification of "connector," "friend," and "unaligned" investment relationships, we propose to test whether alignment-driven FDI shows larger swings around geopolitical shocks such as sanctions episodes, export-control actions, and diplomatic ruptures, than FDI from commercially motivated, unaligned sources. The results will speak directly to a live policy question in Latin America, Southeast Asia, and Sub-Saharan Africa: whether positioning as a friendshoring or nearshoring hub is a durable growth strategy or a new form of concentration risk.

1. Motivation and Research Question

The past four years have produced a genuine break in how capital moves across borders. Trade restrictions covering global commerce have risen sharply relative to the previous decade, and policymakers in Washington, Brussels, and Beijing have each, in different vocabulary, endorsed the idea that investment location should track political alignment rather than comparative advantage alone. The International Monetary Fund's April 2023 analytical work on foreign direct investment found that flows increasingly diverge across host countries along geopolitical lines, particularly in strategic sectors such as semiconductors, and that emerging market and developing economies are more exposed to this reallocation than advanced economies because they depend more heavily on capital originating from geopolitically distant partners.

A parallel literature has begun to measure this shift directly. Recent work using U.S. outward investment and multinational activity data finds evidence of ideological sorting, derisking away from specific high-risk jurisdictions, and nearshoring toward geographically proximate countries, with the clearest signal appearing in capital expenditure and cross-border acquisition data rather than in financial-flow statistics alone. This pattern is consistent with commentary from investment promotion agencies across the developing world, several of which report that they now market themselves explicitly on geopolitical grounds, as "connector" economies positioned between rival blocs, rather than purely on cost or market access.

What remains open is whether this reallocation changes the character of the capital that arrives, not just its volume or direction. Emerging market crises have historically been preceded by a familiar cluster of vulnerabilities: reliance on volatile external financing, currency mismatch, weak banking sectors, and fiscal constraints that limit the room to absorb a sudden stop. FDI has traditionally been treated as the most stable component of the capital account, the counterpart to volatile portfolio and bank flows. If alignment-driven FDI is contingent on political relationships that can deteriorate quickly, a sanctions regime, an export-control expansion, a diplomatic rupture, that stability assumption may no longer hold uniformly. The research proposed here asks directly: does the political motive attached to a unit of FDI change its behavior during shocks, and if so, which emerging markets are most exposed to this new channel of volatility.

2. Relation to Existing Literature

This proposal sits at the intersection of three literatures the conference call identifies as central: geo-economic fragmentation and the reconfiguration of global production; the role of FDI in growth and in boom-bust cycles; and the vulnerabilities that precede financial crises in emerging markets.

The fragmentation literature has moved quickly from description to measurement. Recent Federal Reserve research provides systematic evidence across five distinct channels (ideological sorting, friendshoring, derisking, nearshoring, and reshoring), showing that capital expenditure and merger data pick up these patterns more clearly than aggregate financial-flow statistics, and that friendshoring and nearshoring in merger activity concentrate heavily in goods-producing sectors. Fund staff analysis has separately shown that reallocation toward politically aligned partners tends to reduce diversification for the recipient country, which can raise exposure to shocks even as headline investment volumes rise. Neither strand, to our knowledge, has yet tested whether alignment-driven FDI exhibits different cyclical or shock-response properties than commercially motivated FDI at the recipient-country level, the gap this proposal targets.

The classical FDI-and-growth literature generally treats direct investment as a stabilizing counterpart to portfolio flows, precisely because it is harder to reverse and typically embeds longer-term commitments such as plant and equipment. That premise underlies decades of policy advice encouraging emerging markets to court FDI over debt or portfolio inflows as a matter of financial stability, not only growth. The proposed research does not dispute that FDI remains, on average, more stable than portfolio flows; it asks whether a specific and growing subset of FDI, investment whose location decision is substantially a function of geopolitical alignment rather than market access or factor cost, inherits some of the flightiness normally associated with more liquid capital, because the underlying political relationship can change faster than the underlying commercial fundamentals.

The crisis-vulnerability literature has long emphasized that the composition of external financing, not only its level, determines how a country absorbs shocks. If the proposed hypothesis holds, alignment-driven FDI concentration would belong on that list of vulnerability indicators alongside currency mismatch and short-term external debt, particularly for economies that have deliberately built an industrial strategy around serving as a nearshoring or friendshoring hub.

3. Conceptual Framework and Hypotheses

We propose to classify bilateral FDI relationships into three categories for each recipient emerging market and each source country: aligned (source and recipient sit in the same geopolitical bloc by standard voting-alignment or sanctions-cooperation measures), connector (recipient serves as an intermediate hub for trade or investment between two blocs), and unaligned or diversified (investment relationships that do not track bloc membership). This classification will draw on existing geopolitical distance measures used in the fragmentation literature, extended to the emerging and frontier market sample the conference is concerned with, since existing work concentrates heavily on U.S. and G7 outward investment.

Three hypotheses follow directly and are, in our view, falsifiable with available data. First, aligned and connector FDI should show a stronger positive association with the intensity of bloc competition, rising, for instance, as export-control regimes tighten, than unaligned FDI, consistent with a political rather than purely commercial motive. Second, around discrete geopolitical shocks that alter the alignment calculus for a specific bilateral relationship, aligned FDI should exhibit a sharper contraction or redirection than unaligned FDI of comparable sectoral composition, holding recipient-country fundamentals fixed. Third, emerging markets whose investment inflows have become concentrated in aligned or connector categories should display larger current-account and exchange-rate responses to geopolitical shocks than markets with more diversified investment relationships, even after controlling for standard vulnerability indicators such as reserve coverage and external debt.

4. Data and Empirical Strategy

The empirical strategy rests on three data sources that are publicly available and have supported comparable work in the literature already cited. Bilateral FDI positions and flows will be drawn from IMF Coordinated Direct Investment Survey data and UNCTAD's bilateral FDI statistics, supplemented with greenfield project and cross-border acquisition data from fDi Markets and Refinitiv, which allow sector-level identification of the kind that recent Federal Reserve work has shown to carry the clearest fragmentation signal. The recipient sample will cover the emerging and frontier markets tracked in the IIF's Emerging Markets universe, spanning Latin America, emerging Europe, Asia ex-China, and Africa and the Middle East, over 2010 to 2025, a window that covers both the pre-fragmentation baseline and the acceleration that followed 2018.

Geopolitical alignment will be measured using established distance metrics based on United Nations General Assembly voting alignment and sanctions-participation records, following the approach used in recent work on FDI and trade fragmentation, and will be validated against a discrete event list of sanctions actions, export-control expansions, and diplomatic ruptures affecting the sample countries over the period. The identification strategy for the second hypothesis will use these events in a difference-in-differences design, comparing the response of aligned versus unaligned FDI relationships within the same recipient country around the same shock, which absorbs recipient-specific confounders. The third hypothesis will be tested with a panel specification relating recipient-country FDI concentration by alignment category to subsequent current-account and real-exchange-rate volatility, with standard controls for reserve adequacy, external debt composition, and capital-account openness drawn from IMF and World Bank sources.

We are explicit that this is a proposal for original empirical work rather than a report of completed results. The data sources above exist and are accessible; the alignment classification and event dataset described here have not yet been constructed for this sample and would form the core empirical contribution of the completed paper. We view this as consistent with the conference's

stated purpose of promoting research on these questions rather than only showcasing finished findings.

5. Stylized Facts Motivating the Proposal

Several documented patterns motivate treating this as an open and answerable empirical question rather than a foregone conclusion. Aggregate FDI to major emerging markets recovered strongly in 2024, with net inflows to the systemically important economies tracked by the Institute of International Finance projected to rise by roughly a third relative to the prior year, driven substantially by foreign direct investment rather than portfolio flows, the pattern that has traditionally been read as reassuring for financial stability.

At the same time, the composition of that investment looks increasingly political. India's foreign direct investment rose about seventeen percent year over year in fiscal year 2025–26, concentrated in finance and technology, sectors explicitly named in friendshoring and derisking strategies pursued by investors seeking alternatives to China. Commentary from Indian policymakers has separately flagged that FDI reallocation guided by friendshoring and reshoring can produce output losses for countries left outside the aligned blocs, and that equity FDI into India itself fell to a five-year low in fiscal year 2024 before this recovery, consistent with a reallocation process that produces winners and laggards rather than a uniform rise. Analysts covering nearshoring corridors have separately identified Mexico, Vietnam, Brazil, India, and South Africa as "connector" economies positioned to benefit from bloc-to-bloc intermediation, precisely the category whose cyclical behavior this proposal aims to test rather than assume.

Taken together, these facts describe a capital account transition already underway across the conference's core geographic constituencies without yet answering whether the resulting inflows carry the stability historically associated with FDI or a new form of political contingency. That is the gap the proposed paper is designed to close.

6. Expected Contribution and Policy Relevance

The completed paper would make three contributions relevant to the conference's stated themes. It would extend the fragmentation-measurement literature, currently concentrated on advanced-economy outward investment, to the emerging and frontier markets that are the intended recipients of friendshoring and nearshoring strategies but have not yet been the direct subject of this measurement approach. It would connect that measurement to the classical question of FDI's role in growth and in boom-bust cycles by testing directly, rather than assuming, whether politically motivated FDI retains the stability properties that have justified decades of policy preference for FDI over portfolio and debt inflows. And it would offer a concrete, testable addition to the standard vulnerability checklist used to anticipate financial crises, at a moment when several governments across Latin America, Southeast Asia, and Africa are actively building industrial policy around positioning as connector or friendshoring hubs.

For the host institutions of this conference, the question has direct regional relevance. Costa Rica and several of its neighbors have pursued nearshoring-oriented investment promotion explicitly, and Latin American central banks and reserve funds are actively assessing how much weight to place on FDI inflows in their external-vulnerability frameworks. A finding that alignment-driven FDI behaves more like portfolio capital during geopolitical stress than like traditional FDI would have immediate implications for how these institutions calibrate reserve adequacy and macroprudential policy; a finding that it does not would offer reassurance that current nearshoring strategies do not carry a hidden financial-stability cost. Either result would be useful, and both are genuinely open given the current state of the evidence.

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