

IMPACT OF ECONOMIC CRISIS ON FDI

Methodological articles

Keywords

Foreign direct investment
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JEL Classification

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Abstract

The economic crisis has had a severe impact on the economy worldwide. The investment activity has strongly felt the crisis and caused dramatic changes in the hierarchy of large investors. The financial system did not have availability for credits and funding from companies' own resources was extremely limited in terms of reducing profits. The purpose of the paper is the analysis of global foreign direct investment under the effect of the largest financial and economic crisis. The research results show a dramatic decline in foreign direct investments flows perceived and generated in 2009, and the fact that since 2010 there has been a easy comeback.

INTRODUCTION

With globalization and the current global financial crisis, the issue of foreign direct investment (FDI) and their impact on the economy continues to be a hot topic for research and economic practice. Because of the benefits and the impact that FDI have on the economies of the host countries, the evolution of global FDI flows is a topic of interest for both host countries and foreign investors.

World's economy is facing an economic crisis since 2007. Once the magnitude of the economic shock has increased since the third semester of 2008, the international macroeconomic context experienced large negative changes.

Under the impact of globalization, the economic crisis started in the U.S. in 2007, following the collapse of the housing market has spread globally surprisingly fast and distrust was generalized internationally.

Amid the economic crisis, big companies were heavily affected financially, with a sudden collapse in sales.

It was in 2009 when, under the influence of the dramatic external and internal events, the financial and economic crisis rapidly spread throughout the global economy. Developed and emerging countries were equally affected and states had to intervene heavily to avoid collapse. Too rigid dependence on foreign capital in the countries of Central and Eastern Europe made them vulnerable to the crisis, some of them facing even nowadays economic difficulties.

In the current economic environment, foreign direct investment, by volume, structure and quality are the most important driver of economic growth because they provide efficient use of human resources available to the economy, innovative development of the economy, growth of scientific progress, increased productivity and a boost of the GDP.

FDI -FEATURES

The issue of foreign direct investment and their influence on the economy continues to be a topic of interest for research and economic practice. Thus over time different definitions have been given to the concept of 'direct investment'.

The Explanatory Dictionary of the Romanian Language defines the investment as a placement of funds, of equity in a company or a business (Opera, 2010).

Generally it can be accepted that any placement of funds in the economic, social, cultural, administrative, military, etc. to ensure regeneration or growth of the assets, labor coverage of the activities or promotion of organizations or businesses' goals is an investment (Zai, 2008).

United Nations Conference on Trade and Development defines foreign direct investment (FDI) as those investments that involve a long-term business relationship reflecting a lasting interest of an economic entity (direct investor or parent enterprise), as well as its control on an enterprise resident in a country other than that of the investor (UNCTAD, 2009).

The Organization for Economic Cooperation and Development considers as FDI those investments made in order to establish sustainable economic relations or exercise significant influence over the management of a business (OECD, 2010).

National Bank of Romania believes that foreign direct investment is a long-term investment relationship between a resident entity and a non-resident entity, which usually implies that the investor exerts a significant influence on the management of the companies in which he invested (BNR, 2009).

For the International Monetary Fund, FDI is a category of international investment that reflects the purpose of an

entity resident in a country (direct investor) to obtain a lasting interest in an enterprise resident in another country (direct investment). Lasting interest implies the existence of a long-term relationship between the direct investor and the company (International Monetary Fund, (2011).

Foreign direct investment (FDI) reflects the placement of equity by foreign investors (non-residents) in other countries for the establishment and development of companies in various fields. Foreign direct investment reflects foreign elements, represented by capital, land, placement process, technological streams, knowledge, management, goods and services (Voinea, 2008).

In conclusion, FDI represents the relationship between a resident entity and a non-resident entity, usually - a long-term investment relationship and the investor has a significant influence or control.

ROUTES OF TRANSMISSION OF THE ECONOMIC CRISIS AND THEIR IMPACT ON FOREIGN DIRECT INVESTMENT FLOWS

The current global economic and financial crisis affects both the ability of firms to invest, as a result of reduced availability of funding, and their propensity to invest, because of the pessimistic market perspectives and economic outlook. The effects of the crisis on global FDI flow occur mainly through three channels, namely the reduction of access to finance, the pessimistic economic outlook, pessimistic and risk aversion (Reinhart, 2011).

Reduced access to finance - financial factors have negatively affected the ability of firms to invest, both internally and externally, tight credit conditions and lower profits reducing companies' financial resources for domestic and external investment projects. On the one hand, credit became less

abundant and more expensive. For example, the extent of debt has dramatically increased in the last months of 2008 and still remains at a high level. Bank loans and funds available for takeover transactions with indebtedness have also dropped a lot. This deterioration of the external environment of funding for non-financial companies contributed to increasing inability to invest in foreign operations or in merger arrangements and acquisitions abroad. On the other hand, low incomes of large companies from a wide range of industries in Europe, Japan or the United States, according to declared or planned profits beginning with the 4th semester of 2008, have reduced their capacity of funding the companies.

Pessimistic outlook - a pessimistic evaluation of market prospects, especially in developed economies that pass through the biggest of the post-war recessions, reduced the propensity of companies to invest for the expansion of production capacity, both internally and externally.

Risk aversion - the investment plans of companies may also be discouraged because of the high level of perceived risks and uncertainties, in order to resist the worst scenario of economic and financial conditions. A lot of companies have implemented programs to reduce cost even more drastic than the worst scenarios for business prospects.

Investment plans of the largest companies have been affected by the different aspects of the current crisis. Regarding the negative impact on expansion plans, according to the study UNCTAD-World Investment Prospects Survey 2009-2011, the companies responded that responsible for this are the economic crisis, the financial crisis and the volatility of exchange rates by 86%, 79% and 51%, respectively (Figure no. 1) (UNCTAD, 2009, 2010, 2011).

The impact of these negative factors, however, can vary significantly depending on the type of investment, namely investment in search

of markets, in search of efficiency and in search of resources (Hansen, 2006). The decline in the propensity to invest overseas can take various forms, up to investments and restructuring.

EVOLUTION OF FDI FLOWS IN THE CURRENT GLOBAL ECONOMIC CRISIS CONTEXT

After the onset of the crisis in 2007, the global economic downturn reduced the total volume of foreign direct investment by about 15% in 2008 (Tidiane, 2010). FDI inflows peaked in 2007, with a record of 1.971 billion dollars. Although developed countries have registered a decline in FDI in 2008, developing countries, taken as a whole, showed a modest increase. After a decline of 16% in 2008, FDI inflows fell by a further 32% in 2009 to €1.185 billion USD, while output fell by almost 43% to 1.101 billion USD (Figure no. 2; Figure no. 3).

In 2010, global FDI inflows rose modestly by 5% to 1.244 billion dollars. While overall industrial capacity and world trade are already at the pre-crisis level, global FDI flows in 2010 remained almost 15% below the average of 2005-2007 and nearly 37% below the record registered in 2007. Although in 2010 FDI recovered, there is some uncertainty about the risk factors of the post-crisis business environment, such as the unpredictability of global economic governance, a possible widespread sovereign debt crisis, instability in the financial and tax sector in some developed countries, the rising of inflation and the signs of "overheating" of the most important emerging market economies (Figure no. 4).

Once the economic crisis was triggered, there have been some major changes in overall FDI tendencies that will most likely take off in the medium and long term. Firstly, the relative weight of emerging

economies and in process of transition, as countries of destination, and as sources of global FDI is expected to continue growing.

With the onset of the crisis, FDI flows towards developing countries have significantly changed. Although overall global FDI towards developing countries rose sharply, there were significant regional differences. FDI flows to some of the poorest regions decreased. Flows to Africa, to the least developed countries, to landlocked developing countries, and to small island developing states have continued to decline, the East and South-East Asia and Latin America had a substantial increase in FDI inflows. FDI flows to Africa, for example, fell by 9% in 2010 (UNCTAD, 2012). FDI to the primary sector, especially the oil industry continued to be the main destination for FDI flows to the continent. This trend has led Ghana to pass to the rank of major host country, but also made Angola and Nigeria decline in FDI flows.

Since 2007, the growth of FDI in developing countries is characterized by significant regional differences. The bulk of FDI inflows to South America in 2007 was directed towards extractive industries and natural resource-based production. The increasing of inflows in the countries of Central America and the Caribbean can be explained largely by the dynamics of FDI in mining, steel and banking, which are not primarily geared towards the U.S. market. FDI has played a major role in increasing the export performance of Peru. Between 1990 and 2006, exports of metallic minerals soared from \$ 1.5 billion to \$ 15 billion, with an increase in total exports from 42 % to 62 % (UNCTAD, 2011). In 2010, FDI flows to Latin America and the Caribbean increased by 13 %. The largest increase was recorded in South America, where the growth rate was 56 %, Brazil being the largest recipient of FDI in the region. FDI outflows from Latin America and the Caribbean increased by 67% in 2010 due to mergers

and major transnational acquisitions by large companies in Brazil and Mexico (UNCTAD, 2011). Latin America mostly exported goods and imported production goods.

These savings, which have absorbed almost half of FDI inflows in 2009 are those that describe the overall recovery of FDI. Developing economies became important in 2010 both as beneficiaries of FDI and as foreign investors. While international production, and recently international consumption have shifted to emerging economies or in transition, large companies invest in effective marketing projects in these countries. For the first time since 1980, they have absorbed more than half of global FDI flows in 2010, respectively 51.6 %. FDI outflows from developing economies and in transition increased sharply, by 21 % in 2010.

Secondly, the flow of investment in the manufacturing sector, services and primary sector didn't have the same trend. In 2010 there is a change in the sectoral distribution of external investment projects, manufacturing sector registering a growth of FDI outflows, representing 48% of total FDI outflows. The recovery of FDI flows in 2010 has major fluctuations on sectors and entry ways. FDI in services, which were responsible for much of the decline in FDI flows due to the crisis, continued to decline in 2010, together with the ones in the primary sector. All major industries based on services (business, finance, transport, communications and utilities) fell, but at different pace, FDI inflows in the financial industry having one of the strongest declines.

Thirdly, despite the impact on the flow of FDI, the global crisis has not stopped the growing process of internationalization of the production. The reducing of sales and profits for foreign subsidiaries of multinational firms in 2008 and 2009 was lower than the overall contraction of the world's

economy, the share of foreign affiliates in global GDP reaching a level of 11%. The number of foreign employees of multinational firms grew by 3.4 % in 2009. Developing economies and transition are now host for the majority of employment of foreign subsidiaries. Earnings of foreign subsidiaries increased by 7.5 % in 2009, largely due to the 15% increase in capital inflows. This increase of ISD capital was due to the significant come-back of the global market for capital grants and import flows of FDI, which, although remained at a positive value, slowed down considerably the pace of expansion. Sales of foreign affiliates rose by 9.1 % in 2010, reflecting the recovery in developing and transition countries.

The global crisis has reduced the funds available for FDI, leading to fewer purchases. While low prices on the stock markets have led to the reducing of the transaction value against the global restructuring, they also provided opportunities for multinational companies to access financing. The sharp drop in of cross-border mergers and acquisitions is what caused most of the decline in FDI in 2009. While greenfield investment rose by 15 %, purchases abroad contracted by 34%. Mergers and acquisitions are usually more sensitive to financial conditions than greenfield investments as stock market turmoil affects the value of prices on which are based mergers and acquisitions, mergers and acquisitions investment cycle being usually shorter than that of greenfield projects.

In 2010, economic performance improved in many countries, and growing profits of foreign subsidiaries have raised reinvested earnings to nearly double the level of 2009. The other two components of FDI - investment flows type „equity” and borrowings among companies - declined in 2010. Private FDI „equity” type in 2010 were directed mostly to developing and transition economies. FDI from SWF's fell to 10 billion dollars in 2010 from 26.5 billion in 2009. Increasing

FDI from these special funds in 2011 is linked to a global more gentle business environment. Regarding the value of direct investment flows perceived worldwide in 2012, it was of about 1350 billion dollars, reflecting a 18% decrease compared to the previous year, representing a lower level than the flows recorded in 2006-2008 and 2010-2011. The value of direct investment flows perceived worldwide in 2012 was of about 1350 billion dollars, reflecting a 18% decrease compared to the previous year, representing a lower level than the flows recorded in 2006-2008 and 2010-2011. FDI flows attracted by developing economies in 2012 marked a slight decline compared to 2011 (4.4%), while the decrease in the group of transition countries has been over 9%. The value of FDI received by developing Asia (about 407 billion dollars) decreased by 7%, while that of FDI attracted to Latin America and the Caribbean (nearly 244 billion U.S. dollars) decreased by 2 % . The decline registered in Central America and the Caribbean could not be compensated by an increase of 12% in FDI inflows attracted by South America. The investors' preference for countries such as Brazil, Chile, Colombia, Argentina, Peru is explained by the abundant natural resources and also by the rapid expanding of the middle class in these economies, attracting FDI in search of the market (UNCTAD,2013). In Africa, the perceived value of FDI flows in 2012 exceeded \$ 50 billion dollars, marking an increase of 5%.

CONCLUSIONS

For a better integration in the international economy and in particular the European economy, the reform and restructuring process of the economies in Central and Eastern Europe, including Romania, needs consistent foreign direct investment flows (FDI), which can be achieved by increasing the global nature of the production process. This aspect, together with the existing global nature of trade, requires a new approach to the

identification and distribution of resources. For all countries, a component of development strategies and an essential tool in developing a strong and dynamic private sector is attracting FDI. These investments facilitate the access to foreign markets indirectly through the effect of complementary implementing collateral technology and know-how.

Given the analysis we can say that the worldwide economy has passed since 2008 through a period of unusual developments, characterized by declining or weak resume of growth in developed countries and a fairly robust growth in many emerging countries. Regarding foreign direct investment, the economic crisis has had a negative impact on them, since statistics show that in 2008 and 2009, investment flows have declined, registering a slight recovery in 2010.

Foreign investment is an engine of economic development for the Central-Southeastern European countries. These countries have a high capacity to absorb foreign investment capital, because there are prerequisites for transforming these resources into additional economic value. Until achieving the optimal level of foreign investment, legal and fiscal measures, monetary and any other measures should be focused on stimulating investment, this representing an important lever for economic value creation and achievement of a higher level of social welfare.

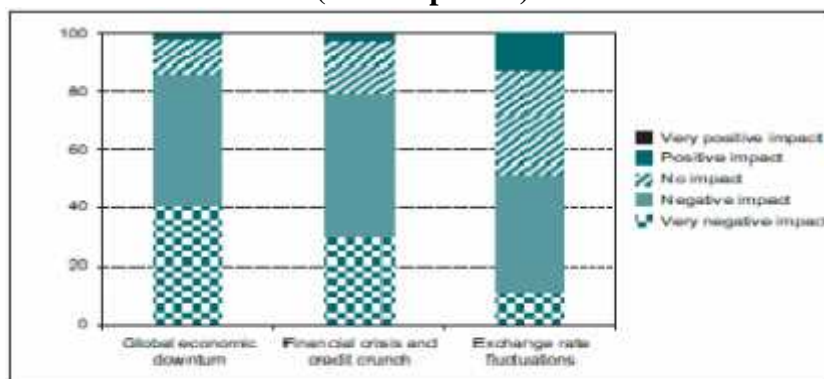
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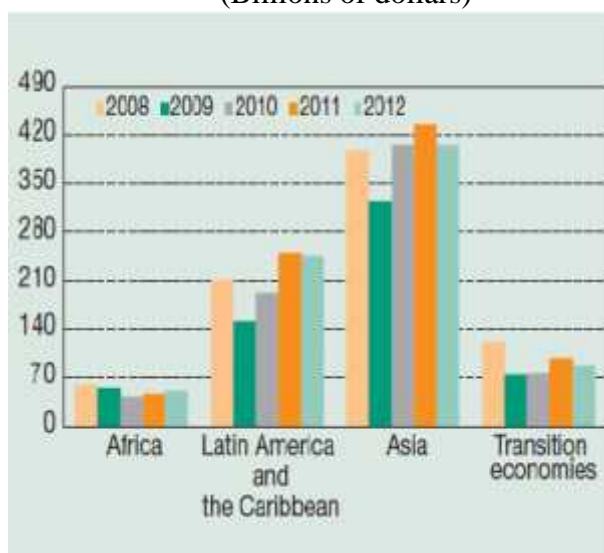
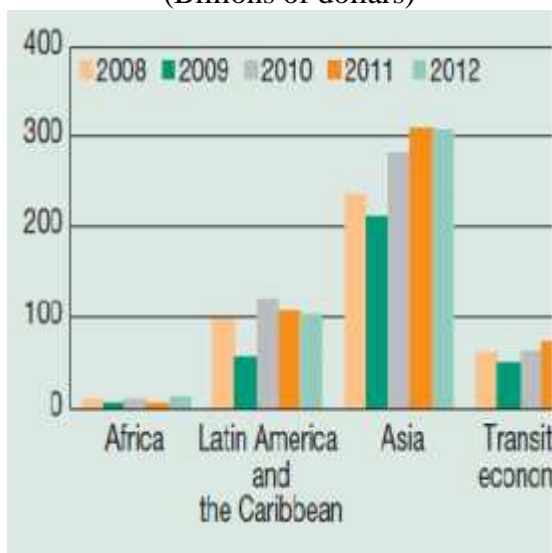
APPENDICES

Figure no. 1: Impact of various aspects of the crisis on the company's investment plans (% of reponses)



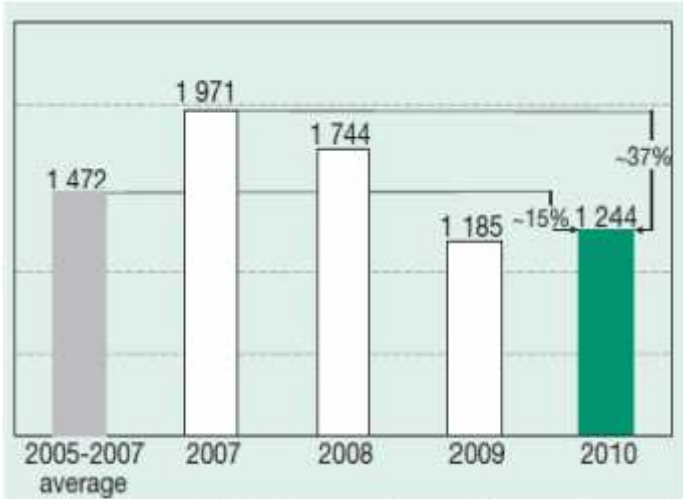
Source: Assessing the impact of the financial and economic crisis on global FDI flows, UNCTAD 2009

Figure no. 2: FDI inflows, by region, 2008-2012 (Billions of dollars)
 Figure no. 3: FDI outflows, by region, 2008-2012 (Billions of dollars)



Source: World Investment Report 2013; Global Value Chains: Investment And Trade For Development, UNCTAD;

Figure no. 4: Global FDI inflows, average 2005-2007 and 2007 to 2010
(Billions of dollars)



Source: World Investment Report 2011, Non-equity Modes of International Production and Development