THE WORLD IN CRISIS – EFFECTS UPON THE FOREIGN DIRECT INVESTMENT

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Abstract:
The article presents the prospects for the foreign direct investment (FDI) in three moments: before the burst of the crisis, after its eruption in the United States of America (the end of 2007, beginning of 2008) and after its generalization through the entire world (end of 2008, beginning of 2009). The authors take into account the causes of the FDI decline, the effects upon the developed and developing countries and the prospects on a longer run.

***Key words**: crisis, foreign direct investment flows, economic growth*

***JEL classification**: F01, G01, G17*

1. Introduction

The world's economy knew in the last few years an extraordinary development, which seemed to never end. The prospects made at the beginning of 2007 had anticipated an ascendant trend for the next couple of years despite the risks that the "burning" economy was bringing into light.

But the year 2007 was not yet finished when the crisis burst, at first as a mortgage crisis in the United States, then as a financial one, in order to finally turn into a complete economic depression. The FDI are being affected by the situation but they should be seen also as a factor of economic revival.

2. FDI prospects before the crisis eruption

One of the conclusions of an UNCTAD survey was that after a decline in the early 2000s, FDI flows have been raising continuously since 2003, with an acceleration of this trend in 2006. As a consequence, FDI flows reached more than $1.3 trillion in 2006, approaching levels similar to the record level observed in 2000 of $1.4 trillion. [U.N., 2007, p.7]

According to the same UNCTAD survey, this trend should have continued up to 2009, as most of the responding companies (70%) expected to increase in their FDI expenditures between 2006 and 2009. Moreover, for about 32% of companies, this increase should have been quite large (i.e. more than 30%). On the other hand, only 9% of the companies anticipated a decrease in their investment flows. [U.N., 2007, p.8]

The overall positive trend was confirmed by the views of location experts, most of whom anticipated growing FDI flows till the end of 2009.

The expectations were that a consistent growth in FDI flows could follow until the end of 2009, as a large proportion of companies took into account the possibility to increase their investments abroad over this period: 68% of them planned to do so in 2007, 66% in 2008 and 64% in 2009.

The specialists explained these prospects by three major factors: a continuation of the prevailing long-term trends that are conductive to the internationalization of companies; a short - to medium - term economic outlook, characterized by sustained growth and availability of financial resources; and the emergence of new sources of and opportunities for investment.

As observed, global economic growth has been sustained at relatively high levels over the past five years, a trend confirmed by growth in 2006 as well. Forecasts issued by various international institutions such as the International Monetary Fund [IMF, 2007], the World Bank [The World Bank, 2009], and the OECD [OECD, 2007], and despite recent turmoil on the financial markets, showed that the world economy was still looking well set for continued growth in 2007-2008. The projected annual growth rates for developing countries were quite optimistic: above 6% for the developing countries and over 2.5% for the developed economies.

This favorable macroeconomic outlook seemed consistent with the optimistic views among business circles, with regard to the economic situation and prospects, as shown by various surveys published by various international consulting companies. These positive prospects were expected to encourage companies to invest all the more, given the availability of financial resources, both externally and internally. [U.N., 2007, p.13]

Respondents to the UNCTAD survey anticipated a sustained growth in FDI flows until 2009. Still, there were fears regarding possible major events that might undermine such optimism, as was the case in previous periods of FDI recession (such as in 2001–2002). The UNCTAD survey attempted examined the major potential risks, grouped into three categories: geopolitical (e.g. war or terrorism), macroeconomic (e.g. impact of volatile oil prices and financial instability), and institutional (e.g. changes in investment regimes and government effectiveness).

Although company executives perceived a rather high degree of potential risk in all three categories, geopolitical risks were considered the most significant, and only on the second place came those linked to financial instability and changes in investment regimes. These concerns, however, seemed unlikely at the time to dissuade them from increasing their investment efforts, but could lead them to focus more on risk management strategies.

A relatively high percentage of respondents pointed out the existence of macroeconomic and financial risks, and, as a consequence, more than three quarters of them considered a global economic downturn as a major risk in the years ahead, and about 90% expressed concerns about the potential impact of financial instability on FDI flows.

Various economic outlook reports confirmed the existence of these risks. According to the IMF [IMF, 2007, p.6], the major sources of risk for world economic growth were (in order of importance):

- A sharper slowdown in the United States if that country’s housing sector continued to deteriorate;
- A revival of inflationary pressures, particularly in the event of another spike in oil prices in connection with geopolitical tensions in West Asia;
- Reducing risky assets if financial market volatility were to increase from historically low levels;
- A disorderly unwinding of large global imbalances (especially related to the United States external trade deficits and Chinese surpluses and possible adjustments in currency exchange rates).

In addition to these risk factors, the location experts cited a possible overheating and slowdown of both the Chinese and Indian economies.

However, international experts generally saw the potential short-term impact of those risks as rather limited. Even in the worst-case scenario considered by the IMF, annual world growth would have remained at around 4%.

3. FDI – first prospects – beginning of the crisis

But a banking crisis erupted in September 2008, followed more than a year of less acute financial turmoil. Following the insolvency of a large number of banks and financial institutions in the United States, Europe, and the developing world, financial conditions have become much tighter, capital flows to developing countries have dried up, and huge amounts of market capitalization have evaporated.

The crisis began in high-income countries (unlikely the 1997 crisis) but developing countries have been caught up in its wake. An analysis of the World Bank [IBRD, 2009, p.1] showed that developing country equity markets had given up almost all of their gains since the beginning of 2008 and initial public offerings had disappeared. Risk premiums, which had risen to more than 800 basis points on sovereign bonds and 1,000 on commercial debt, have declined but remained well above 600 basis points in every developing region.

As corporate bonds had been one of the most important sources of developing country finance, these developments suggest that a sharp slowing in developing-country investment growth is to be expected. Bank lending and foreign direct investment inflows were also down, but less dramatically. The increased volatility and losses emanating from the banking sector have caused investors worldwide to sell stocks and increase their holdings of less risky assets, notably U.S. treasuries. As a result, the currencies of virtually every developing country in the world have depreciated vis-à-vis the dollar.

At the end of 2008 and the beginning of 2009, UNCTAD released to the press new estimates showing that global foreign direct investment inflows are estimated to have fallen by 21% in 2008 to an estimated $1.4 trillion, and will likely fall farther in 2009. [UNCTAD, 2009] In the three major groups of economies (developed countries, developing countries and economies in transition), the global economic slowdown and intensifying financial turmoil have had different impacts on FDI inflows. [U.N., 2009, p.69]

Despite the answers received by the above-cited UNCTAD survey [U.N., 2007], many companies have announced plans to curtail production, lay off workers, and cut capital expenditures, all of which tend to reduce FDI. The constraints are given the global economic recession, tighter credit conditions, falling corporate profits, and gloomy prospects and uncertainties for global economic growth. Still, the impact of the crisis will vary widely depending on region and country, with consequently varying impacts on the geographic patterns of FDI flows.

4. FDI – present projections – the plenary crisis

For the developed countries, preliminary data for 2008 indicates that FDI flows have fallen, mainly as a result of the protracted and deepening problems affecting financial institutions and as a result of the liquidity crisis in the money and debt markets. In figures, preliminary estimates show a decline of about 33% from flows in 2007 for this group of countries.

In developing and transition economies, preliminary estimates suggest that FDI inflows have been more resilient, though the worst impacts of the global economic crisis had still, at year's end, to be fully transmitted to these countries. The growth rate of FDI inflows to developing countries, while lower than in 2007 (when it exceeded 20%), were estimated to remain positive for 2008 at an estimated 4% [UNCTAD, 2009], or even 10%. [U.N., 2009, p.13]

In UNCTAD view, in the short-run (2009), the negative impacts of the financial and economic crises on FDI are expected to remain dominant and to contribute to a continued fall in overall FDI through 2009.

Developing countries will not be excluded, that is, FDI falls in 2009 will be more widespread. A continued deleveraging in the large financial institutions of developed countries and the eroded confidence of international investors are likely to limit portfolio inflows to emerging market economies, while the pro-cyclical nature of FDI flows will also imply a slowdown in FDI along with weakening growth prospects for emerging market economies. [UNCTAD, 2009]

A recent outlook for private capital flows to emerging economies demonstrates a significant deterioration in recent months. [UNCTAD, 2009] Net flows are now projected to be just $165 billion in 2009, down from $466 billion in 2008. This estimate for capital flows in 2009 is unambiguously weak and proves a decline of 82% from the boom year of 2007 ($929 billion).

This sharp downward revision for 2009 is a reflection of a very tough environment for capital flows that became increasingly evident as the end of 2008 arrived. It is also consistent with the much weaker global growth outlook that is now envisaged for 2009, which both reduces the supply of external finance, as lenders and investors turn more risk averse, as well as the demand for external finance for both consumption and investment spending.

Overall global GDP growth is projected to decline to 0.9% in 2009, with developing economies expanding by 4.5%, well below the 7.9% growth rate recorded in 2007. International trade should decelerate sharply, with global export volumes declining for the first time since 1982. As a result, both commodity prices and inflation are projected to ease, with oil prices averaging about $75 a barrel in 2009 and food prices projected to decline by about 23% compared with their average for 2008.

The region most directly affected by the slump in capital flows seems to be the Emerging Europe, which had been heavily dependent on external finance. An analysis of some countries from the region proves that strains have been most evident in Russia and Ukraine, although some smaller countries in the region (not under analysis) have been hit harder.

A general comparison of previous slumps in net private capital flows to emerging markets proves that the current is shaping up to be the most dramatic on record. This is a remarkable development, since the two previous serious crisis episodes, 1981 - 1986 and 1996 – 2002, were periods of very severe adjustment for emerging market economies. Net private inflows fell from a peak of 3.5% of emerging market GDP in 1981 to a trough of 0.3% on GDP in 1986; they fell from a peak of 5.7% of GDP in 1996 to a trough of 2% of GDP in 2002. But this time, however, net flows seem likely to fall from a peak of 6.9% of GDP in 2007 to just 1.1% of GDP in 2009.

5. FDI on the long run

Still, the descending evolution is not expected to continue on medium term because various positive factors are at work and will trigger, sooner or later, a resurgence of international investment flows. These factors include investment opportunities based on cheap asset prices and industry restructuring, relatively large amounts of financial resources available in emerging countries and cash-rich oil-exporting countries, quick expansion of new activities such as new energy and environment – related industries, and the relative resilience of international companies.

A World Bank Report [IBRD, 2009, p.15] illustrates that the efforts made by central banks and governments to resolve the growing crisis through liquidity injections and various ad hoc measures (partial nationalization of nine banks, trillions of dollars in rescue plans introduced by governments in the United States and Europe, recent multilateral meetings to address weaknesses in the global financial architecture), have not been forcefully enough to restore confidence in the international banking system.

But the expectations are optimistic. Although output contractions across all economies are currently severe, and this is likely to persist through the first few months of 2009, by mid-year, however, the combination of easier monetary and fiscal policies, including the fiscal program of the new U.S. Administration, should begin to provide a net lift. In consequence, it is expected that the second half of 2009 should produce better outcomes. [UNCTAD, 2009]

The role of FDI for a turndown of the situation is a major one, but it could be decelerated by the tendencies towards protectionism and other public policies. The reforms should aim a wider stability in the financial system, an open attitude towards FDI and the implementation of policies aimed at favoring investment and innovation.

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