

# Foreign direct investment in times of crisis

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The paper compares the current FDI recession with FDI responses to past economic crises. While the decline in outflows from developed countries has been similar in magnitude to that in previous recessions, the recovery in FDI has been much slower than in the past. Inflows to emerging markets, which remained stable during previous economic crises, have experienced an overall decline. Both patterns indicate that the global scale of the current crisis has had a different and more marked FDI response than after earlier individual country crises. Compared with other global economic downturns since the 1970s, the current FDI recession has also been greater in magnitude. (The exception to this was the large FDI plunge in the early 2000s, despite the much smaller economic crisis at the time.) To the extent past FDI patterns can provide relevant insights to the current FDI slump, this could indicate that global FDI flows may remain below 2007 levels until at least 2014. The paper concludes by recommending policymakers to not just further liberalize FDI regimes – the typical response to earlier crises – but rather to use the downturn to completely rethink their FDI policies, with an enhanced focus on promotion of “sustainable FDI”.

## 1. Introduction

In 2007, global foreign direct investment (FDI) flows amounted to a historical high of around \$2 trillion – a sum equivalent to more than 16 per cent of the world’s gross fixed capital formation (GFCF) at the time.<sup>1</sup> This marked the peak of a four-year upward trend in FDI flows. Along with the subsequent worldwide collapse in real estate values, stock markets, consumer confidence, production, access to credit, and world trade, global FDI flows also began to fall – by 16 per cent in 2008, and when worldwide output contracted in 2009

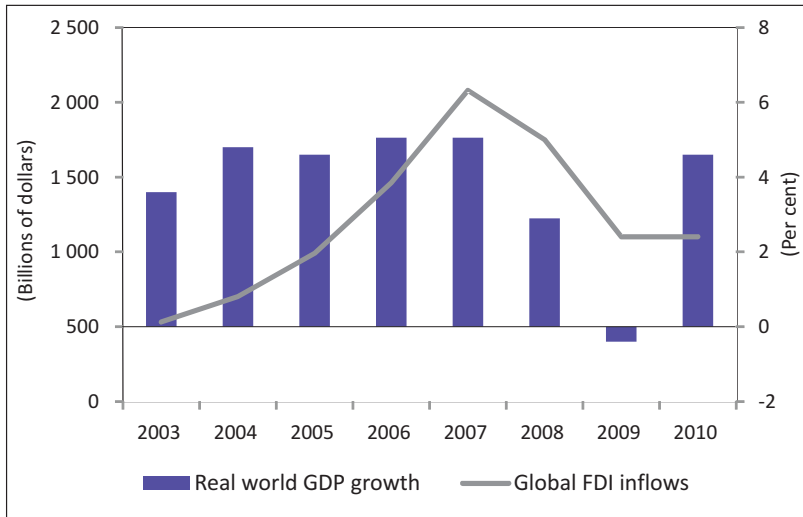
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<sup>1</sup> FDI figures are from UNCTAD throughout.

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for the first time in sixty years, FDI declined a further 40 per cent. In 2010 FDI stagnated at just above US\$1 trillion.

**Figure 1. The FDI recession**



The decline in FDI flows can be attributed to three main factors (UNCTAD, 2009a). Firstly, the global financial crisis has led to liquidity constraints for transnational corporations (TNCs) worldwide, as access to credit has tightened and corporate balance sheets have deteriorated. Even if they wanted to, the capacity of firms to invest has thereby weakened considerably. Secondly, the traditionally strong link between economic growth and FDI flows means that the world slowdown – particularly in the developed world – has further decreased the appetite of TNCs for new investment abroad. Finally, the crisis has probably fostered a more cautious attitude among managers, resulting in a move away from high-risk projects (such as major infrastructure) to safer assets (in the extreme, government bonds).

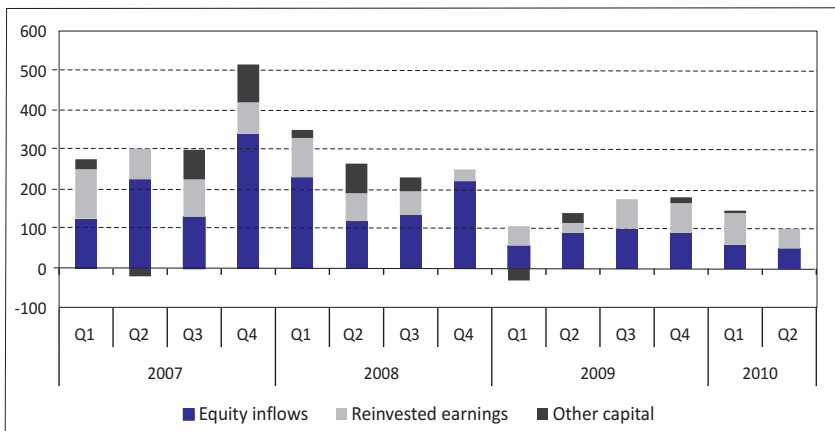
Disentangling more detailed implications of the crisis for TNCs is difficult, depending, *inter alia*, on the type and extent of production and financial linkages between parent firms and foreign affiliates, sector and industry characteristics, host and home state economic performance, modes of entry (see e.g. Alfaro and Chen, 2010). Rather than analysing in detail the many complex, and at times endogenous,

channels through which the crisis has impacted FDI patterns, the aim of this paper is simpler. Taking a bird’s-eye view, we ask just how bad the “FDI recession” has been in the wake of the crisis compared to previous such episodes? Has it been unique in terms of either its severity or the political response? Comparing the current FDI recession with FDI patterns during and after past crises may in turn provide insights to how long the FDI slump can be expected to last.

## 2. The FDI recession in brief

All main FDI components have been negatively affected since 2007 (figure 2). Even after sales and profits of foreign affiliates began to improve in late 2009, parent companies continued to repatriate large shares of their profits, rather than invest in host states (UNCTAD, 2011). Intra-company loans have dwindled also, as TNCs have restructured their operations – for instance, by relocating activities to countries which have weathered the crisis – and compelled their foreign affiliates to help strengthen parental balance sheets at home (UNCTAD, 2009b). As a result, not only have host countries struggled to attract new FDI during the crisis, they have struggled to retain what they already had. As we shall see later, this pattern is reminiscent of past crises, where the fall in more liquid FDI components was the main driver of declines in

**Figure 2. Quarterly FDI components for 36 selected countries, 2007Q1-2010Q2**  
(In billions of dollars)

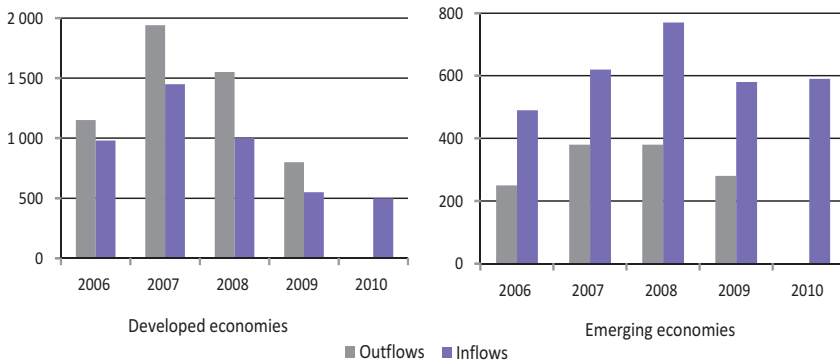


FDI. What is perhaps more worrying, therefore, is the disproportionate fall in equity investment since the beginning of 2009. This is notable, as equity investments reflect the long-term strategic commitment by TNCs to their host countries, and typically are not determined by short-term factors such as liquidity demands or tax-considerations, unlike reinvested earnings and intra-company loans (Desai et al., 2003; Ramb and Weichenreider, 2005). The stagnant level of equity investments may therefore signal that a recovery of FDI flows could take longer after this crisis, a possibility we will return to later.

Given that the crisis started in Western countries, and economic growth is by far the most important determinant of FDI, it should come as no surprise that FDI flows to and from developed countries declined more sharply than the corresponding flows to and from emerging economies (figure 3). The downturn has had a particularly strong impact on Western banks and financial institutions, which as a result had to cancel, postpone, or downscale cross-border mergers and acquisitions (M&As) – the most important mode for FDI.

The global drop in FDI has therefore primarily been due to the steep decline in cross-border M&A deals of developed-country companies since 2007. Despite a slight rebound in cross-border M&As worldwide in 2010, overall these were nevertheless 67 per cent below their level three years earlier.

**Figure 3. FDI flows, 2006-2010**  
(In billions of dollars)



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For emerging economies, FDI remained an important stabilizer in the early stages of the crisis. While their net inflows of portfolio investments and bank lending were negative in 2008 (IMF, 2009), their FDI inflows actually increased, albeit at a slower pace than previous years, and outflows grew as well. But as the credit crunch and recession spread to emerging markets in the second half of 2008, both their outflows and inflows of FDI started to decline, and 2009 was therefore the year when the FDI recession became truly global in character. Apart from the drop in M&As, there was a reduction in greenfield investments – a class of FDI that is more important in emerging markets than developed economies – which dropped 15 per cent in emerging economies from 2008 to 2009. In 2010, however, FDI inflows began to rise again, driven by strong performance in much of Latin America and Asia.

### *Uncertain FDI outlook for the coming years*

So what does the future hold? On the one hand, undoubtedly there are economic and political factors at work which will counteract the current slump in global FDI.

Firstly, a number of major emerging economies have weathered the crisis better than developed countries, and developing and transition economies now account for more than half of global FDI inflows – the highest share ever recorded. With respect to outflows, developing and transition economies accounted for more than 25 per cent of global outflows in 2009 – also the highest share on record – compared to less than 10 per cent just ten years earlier. Many “Southern” TNCs are increasingly investing abroad, and particularly so in other emerging markets (Sauvant et al., 2010).

This geographic shift in the distribution of global FDI flows seems likely to continue, as the positive growth prospects in countries like India and China are a strong incentive for TNCs with the necessary funds to invest, particularly through market-seeking and efficiency-seeking FDI.

Secondly, the policy response to the crisis has been rather favourable to TNCs overall. With respect to the international investment regime, some countries are slowly moving towards a re-balancing of the rights and obligations between investors and their host countries

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(Waibel et al., 2010). This shift in favour of host countries is not directly related to the crisis, but rather a response to the rising number and impact of investor-state arbitrations over the last decade. Also, it should not be taken as an indication that the international investment regime is unravelling, as investment promotion and protection treaties are still being signed in large numbers, either as stand-alone agreements or as parts of preferential trade agreements. Although the rush to sign investment treaties has slowed compared to a decade ago – and a few countries have even begun cancelling theirs – this is unlikely to have a significant impact on global investment flows (see e.g. Yackee, 2010; Poulsen, 2010).

National FDI regimes, rather than investment rules on the international level, are now the main policy drivers of FDI flows. Where data are available, there are no signs that the crisis has led to a protectionist backlash – while expropriation of foreign assets in the natural resources sector was beginning to become fashionable before the crisis in parts of Latin America, for instance, falling commodity prices in the initial stages of the crisis made expropriation less attractive (Lloyd's, 2009). With respect to less extreme forms of FDI restriction, however, recent years have seen an increase in limitations on cross-border M&A activity, particularly when target firms have been considered strategic industries, or when investment has been facilitated through sovereign or quasi-sovereign entities (Sauvant, 2009). These trends began before the onset of the crisis (OECD and UNCTAD, 2010), and although some national bailout packages are likely to have particularly adverse effects on FDI – either directly (by being closed to participation by foreign-owned firms), or indirectly (by allowing government officials greater discretion to favour national firms) – most investment initiatives taken during the crisis have been aimed at facilitating, rather than restricting, FDI (UNCTAD, 2009a). The issue of whether beggar-thy-neighbour policies are on the rise in the trade regime is as yet unresolved,<sup>2</sup> but the general trend is clearly towards greater openness for TNCs in most countries.

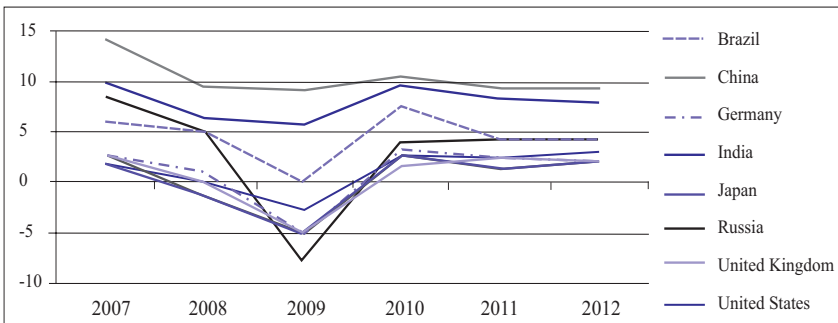
Yet, there are also reasons to be pessimistic about the prospects for FDI over the coming years. While the world economy has begun to expand once again, growth remains sluggish in many regions, considering

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<sup>2</sup> Compare, e.g. Global Trade Alert (2009) with Rodrik (2009). Also see Hufbauer et al. (2010).

the magnitude of (potential) output lost in recent years (figure 4). And, while China is moving towards private-sector-led growth once again, austerity reforms are likely to slow the recovery in key Western markets. Also, credit is still tight despite low interest rates, which dampens the ability of firms to expand their activities at home and abroad. Finally, the risk of currency wars looms large, as global imbalances persist, and remaining sovereign and bank vulnerabilities heighten concerns about the stability of the global financial system. The crisis itself was a humbling experience for the economics profession, which largely failed to predict its timing and magnitude, and those organizations (including UNCTAD, 2010b) which expect FDI to return to 2008 levels as early as next year, may prove to have been unduly optimistic.

**Figure 4. Real GDP growth, selected countries, 2007-2012**



Given these uncertainties, it may be informative to look at FDI patterns during past crises for hints about the prospects for recovery in TNCs' investment activity. Not because past events are necessarily a good indicator for present conditions, but rather to see if the current FDI recession is unique in terms of its scale or policy reactions.

### 3. FDI during past crises

#### *Individual country crises*

We begin by looking at FDI patterns during individual country crises. As a benchmark for the 2007 subprime crisis in the United States, Reinhart and Rogoff (2008) assembled historical data on 18 bank-centred financial crises in developed countries. Unlike the

current downturn, several of these were relatively minor affairs, and we therefore focus on the so-called “Big Five” systemic financial crises, which all led to major falls in economic performance for several years: Finland (1991), Japan (1992), Norway (1987), Spain (1977) and Sweden (1991) .

**Figure 5. Median GDP growth and FDI trajectories after the “Big Five”**

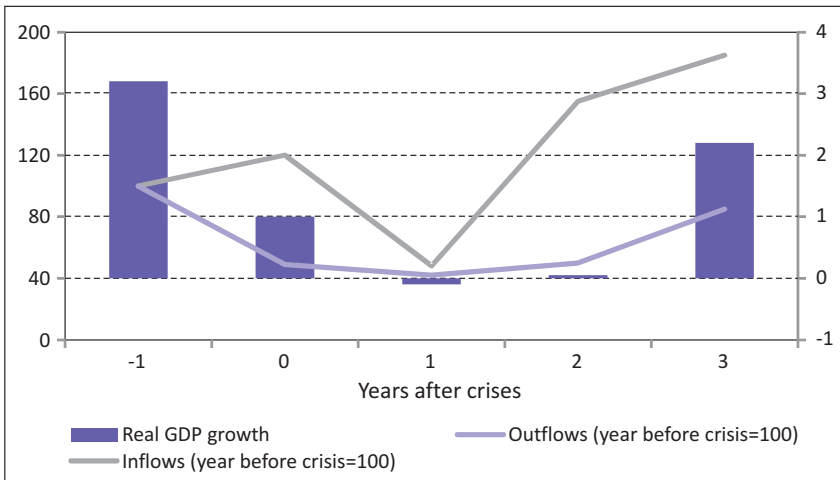


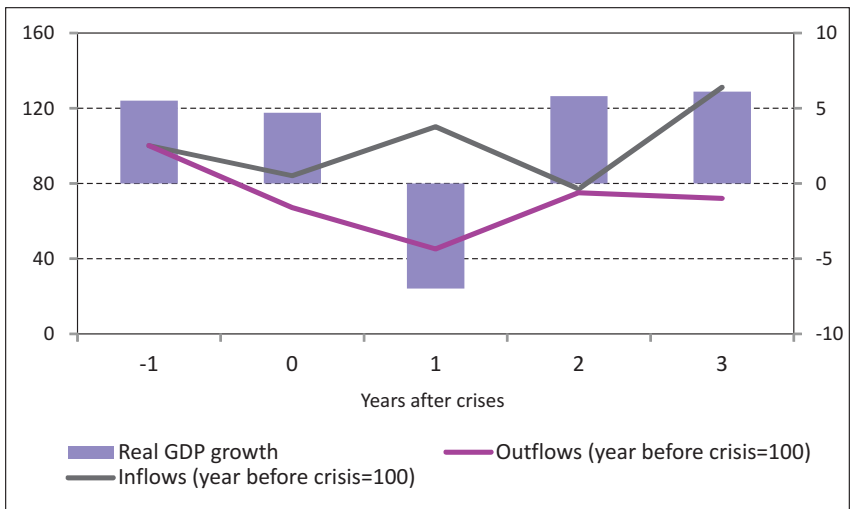
figure 5 plots the median country real GDP growth and FDI trajectories from one year before the crises to three years after. Median rather than mean values are used so that results are not driven by outliers. As the crises were in developed countries, the impact on outflows may be particularly illuminating for the current FDI downturn: when median real GDP growth turned negative, one year into the crises – as global GDP did in 2009 – outflows had fallen as much as developed country outflows fell during the current downturn, by almost 60 per cent. But while that marked the end of the downward trend in outflows after the individual country crises, 2010 figures available at the time of writing indicate that developed country outflows are still contracting two years into the current downturn (UNCTAD, 2010a). So, while outflows had almost returned to pre-crisis levels three years after the onset of the individual country crises, recovery could take longer this time.

Moving on to emerging markets, figure 6 again plots median country real GDP growth and FDI trajectories around seven emerging



market crises for which we have data: Argentina (2001), Malaysia (1997), Mexico (1994), the Philippines (1997), Republic of Korea (1997), Russia (1998) and Thailand (1997). By contrast with the comparison between the current crisis and the earlier developed country crises, the data presented in figure 6 indicate that outgoing FDI from emerging markets has been more resilient during the current downturn compared to emerging market crises in the 1990s and early 2000s. Partly due to the increasing internationalizing of “Southern” TNCs and the decoupling of key emerging markets in the early stages of the current crisis, the relative drop after individual country crises was much larger than the approximately 20 per cent decline in outgoing investments from emerging economies observed since 2007.

**Figure 6. Median GDP growth and FDI trajectories after 7 emerging market crisis**



Despite their growing role as sources of FDI, emerging markets are still mostly capital importers. So, for our purposes, inflow patterns are the main interest in the aftermath of the emerging market crises. Several emerging economies experienced falling inward FDI levels during and after their economic crisis. After the 2001 crisis struck Argentina, for instance, inward FDI collapsed to levels similar to those of the early 1990s. Nevertheless, as in the case of developed country crises, inflows to emerging markets were stable overall, or indeed rising, during and

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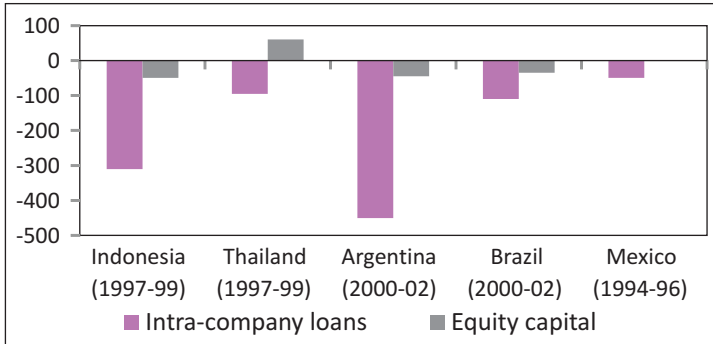
after their crises.<sup>3</sup> Stability was often backed up by FDI liberalizing policies. Following its crisis in the mid-1990s, for instance, Mexico liberalized important sectors of its economy over and above its NAFTA commitments (see e.g. Haber, 2005). The East Asian crisis likewise sparked liberal FDI reforms in a number of countries, resulting in considerable policy convergence across the region with respect to FDI regulation (Athukorala, 2003; UNCTAD, 2000, pp. 148 and 150). So rather than fostering FDI protectionism, past crises generally led to increased liberalization – as appears to be the case today. Yet, the resilience of FDI inflows to emerging economies after their earlier crises is in marked contrast to the grim FDI developments in 2009, where M&A deals and greenfield investments declined in most emerging markets – despite the equally open investment policy environment. And although slowly beginning to rise again in 2010, inflows to emerging markets remained more than 20 per cent below their 2008 level.

One indicator of the greater effect on inflows to emerging markets of the present crisis compared to past crises is that earnings and intra-company debt exhibited much more pro-cyclical patterns than equity investments during past crises in emerging markets (World Bank, 2009, pp. 51–54). In order to limit the impact of economic turmoil in host countries without having to sell off assets, TNCs often reduced intra-company loans to a much greater extent than equity holdings (figure 7). For example, United States TNCs in countries affected by the Asian crisis repatriated all their income from the region to parent companies (World Bank, 2009, p. 52). Similarly, while there was a net inflow of United States FDI to Mexico in 1995, the current assets of United States affiliates there dipped while equity components remained stable, suggesting the withdrawal of liquid funds (Graham and Wada, 2000, pp. 794–796). Thus, while TNCs – like portfolio investors – typically pulled out funds from emerging markets during past crises, they did not relinquish their long-term strategic commitment. This is somewhat in contrast to the current downturn, where equity investments have declined substantially in both absolute and relative terms.

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<sup>3</sup> This has been observed before. See Lipsey (2001), Sarno and Taylor (1999), Ramstetter (2000), Athukorala (2003) and UNCTAD (1998).

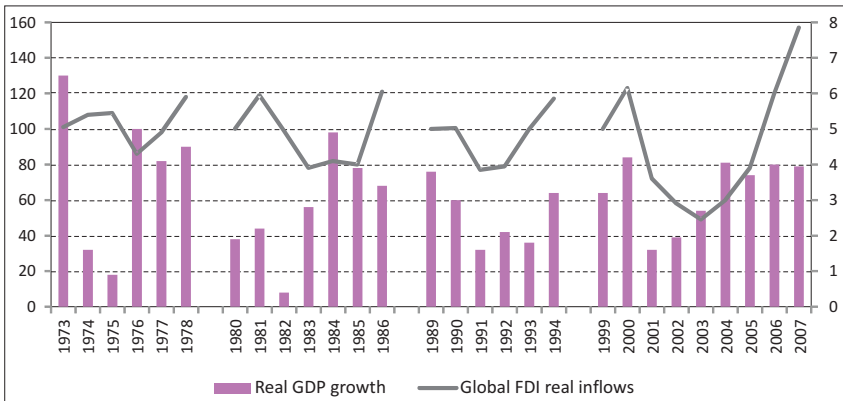
**Figure 7. Intra-company loans versus equity components of FDI during financial crises (Percentage)**



### Global crises

Having examined the response of FDI to individual country crises, it may be informative to review crises which were not specific to individual countries, but more global in character. We follow Freund (2009) in identifying 1975, 1982, 1991, and 2001 as prolonged global downturns. In these episodes, world real GDP growth (i) fell below 2 per cent; (ii) dropped more than 1.5 percentage points from previous five-year averages; and (iii) was at a minimum level compared to two years before and after. Figure 8 plots global real FDI inflows against GDP growth around the four crises.

**Figure 8. FDI responses to four global downturns (Inflows two years before downturns=100)**



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During the oil shocks and the downturn in the early 1990s, it took an average of three years for FDI flows to recover after their first dip. These swift recoveries took place in the context of policies that were largely favourable towards FDI. During the 1970s and 1980s, both European and American FDI policies were generally liberal. Starting with the United States, the approach towards inward FDI of both the Carter and Reagan administrations was principally based on a doctrine of neutrality (Graham and Krugman, 1995). Though the Committee on Foreign Investment in the United States (CFIUS) was created to keep track of investors coming to the United States, partly due to the rise of Japanese multinationals, it rejected very few M&A deals in practice and the fact of its existence certainly did not imply that the United States was closing its doors to inward FDI. Furthermore, both administrations also strongly supported US investment overseas, both rhetorically and by launching the United States Bilateral Investment Treaty (BIT) programme. Similar developments took place in Europe, where the Single European Act of the mid-1980s liberalized large parts of the European continent to foreign investment (OECD, 1992), and more and more European countries began treaty programmes to protect and promote their investors abroad. Furthermore, the debt crisis and global downturn in the 1980s similarly led the majority of Latin American countries to remove legislative and administrative barriers to FDI, which previously had closed large swathes of the continent to foreign firms (Williamson, 1990). Likewise, in the early 1990s, most countries further liberalized their FDI regimes, despite the downturn (UNCTAD, 2010b).

The policy responses regarding FDI were therefore largely comparable to today's. But just as the three previous global downturns were minuscule compared to the current crisis, so were the initial FDI drops when compared to the collapse since 2007. A more interesting comparison may therefore be the FDI recession of the early 2000s. Here, the halt in developed country M&A deals led real inward FDI to fall by more than 40 per cent in 2001. The decline continued, with 25 per cent in 2002 and a further 12 per cent the year after, which means the FDI collapse then was greater in percentage terms than the one the

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world is facing now. In 2006, global FDI was still below its 2000 level,<sup>4</sup> which raises the question whether we should expect the current FDI recession to be as prolonged – or even longer – as the recession after 2001?

### *A return to the early 2000s?*

Despite the greater FDI collapse in the early 2000s, the answer could very well be in the affirmative. This is for several reasons. First of all, equity investments have been affected to a greater extent during the current crisis than in the early 2000s (UNCTAD, 2009b). As mentioned above, equity investments are typically made for the long term, and their proportionate decline this time around may suggest that if anything, recovery will be longer than after the 2001 FDI recession.

Second, trade flows have dropped much more during the current downturn than in earlier global crises (Baldwin, 2010). Just as the current crisis is the largest since the Second World War, so has been the trade collapse; world trade may take a while to return to trend levels for the most badly affected regions – notably the United States and the European Union (IMF, 2010).

Third, maintaining liberal FDI policy alone cannot be relied upon to contribute to a faster recovery than the previous crises. At the time of the last FDI slump in 2001, while security concerns prompted several countries to tighten their FDI regulations in the years after 9/11, this did not reverse the overall trend of prior decades, where investment liberalization and promotion “replaced red tape with red carpet treatment of foreign investors” (Sauvant 2009, p. 222). Thus, today’s liberal policy environment is no more favourable than those during the past crises.

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<sup>4</sup> It should be noted that global FDI would have been higher in 2005 had it not been for the Homeland Investment Act, which created a one-year tax incentive for repatriation and led to a massive withdrawal of retained earnings from US foreign affiliates that year. From around \$80 billion in 2004, repatriations rose to almost \$300 billion in 2005, and then dropped again to approximately \$100 billion in 2006. As a result, reinvested earnings of American affiliates abroad dropped from around \$160 billion in 2004 to a negative \$10 billion in 2005, and then bounced back to almost \$220 billion in 2006 (Bureau of Economic Analysis, Table 7a).

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Fourth, although countries like China and India that are rapidly growing in importance as both hosts and sources of investment could thus soften the current FDI recession, one should not exaggerate the contribution of emerging market outflows to global FDI. For now, they constitute only around one-quarter of world FDI flows. So although favourable investment prospects in key emerging markets, combined with increased South-South flows, does imply that emerging market FDI could rebound faster than that of developed countries<sup>5</sup> – as they did in the early 2000s – Southern TNCs can not be relied upon to pull global FDI out of its current slump.

Fifth, while world stock markets also plummeted in the early 2000s, global real GDP growth never went below a positive level of 2 per cent. This contrasts with the current downturn, in which the global economy contracted during 2009. This in particular makes it unlikely that global FDI flows will recover more quickly after the current downturn, than they did after the 2001 plunge. In brief, there are no persuasive reasons to expect FDI to regain pre-crisis levels (around \$2 trillion) before at least 2014.

## 4. Conclusions

When attempting to forecast when, and how, the world will recover from the FDI recession, it is worth keeping in mind that just as predictions of financial resilience before the crisis turned out to be false, so any predictions of recovery could similarly be wide of the mark. This includes our own. But even if the worst of the current downturn has faded in the rear-view mirror, and world FDI bounces back quicker than we expect, do our observations have any implications for investment policymakers?

We think so. First of all, it is important to keep in mind that the scope and duration of the FDI recession depends primarily on how governments address the underlying macroeconomic risks of the

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<sup>5</sup> This expectation accords with the results of a June 2010 survey conducted by the Economist Intelligence Unit on behalf of the Multilateral Investment Guarantee Agency (MIGA). According to those soundings, around 40 per cent of the almost 200 surveyed executives expected to increase their investments to developing countries over the next year (MIGA, 2010).

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global economy in the coming years – including continued threats to financial stability. Here, FDI policies play only a minor role. And even if restraints on protectionist urges go some way to facilitate investments from abroad – in some cases enhancing the benefits of existing FDI (Moran, 2005) – in most countries, such restraint will do little to reverse the damage resulting from the crisis. Investment policymakers should therefore beware of myopia: in the vast majority of countries, the path of recovery from the crisis will not be paved by ever-greater incentives for TNCs, more favourable investment contracts, or a rush to enter into investment treaties.

Rather than desperately scrambling to increase the volume of FDI flows, officials might instead use the downturn as an opportunity to take a step back and reconsider their thinking. In recent decades – including during times of crisis – host country FDI policies have largely focused on increasing the volume of inward investment. In some cases, this is indeed still necessary. But not all FDI promotes development; larger quantities of FDI flows cannot be the sole indicator of a successful development policy. To increase the positive impact of FDI for economic development, and avoid the adverse consequences, officials should instead consider a “sustainable FDI” strategy, which enhances not only the quantity of investments, but also the “quality” (Vale Center and WAIPA, 2010).

Acknowledging that administrative and political constraints will prevent wholesale reforms of FDI regimes – particularly as the crisis demands a focus on other more pressing policy areas for most governments – a prudent and more realistic approach would be to target the most binding constraints on sustainable FDI promotion (see Hausman et al., 2007). These are bound to be country- and sector-specific. If fairer contract and treaty negotiations can provide the greatest benefits for a country, scarce resources would be best spent investing in more in-house legal expertise. If it is greater links between foreign investors and domestic firms, then providing technical and other support to potential domestic suppliers could prove instrumental (see UNCTAD, 2001). In some cases, environmental damage will be the greatest obstacle to sustainable FDI promotion, while in others, the problem of foreign investors taking advantage of non-transparent and corrupt state institutions is what must be addressed. And so forth.

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Suffice it to say, this is easier said than done, and will require considerable expertise and institutional capacity at national and sub-national levels, features which are often absent in emerging markets in particular. And unless carefully implemented, reforms could conflict with investment treaty obligations, and thereby expose governments to expensive investor-state arbitrations. Multilateral organizations, aid-donors and non-governmental agencies will therefore clearly have important roles to play. Academics can contribute, too. Rather than providing long shopping-lists of institutional and governance reforms, they could instead focus on operational methodologies to identify where investment policymakers realistically can get the most out of their scarce resources towards more sustainable FDI strategies. Finally, TNCs can often benefit as well from promoting more sustainable and transparent FDI regimes.

Ultimately, however, policy reforms have to start at home. Governments therefore ought to consider whether the crisis should simply prompt more liberalization in an attempt to attract TNCs – as was the pattern during earlier crises – or rather mark the beginning of sustainable FDI regimes at the national and international levels. In most cases, the balance between the two will do little to prolong or shorten the FDI recession over the next few years, but it will surely have important economic and social welfare implications over the longer term.

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