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The FDI recession has begun

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With $1.8 trillion (according to UNCTAD), world foreign direct investment (FDI) flows reached an all-time high last year. All major regions benefitted from increased flows. But that was then. What is, and will be, the impact of the financial crisis and the recession on FDI flows this year and next?

Several forces are at work, best discussed in terms of the three sets of FDI determinants: economic conditions, the regulatory framework and investment promotion.

If we are lucky, as far as the first set of factors is concerned, *global* GDP will not shrink in 2009, although it is currently expected to do so a bit in developed countries offset however by expected growth in emerging markets (according to the International Monetary Fund's (IMF) latest forecasts). Moreover, with the present commodity boom cycle winding down, FDI in natural resources is posed to decline as well, affecting especially FDI flows into Africa, Latin America, Russia, and Central Asia.

Since economic growth is the single most important FDI determinant for attracting investment (and developed countries having received some 70 percent of FDI flows in 2007), this economic slowdown, further accentuated by the financial crisis, makes key markets less attractive to invest in -- and hence depresses FDI flows. Even from the narrow perspective of FDI, the proposals by Jeffrey Sachs (*Financial Times*, 27 October 2008) and George Soros (*Financial Times,* 29 October 2008) on avoiding a global recession should be heeded.

The financial crisis and the credit crunch adds to this impact as it severely restricts the ability of firms to invest abroad and finance cross-border mergers and acquisitions (M&As) which are by far the most important form of entering foreign markets for many multinationals. Even where M&As do occur, they would involve lower values than, say, six months ago, as share prices -- and hence the values of companies -- have declined, depressing the value of FDI flows. The current economic difficulties will also entice parent companies to repatriate earnings if not to sell foreign affiliates to shore up their balance sheets, thus reducing net FDI flows. Earning downgrades and weak balance sheet make it more difficult for firms to finance deals, especially if they have to absorb other financial burdens (e.g. supporting the declining value of pension funds) and further deleveraging takes place. These considerations apply also to private equity funds, a number of which are in great difficulties. (These funds accounted for about one-

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quarter of the value of cross-border M&As in 2007.) The ability of firms to undertake outward FDI is therefore impaired. Not surprisingly, the value of cross-border M&As has declined by 28% during the first nine months of this year and is likely to decline further.

But the decline could be softened. In particular, if Asian counties and especially China should further stimulate domestic demand it would be even more attractive for multinationals to increase investment in those markets (although China, with $84 billion of FDI inflows, was already by far the largest emerging market host country in 2007). Similarly, if Asian firms are less affected by the crisis, they may accelerate their outward FDI. Chinese outward FDI, for instance, which was $23 billion in 2007, was $26 billion during the first half of 2008 alone, possibly reaching $50-60bn during this year. Add to that the potential FDI by Sovereign Wealth Funds (SWFs); so far, such sovereign FDI has barely taken off (and, in the financial sector, was not very profitable). Moreover, undervalued or distressed assets in developed countries and elsewhere beckon, helped possibly by the strong currencies of some home countries and the weak currencies of some host countries. What this could mean is that important investors are sitting on the fence, waiting for the stock market to hit rock-bottom, before investing abroad. If so, there is a chance that FDI outflows from emerging markets (which were $300 billion in 2007) could possibly hold up, a least this year.

This possibility depends on the continuous openness of the regulatory framework for FDI, especially in developed countries. While this is, grosso modo, most likely assured, there are mounting signs of a reevaluation of, if not distinct uneasiness about, at least certain forms of FDI. This is reflected, among other things, in the increase of national policy changes, as well as more restrictive review processes, that make the investment environment less hospitable, especially for cross-border M&As. A good part of such protectionist attitudes is directed against sovereign FDI by state-owned enterprises and SWFs from emerging markets – precisely those entities that, at least for the moment, still are in a position to continue, if not increase, their outward FDI. It is actually surprising how little FDI SWFs have undertaken so far; the skeptical attitude in developed countries partly explains this. Regulatory risk could exacerbate the negative economic factors.

It is here where investment promotion comes in: investment promotion agencies worldwide can be expected to make an extra effort to convince their governments to keep the investment climate welcoming. In fact, investment promotion agencies and individual firms seeking strong partners can be expected to make an extra effort to entice multinationals, private equity groups and sovereign FDI to come to their shores. How influential investment promotion agencies will be in their national decision-making processes remains to be seen.

So what does this all add up to? In the current situation of uncertainty it is impossible precisely to predict how these various factors will play out. Moreover, they need to be seen against the long-term nature of FDI, undertaken in-line with broader corporate strategies, which makes this type of investment more stable than portfolio investment (as we have seen during the Asian financial crisis) and hence could mitigate some of the immediate negative effects. In the past, a recession was typically followed in one-to-two years by a decline in FDI flows. This time, the credit crunch is accelerating the onset of the decline and it is likely to deepen it. It is quite

certain that FDI flows in 2008, and especially in 2009, will decline – the only question is by how much and for how long.

The steepness of the decline will largely be a function of how deep, long and widespread the recession will be. The decline is likely to be at least 20% this year and could well reach another 30% or more next year – making an already difficult economic situation even more difficult. If anything, the FDI recession puts a premium on maintaining a welcoming investment climate.

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Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

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