The impact of investments in global financial crisis

Impactul investiţiilor în perioada crizei financiare globale

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Abstract

The global financial crisis really started to show its effects in the middle of 2007 and into 2008. Around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems. The most important task is to break the spiral of falling asset prices and falling demand and to revive the financial sector's ability to provide credit for productive investment, to stimulate economic growth and to avoid deflation of prices. In this time of global financial crisis and recession it is essential to keep markets open to international trade and investment. The current global financial crisis is probably the most severe for the world's financial system since the Great Depression in 1929. This crisis has gone far beyond the financial sector and has seriously affected the real economy. An ample evidence of its negative impacts on FDI has been observed.

Keywords: *investment risk, mergers*

Rezumat

Efectele crizei financiare globale au început să se observe încă de la jumătatea anului 2007 şi au continuat în 2008. In întreaga lume, pieţele bursiere au început să aibă o evoluţie descendentă, mari instituţii financiare au intrat în colaps, iar guvernele celor mai puternice naţiuni au înaintat pachete de măsuri pentru a-şi salva propriul sistem financiar. Cea mai importantă măsură este de a opri spirala scăderii preţurilor activelor şi a scăderii cererii şi de a restabili capacitatea sectorului financiar de a acorda credite pentru investiţii, în scopul stimulării creşterii economice şi evitării unei posibile deflaţii. In această perioadă de criză financiară globală şi recesiune, este esenţial ca pieţele să rămână deschise comerţului internaţional şi investiţiilor. Actuala criză financiară globală este cu siguranţă cea mai gravă din sistemul financiar global de la recesiunea din 1929, *depăşind sectorul financiar şi afectând puternic economia reală. Este mai mult decât evident impactul negativ asupra fluxurilor de investiţii străine directe.*

Cuvinte-cheie: *risc investiţional, fuziuni*

JEL Classification: G32

Overview of the global financial environment

According to UNCTAD (United Nations Conference on Trade and Development), the year 2008 will mark the end of a growth cycle in international investment that started in 2004 and saw world foreign direct investment (FDI) flows reach a historic record of $1.8 trillion in 2007 (UNCTAD, 2009). A further decrease in FDI flows can be expected in 2009, as the full consequences of the crisis on transnational corporations' investment expenditures will continue to unfold.

The fall in global FDI in 2008–2009 is the result of two major factors affecting domestic as well as international investment. First, the capability of companies to invest has been reduced by a fall in access to financial resources, both internally – due to a decline in corporate profits – and externally – due to lower availability and higher cost of finance. Second, the propensity to invest has been affected negatively by economic prospects, especially in developed countries that are hit by severe recession.

The impact of both factors is compounded by the fact that, as of early 2009, a very high level of risk perception is leading companies to extensively curtail their costs and investment programmers in order to become more resilient to any further deterioration of their business environment.

However, the impact on FDI is different, depending on region and sector. Developed countries have so far been the most affected, with a decline in FDI inflows in 2008. Flows into developing economies continued to grow in 2008, but at a much lower rate than the year before. An outright decline in FDI inflows to those countries is possible in 2009, due to a pull-back both in efficiency and resource-seeking FDI.

Among industries, FDI flows to financial services, automotive industries, building materials, intermediate goods and some consumption goods have been the most significantly affected to date, as shown in the UNCTAD study. But the consequences of the crisis are now quickly expanding to FDI in other activities, ranging from the primary sector to non-financial services.

Developed countries have thus been directly hit by the financial crisis, while its effects on developing economies have so far been indirect in most cases, with varying degrees of severity among regions and countries. This has direct consequences on the geographical patterns of FDI inflows.

In the short term, the negative impact of the present economic recession on global FDI prospects should be the dominant one. Medium-term FDI prospects are more difficult to assess, due to the exceptional magnitude of the present crisis and to the fact that it could lead to major structural changes in the world economy.

According to UNCTAD's 2008-2010 *World Investment Prospects Survey,* conducted April–June 2008, 40 per cent of the respondent companies already mentioned at that time that the financial instability had a "negative" or "very negative" impact on their investment expenditures and programs.

A global economic slowdown is now projected and recession is already gripping a number of major developed economies. Industries likely to be especially affected are a number of manufacturing industries, including automobiles, aircraft, building materials, consumer goods, steel, and services such as transport services (airlines, logistics).

The current financial and economic crisis is different in nature and magnitude from those of the last 20 years, for at least three reasons: (a) originating in the developed countries, it has rapidly impacted the world economy as a whole due both to its unusual scale and to the existence of large diffusion channels related to globalization; (b) it is not a "usual" business cycle incident, but is of a more profound nature – it reveals structural weaknesses in the regulation of the world financial system, such as lack of transparency and control mechanisms and the incapacity to prevent hazardous behaviors excessively focused on the search for short-term profitability; (c) it might also reflect changes in economic power between the advanced economies – considerably affected by the crisis, including for inward FDI flows – and emerging and cash-rich developing countries, the position of which in the world economic and financial system is presently strengthening (UNCTAD, 2008 October).

FDI inflows and cross-border mergers and acquisitions by region and major economy, 2007-2008

Many large transnational corporations have revised their global expansion plans, and a large number of greenfield and cross-border merger and acquisition (M&A) projects are being cancelled or suspended. There is also evidence that *cross-border M&As* have already been sharply affected as a direct consequence of the crisis, with a 17 per cent decline in cross-border M&As in the first 10 months of 2008 as compared to the same period of 2007 (Table 1). This decline was due, among other factors, to the fact that leveraged buyouts, a common transaction method in M&As, have fallen considerably due to weakened world stock markets. For some countries, the difficulties emerging in M&A deals have brought large privatization projects to a halt. The decline in cross-border M&As is of utmost importance for FDI flows, which are strongly correlated with cross-border M&A amounts.

The impact of the crisis on *efficiency-seeking* projects is more difficult to assess. On the one hand, these projects will suffer globally from the decline in the companies' financial capabilities. On the other hand, many companies might be compelled by the ongoing crisis to restructure their international activities to cut cost and boost overall efficiency. This means above all closing or downsizing obsolete or non-cost-competitive facilities (often located in advanced economies), but also opening some new cost-efficient facilities, especially in emerging economies.

The decline in the propensity to invest abroad can take various forms (including divestment and restructuring), and differ according to entry modes (e.g. M&As, greenfield investment).

FDI Inflows and Cross-border M&As

Table 1

Region/economy	FDI inflows			Cross-border M&As		
	2007	2008 [a]	Growth rate (%)	2007	2008 [a]	Growth rate (%)
World	**1,833.3**	**1,449.1**	**- 21.0**	**1,637.1**	**1,183.7**	**-27.7**
Developed economies	**1,247.6**	**840.1**	**- 32.7**	**1,454.1**	**981.8**	**-32.5**
Europe	848.5	562.3	- 33.7	825.0	548.7	-33.5
United States	232.8	220.0	- 5.5	379.4	314.9	-17.0
Japan	22.5	17.4	- 22.6	21.4	19.1	-10.8
Developing economies	**499.7**	**517.7**	**3.6**	**152.9**	**177.0**	**15.7**
Africa	53.0	61.9	16.8	10.2	26.3	157.0
Latin America and the Caribbean	126.3	142.3	12.7	30.7	29.5	-3.8
Asia and Oceania	320.5	313.5	- 2.2	112.0	121.2	8.2
West Asia	71.5	56.3	- 21.3	30.3	31.5	4.0
South, East and South-East Asia	247.8	256.1	3.3	81.5	89.4	9.7
Transition economies	**85.9**	**91.3**	**6.2**	**30.1**	**25.0**	**-17.0**

Source: UNCTAD.

[a] Preliminary estimates.

What next? Scenarios for the medium term

While the negative impacts of the financial and economic crisis on FDI will presumably remain dominant in 2009, various positive factors are still at work and will trigger, sooner or later, a recovery of international investment flows.

For the short-to-medium term (2010–2012), UNCTAD proposes three scenarios, the probability of which depends on a range of factors, including in particular the evolution of the financial crisis itself, the severity and duration of the global recession, and the efficiency and effectiveness of policy responses.

The exact date of this upward switch will, however, depend on a series of uncertain factors such as the speed of economic and financial recovery, the efficiency of public policy in addressing the causes of the present crisis, the return of investor confidence and the ability to prevent protectionist tendencies. To illustrate those uncertainties and provide a framework for further discussion and analysis, this paper presents a set of three scenarios: V (quick recovery of FDI as soon as 2010), U (slow recovery beginning in 2011), and L (no recovery before 2012).

V scenario (optimistic): Quick upturn in FDI flows, beginning end 2009. Underlying assumptions are: (a) end of the recession as early as the second half of 2009; (b) quick return of investors' confidence due, among others reasons, to efficient government policies; (c) no protectionist setback; (d) fresh wave of cross-border M&As due to industry restructurings and availability of cash in some companies and financial institutions. Based on a combination of very optimistic assumptions, this scenario seems rather unlikely as seen from today.

U scenario (base case). FDI flows begin to pick up only in 2011. Major underlying assumptions are: (a) global recession is worse than in the V scenario, lasting at least till the first semester of 2010; (b) the global value of cross-border M&As remains limited due to the low price of stocks; (c) the trend towards the internationalization of companies is still at work in the medium term. To date, this scenario appears as the most probable one.

L scenario (pessimistic). FDI flows do not pick up before 2012. Underlying assumptions are: (a) a longer and worse-than-expected economic depression results, among others, in protectionist tensions affecting the overall trend in globalization; (b) due to the accumulation of negative factors, companies remain extremely cautious about investments, especially those aimed at financing their international development.

The current financial and economic crisis has two major consequences for FDI in 2009 and onwards. First, it could have a lasting negative effect on the dynamics of FDI flows, due to its forceful impacts on market growth and financial resources. Second, it creates a situation of widespread uncertainty regarding the future evolution of FDI and notably the date and conditions of a future pick-up of flows.

The challenge is to restore the credibility and stability of the international financial system, to provide stimulus to economic growth in order to prevent the risk of a spiraling depression, to renew a pragmatic commitment to an open economy, potentially put at risk by rising protectionist tensions, and to encourage investment and innovation. So far, however, it is hard to say that the crisis has led to a clear set of measures either favorable or not to FDI. But, as it has revealed some structural shortcomings in the way the global economy is operated, it can also pave the way for the implementation of public policies aimed at maximizing the positive impact of FDI on development.

On the one hand, a number of policy initiatives at the national level could stimulate FDI. Three categories of policy measures can be distinguished. First, many developed countries have adopted large-scale bailout plans and rescue packages for the financial sector. Providing State guarantees to financial institutions could have a crowding-in effect on FDI, as these companies might be considered as "safe" investments by foreign investors.

Beyond its immediate negative impact on FDI flows in 2008 and presumably 2009, the ongoing crisis opens a period of major uncertainty. For effectively dealing with the crisis and its economic aftermath, it is important that policymakers maintain an overall favorable business and investment climate (including for FDI) and refrain from protectionist tendencies.

Romanian's foreign direct investment evolution

Romania looks more attractive to foreign investors than a year ago despite the financial troubles, as revealed by the newest figures of the country's central bank BNR (National Bank of Romania, 2009 February 12). These shows that in January 2009 foreign direct investments in Romania amounted to 912 million Euros, up 51% as compared to January 2008.

An important driver for growth and development in Romania has been foreign direct investment. This is typically limited to the few developed economic centers. As a result the economy has to face sharp shortages on local labor markets, which again set low upper boundaries to the progresses experienced after 2000.

In addition, much of the FDI in Romania is yet rather labor intensive – not technology based. As a result, the trade deficit keeps being huge and growing, so does the current account deficit of Romania. Thus, a great deal of foreign debt has to be paid back in the future - setting also the currency under pressure what can already be observed since early 2009.

In Romania, the evolution of foreign direct investment in the year of 2008 and the impact of the financial crisis from the United States was unsignificant. However, the possiblity of a slowdown of foreign direct investment is taken into consideration.

Due to the global financial crisis, the capacity of companies to invest has been weakened by reduced access to financial resources, both internally and externally, and their propensity to invest has been severely affected by collapsed growth prospects and heightened risks.

Also, the various economic stimulation programmes recently launched in many developed countries may have a positive impact on FDI inflows. However, at least in the short run, the negative impacts of the ongoing crisis are likely to remain dominant, and a further decline in FDI inflows is expected.

An important driver for growth and development in Romania has been foreign direct investment. This is typically limited to the few developed economic centers. That is to say that FDI in Romania keeps being crowded in some developed cities of Romania. As a result the economy has to face sharp shortages on local labor markets, which again set low upper boundaries to the progresses experienced after 2000.In addition much of the FDI in Romania is yet rather labor intensive – not technology based. As a result, the trade deficit keeps being huge and growing, so does the current account deficit of Romania. Thus, a great deal of foreign debt has to be paid back in the future - setting also the currency under pressure what can already be observed since early 2009.

Overall, Romania certainly did great progresses in the past years, and it will continue to do so. However, upper boundaries for the future are currently low as the business environment (such as infrastructure and human capital) needs significant improvements.

In Romania, the financial crisis has no direct effects, according to the Governor, Mugur Isărescu, the banking system being fundamentally sound due to the lack of "exposure" to "toxic assets" and to the high profitability of traditional banking products.

However, the indirect effects are significant. These indirect effects are: the availability and cost constraints of external financing, Decline in the volume of FDI inflows, Negative impact on foreign demand, affecting Romania's Exports, increased exchange-rate volatility,

The likely decrease in the FDI flow will make financing more expensive and significantly less available. However, higher deposit rates should stimulate saving and would, therefore, reduce the gap between saving and investment, in the opinion of the Governor Mugur Isărescu (2008).

Major changes in investors' behavior occurred –increased risk aversion there has been a shift from global excess liquidity to liquidity crunch.

The most important measures to take into account are especially to maintain the investor's confidence. This could be realized by sustaining a solid banking sector and by reviving the financial sector's ability to provide credit for productive investment. The Government must sustain the banking system in order to prevent any that could occur due to the effects of the financial crisis and to the measures taken in the United States.

The global financial system is vulnerable and the management of the major financial institutions must take effective measures which should not imply a high level of risk.

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