Economic Size, Foreign Direct Investment, and Economic Crisis

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Abstract

The economic crisis of 2008-09 affected the world Foreign Direct Investment (FDI) inflows. This paper investigates the impact of the first year of the crisis per region and type of economy and tries to identify the "winner" between developed and developing countries in terms of attracting FDI inflows. Furthermore, the main aim is to identify specific trends that make countries more attractive for FDI with a specific focus on the size of the population. Results indicate that a specific trend of FDI growth in countries with significant population existed, which was not interrupted not even during the first year of the crisis.

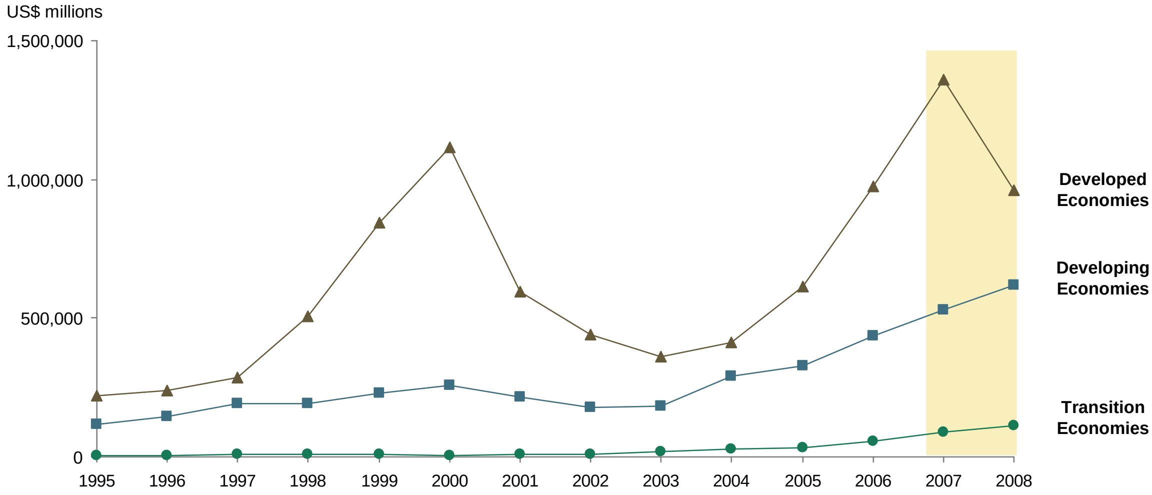
Keywords: FDI, Economic Crisis.

JEL Classification: F20, F23

1. Introduction

The economic crisis in 2008 affected the world FDI inflows. In 2008 the FDI decreased by 14% to $1697 billion. However during the first year of the crisis all countries were not affected in the same level. The developed economies were strongly influenced (-29%) while developing (+17%) and transition (+26%) economies managed to further increase their FDI inflows. The drop in FDI of developed countries is mainly driven by the significant drop of M&As (Filippov S., Kalotay K, 2009). The last crisis, in contrast with the majority of them, started from the developed economies, which were firstly affected. Developing and transition economies were not affected so much in 2008 because of the time lag in the spread and the impact of crisis.

Figure 1- 2008 FDI Inflows



Data: World Investment Report 2009

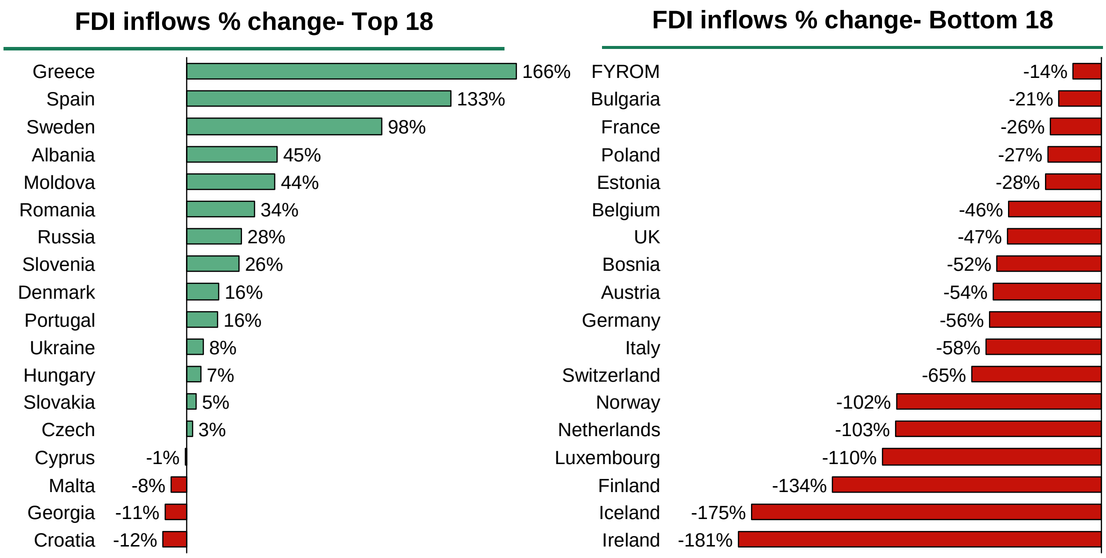
The trend of drop of FDI inflows is also observed while examining the regional FDI inflows. Europe and North America had a drop in FDI inflows which however was more severe in Europe (-42%), while in North America was limited to -5%. The "winners" in 2008 in terms of increasing their world share of FDI inflows were Africa (+27%), SE Europe and CIS (26%), Asia (16%) and South and Eastern America (+13%). An interesting point to state is the identification of certain factors that explain, in an extent, the positive performance of specific countries in the same region and especially inside Europe.

2. Economic Crisis and Europe

2.1 "Winners" and "Losers" during the first year

Europe was strongly affected in terms of reduction of FDI inflows during the first year of the crisis. As it can be seen in figure 2, the majority of the countries faced a reduction in FDI. However the main losers of the first year were mainly Iceland and Ireland due to the significant economic problems they were facing in 2008, which continued also in 2009. The European countries that achieved significant increase were both developed (e.g. Sweden, Spain, etc) and developing (e.g. Albania, Ukraine, etc). Although the roots of FDI reduction are obvious (economic crisis) the question that arises is whether the performance of the "winners" was based on specific structural changes that allowed them to improve their competitiveness and steadily attract increased amount of FDI. For this case we will analyze/study the case of Greece which was the "winner" in 2008 in terms of increase of FDI inflows.

Figure 2- % Change 2008

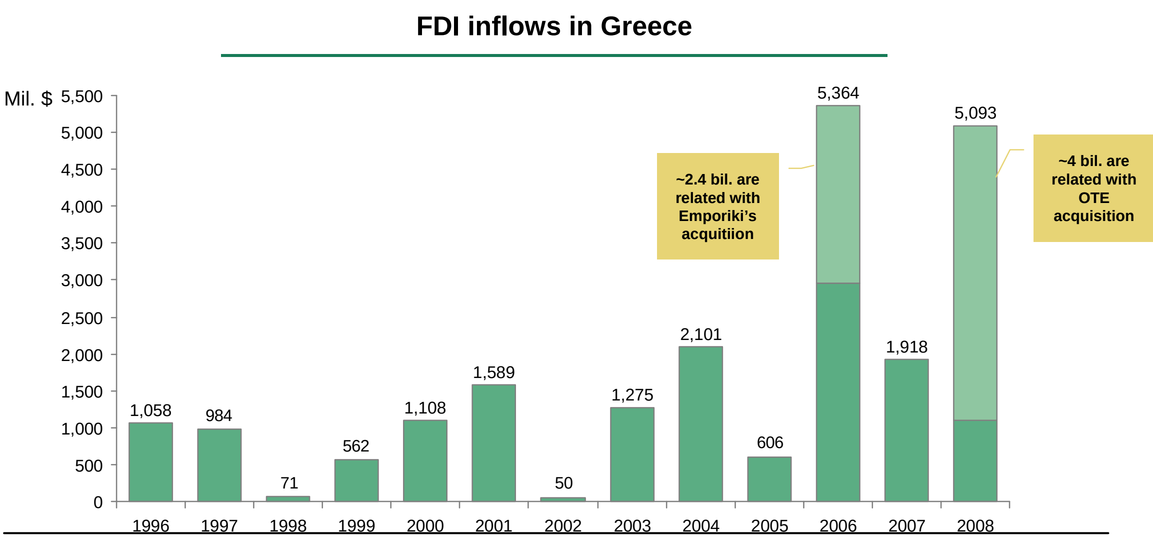


Data: World Investment Report 2009

2.2 The case of Greece

Greece achieved in 2008 to attract ~$5 bn which is a remarkable growth of 166%. However what should be examined are the main reasons for this growth. Greece in 2009-10 Global Competitiveness Report (GCI) is ranked 71st while in 2008-09 was 67th and in 2007-08 65th. This constant deterioration proves that the significant increase of FDI inflows is not a result of economic growth, structural changes or a general improvement of competitiveness but a result of circumstantial reasons. As it can be seen in figure 3, the increase of FDI is a result of the acquisition of OTE from Deutsche Telecom that accounted for ~$4 bn. Many years ago the government had started the privatization of the company which ended in the buyout of a significant percentage of OTE by DT. A similar case took place also in 2006 when the Greek government sold Emporiki Bank to Credit Agricole and achieved a significant increase of FDI inflows. However, all these acquisitions were not a result of improved competitiveness of the country. The main problems of Greece that discourage the foreign investors remain (Pantelides P., Kyrkilis D. 1997, Pantelides P, Nikolopoulos E, 2008) and thus the increase of FDI is random and not sustainable.

Figure 3

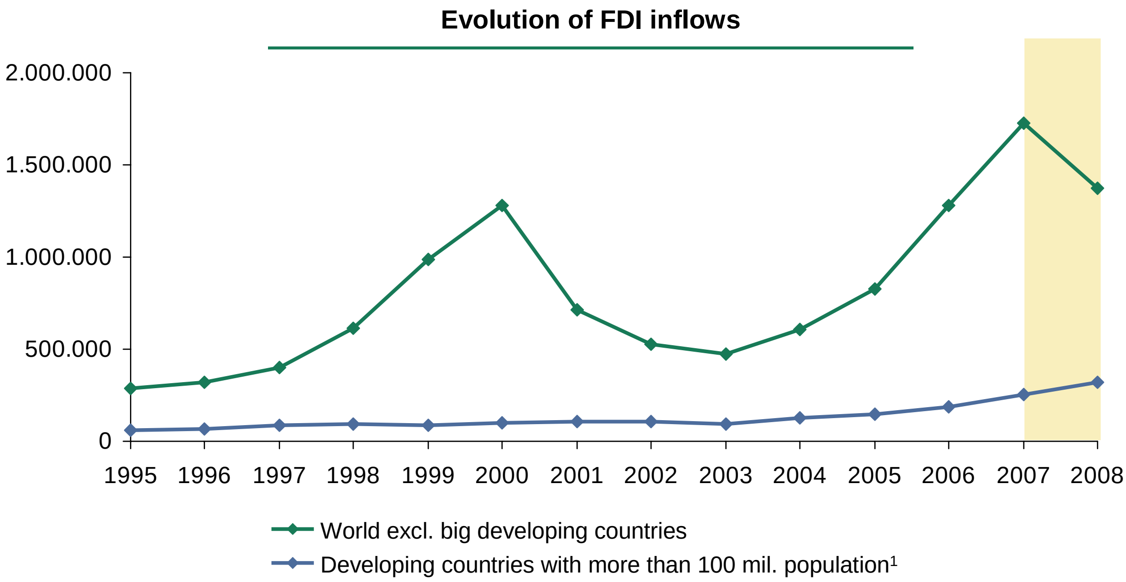


Data: World Investment Report, press search

3. Focus to domestic size

Although it is obvious that developing and transition economies were in general the winners during the first year of the crisis, it is interesting to identify if there is any specific group of countries that constantly overperforms. According to the World Investment Prospects Survey 2009-11, the multinationals claimed that it is most possible to cut investments first in North America and EU and after in Asia , CIS and Latin America. Our hypothesis is that multinationals are not going to change their strategy towards specific markets, despite the crisis. Thus the investment cuts will take place either in mature markets where it is more difficult to have further significant growth or to countries which are not set as priority. The major factor which affects the attractiveness of a country as an investment option, even during the crisis, would not only be the cost of labour, the level of innovation and the competitiveness of the economy but also the domestic market size. As it can be seen in figure 4 developing and transition countries with more than 100 million population have achieved a significant growth in terms of FDI inflows during the last years, steadily overperforming the rest of the world. The trend became more significant from 2000 onwards when the FDI of these countries was barely influenced in contrast with the global reduction of world FDI inflows.

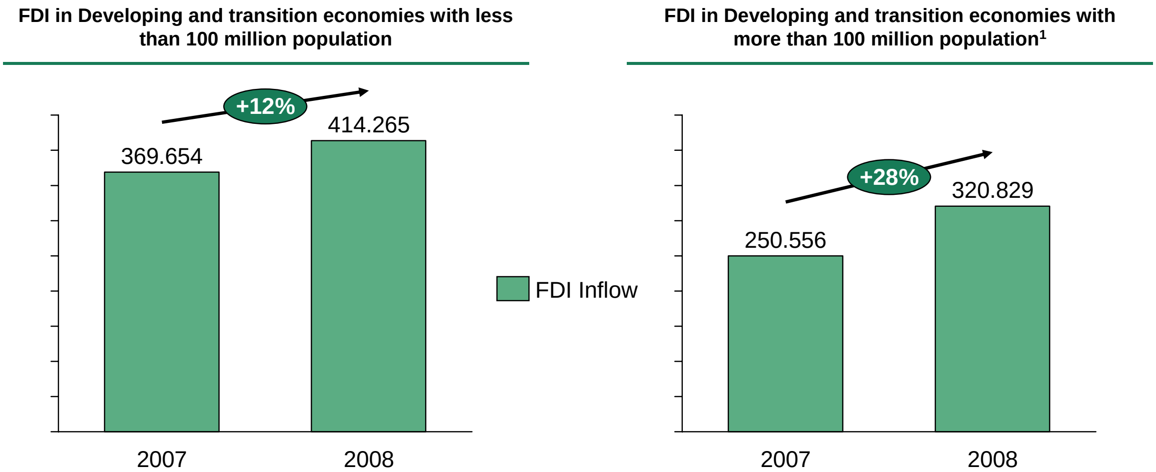
Figure 4



Data: World Investment Report 2009, EIU

It is clear that countries with significant market size, in terms of population, are considered a strategic choice for the multinationals. Thus, at least in the beginning of the crisis, the companies were not willing to significantly reduce their investment. As it can be seen, in figure 5, developing countries with population more than 100 million overperfomed and achieved a growth of 28% while the rest developing and transition countries achieved a growth of 12%.

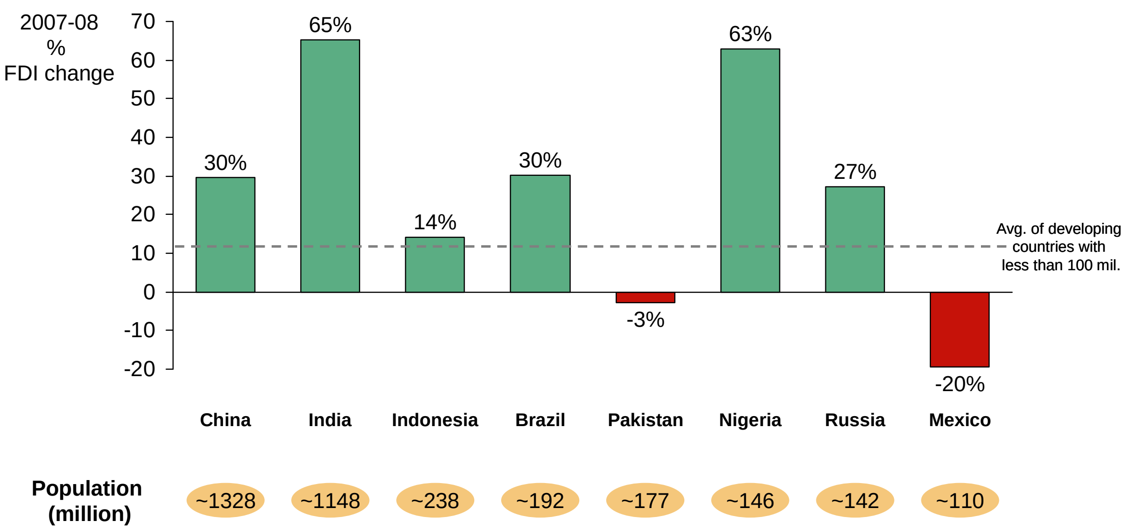
Figure 5



Data: World Investment Report 2009, EIU

It is also important to identify if there are specific trends inside this group of countries with high population. As it can be seen in figure 6 the top four developing countries have a positive growth which on average is higher than the rest four countries. However it can not be said that there is significant difference in terms of growth trends. What could be stated is that countries with the highest population might be more resistant in reductions of FDI inflows, especially during periods of crisis. One possible explanation for this result might be that the main multinational companies place high significance in these countries.

Figure 6



Data: World Investment Report 2009, EIU

The trend of overperformance of developing countries seems to maintain also in 2009. The first initial estimates from UNCTAD show that in 2009 the world FDI dropped by ~39%. On one hand, developed countries again underperformed with a drop of ~41%. On the other hand, developing countries also faced a significant reduction in terms of FDI inflows (~ -35%) as the crisis expanded. However the drop was again smaller than that of developed countries. What is important is that China announced that in 2009 had a reduction of FDI inflows of only 2.6% again significantly overperfoming the average of both developed and developing countries and signalling that the overperformance trend for countries with significant size might continue also for the rest countries of this group.

4. Conclusion- Next steps

It can be stated that the economic crisis had a significant effect on the world FDI inflows. During the first year of the crisis developed countries were influenced significantly mainly because of the drop of M&As. However developing countries continued to attract FDI as a result of the time lag before their economies are affected by the crisis. In terms of regions, North America and Europe show a reduction of FDI. The different trends inside Europe, especially the overperformance, could mainly be attributed to circumstantial reasons rather than to sustainable factors that would attract and retain foreign investors.

The countries with significant population, more than 100 million, tend to significantly overperform during the last years and achieve a higher increase of FDI inflows against rest developing countries even during the crisis. The underlying hypothesis is that multinationals continue to invest in countries which have both potential for growth and considerable internal market that could absorb a major part of their production.

An interesting future research direction is to examine the FDI inflows towards countries with high population, in the next years, and identify whether the upward trend continues. Furthermore it would be interesting to examine if the medium size countries follow any specific pattern in terms of over-under performance. Finally it would be interesting to examine the effect of the debt crisis, as a spillover of the cases of Iceland, Dubai and Greece, in both developing and developed countries and mainly towards those with high relative debt.

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