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FDI and the Ongoing Economic and Financial Crisis

Abstract

Due to the impact of the ongoing worldwide crisis, Foreign Direct Investments (FDI) flows could decline by more than 20 per cent in 2008. A further decrease in Foreign Direct Investment (FDI) flows can be expected in 2009, as a result of growing investment expenditures.
Lower FDI flows to the Central East European Countries (CEECs) faced a setback in 2008 in all parts of the region, after the continuous expansion in 2004 through 2007. CEECs have to do with the global financial turbulence, the declining rate of economic growth in Europe and with home-made problems in some of the countries.
Recession in the developed countries, which are Macedonian traditional foreign trade partners, is expected to have a significant consequence on the external sector in Macedonian economy.

Keywords: Central East European Countries, FDI, Macedonia, crises, economic.

Foreign Direct Investments and ongoing economic and financial crises

The financial and economic crisis which had worldwide repercussions in 2007, had begun to take its toll by mid-2008. So far, forecasts for 2008 are pointing recession with simultaneous mixed impact on FDI flows. The credit crisis in the United States which causes the depreciation of the dollar has stimulated FDI flows into the United States from countries with appreciating currencies (Europe and developing Asia). On the other side, long-term effects in terms of difficulties and higher costs of obtaining credit, are also affecting FDI flows. Such effects can be perceived at the micro as well as macroeconomic levels. At the macroeconomic level, developed-country economies could be affected both by the slowdown of the United States economy as well as by the impact of the turmoil in the financial markets on liquidity. At the micro level the direct impact of the crisis is mainly on FDI flows in a cross-border M&As, having in mind that in developed countries FDI is mostly in the form of M&As. The question is whether such effects are also being experienced in developing economies, in particular those where there is strong and growing demand for FDI. The growth rate of FDI inflows to developing countries, while lower than in 2007 (when it exceeded 20%), for 2008 they remained positive, but witt lower growth rate. The fact that economic growth of these economies has remained resilient suggests that this may not be the case.
As the financial crisis has evolved into a global economic crisis, the outlook for FDI has likewise darkened. Global Foreign Direct Investment (FDI) inflows are estimated to have fallen by 21% in 2008 to an estimated $1.4 trillion, and will likely fall farther in 2009, according to new estimates released today by UNCTAD[1]. According OECD estimations, based on current trend, inflows will be down 13% and outflows by 6% by the end of the year. FDI flows will fall sharply in the second half of 2008 and continue to decline into 2009, especially considering the speed with which the global economic crisis deepened during Q3 and into Q4 of 2008.
In the past 10 years, international capital flows to developing countries has changed dramatically. During this period, FDI's share of total capital inflows fell from almost 90% to under 50%, with increasing portfolio flows and private debt in the same time, which could result in a sharp contraction of international capital flows for many developing countries. For example,

[1] UNCTAD/PRESS/PR/2009/001.rev1;19/01/09 :"Global Foreign Direct Investment now in decline - and estimated to have fallen during 2008 "

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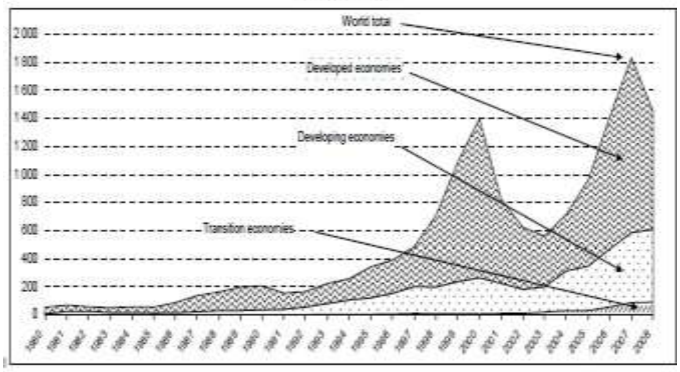
according to the *Institute of International Finance*, private credit financing into 30 developing countries surveyed will decline by half between 2007 and 2009 (from US$600 billion to $300 billion), while net portfolio inflows, which are already negative, will decline further (from –US$6 billion to - $US20 billion). FDI flows into these 30 developing countries, however, are only expected to decline by 7% (from US$302 billion to US$282 billion)[2]. FDI inflows to the Central East European Countries (CEECs) will face a setback in 2008 in all parts of the region, after the continuous expansion in 2004 through 2007. Lower FDI flows to CEECs have to do with the global financial turbulence, the declining rate of economic growth in Europe and with home-made problems in some of the countries.

Regarding developed countries, estimated annual 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. Preliminary estimates show a decline of about 33% from flows in 2007 for this group.

From the institutional aspects, effects from financial crisis has mainly affected North American and European commercial and investment banks, whereas the negative effects on the Asian financial system have been fairly limited. Banks that were able to ride out the crisis without suffering large losses are seeing an opportunity for cheap investment in banks that were severely hit, and the equity prices of which fell sharply, by 40% to 60%.

Figure 1. FDI inflows, global and by group of economies, 1980-2008
(Billions of dollars)



Source: UNCTAD, based on FDI/TNC database (www.unctad.org/fdi statistics) and UNCTAD own estimates.

[2] For further reading on this topic:OECD work on FDI statistics www.oecd.org/daf/investment/statistics

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. But the consequences of the crisis are now quickly expanding to FDI in other activities, ranging from the primary sector to non-financial services.

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 firms 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 programs in order to become more resilient to any further deterioration of their business environment. International Greenfield investments have been less impacted to this point, but could be increasingly affected in 2009 as a large number of projects are presently being cancelled or postponed. [3]

The effects of exchange rate changes on aggregate FDI flows are not straightforward[4]. While it is difficult to isolate the effects of exchange rate changes from the effects of other determinants on FDI flows, there are some appreciable cases of European firms that increased their FDI in the United States in reaction to the appreciating euro, with total share around 60% from EU countries. On the other hand, the relatively resilient economic growth of developing economies may counteract this risk. In addition to the credit crunch in the United States, the global economy was also affected by the significant depreciation of the dollar. European FDI to the United States was spurred by the increased relative wealth of European investors and reduced investment costs in the United States. Moreover, companies exporting to the United States have suffered from the exchange rate changes, which have induced them to expand local production in the

[3] "Assessing the impact of the current financial and economic crisis on global FDI flows" by UNCTAD, January 2009; box 1

[4] 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, while 58% of TNCs said there had been either a positive impact or no impact from dollar deprecation.

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United States. This is illustrated by changes in the strategy of several European Trans National Corporations (TNCs); particularly carmakers that plan to build new or expand existing production facilities in that country. The slowdown in the world economy and the financial turmoil has led to a liquidity crisis in money and debt markets in many developed countries.

Some TNCs may avoid effects from currency change movements trough the raising funds in the capital markets in their host countries or in international capital markets. Also, some of TNCs are skilful in using derivatives (such as futures, forwards, options and swaps) to hedge against exchange rate changes. Lot of FDI flows into off-shore companies in tax heavens countries are establishing for this purpose. The current depreciation of the dollar has stimulated this type of FDI as well.

The main impact of the crisis on the low-income countries will be through trade. Exports are projected to decrease sharply and for commodity exporters, they're facing a particularly hard hit. The outlook for FDI in developing countries is bleak. The forecast is around 20 % decline. It reflects, of course, investor uncertainty, and until this uncertainty disappears, there's no real hope for FDI to resume. The lending cost has risen significantly, and even sometimes whatever the price the country may pay, it is just unable to find any money to borrow. Remittances are also likely to drop, and aid flows are under stress because of budgetary pressures in developing countries. So, these two shocks, the trade shock and the financial shock, may have a major negative impact on the external finances of the poorest countries[5]. While the decrease in FDI inflows has hit developed countries the hardest, some developing economies with open but weak financial systems are also very vulnerable to external shocks. They face unprecedented challenges from the possible drying up of financial flows from both official and private sources.

Having in mind that the current crisis began in the developed world, with rapidly spreading to developing and transition economies, the impact of the crisis also very much depends on region and country, with consequences for the geographic pattern of FDI flows. 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.

[5] Strobe Talbott on the Brookings Institution meeting: "THE IMPACT OF THE FINANCIAL CRISIS ON LOW-INCOME COUNTRIES" - Washington, D.C. Tuesday, March 3, 2009; p.8

As we already mentioned, FDI inflows in developing and transition economies have so far remained more resilient. FDI flows to the transition economies of South-East Europe should maintain their upward trend despite the financial crisis and regional conflicts, registering an increase of about 6%. While the decrease in FDI inflows has hit developed countries the hardest, some developing economies with open but weak financial systems are also very vulnerable to external shocks. They face unprecedented challenges from the possible drying up of financial flows from both official and private sources.

This situation 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.

A number of large emerging economies have remained attractive to FDI, particularly to market-seeking FDI. They maintained relatively high economic growth rates (compared to advanced economies) in 2008.[6] As prospects continue to deteriorate in developed countries (more markedly than in developing ones), investors will favor the relatively more profitable options available in developing countries.[7]

Crucial role in process of creating favorable climate for new FDI inflows will play effective government policy which will be able to response on national and international needs for extracting financial crises economic aftermath. Credibility and stability of the international financial system should be restored in order to provide stimulus to economic growth which will lead to the risk prevention of a spiraling depression, to rebuild a pragmatic commitment to an open economy, and to encourage investment and innovation. Such a response needs to involve many elements, including access to external funding for emerging economies via official channels, support for advanced economy banks with large presence in emerging

[6] According to the November estimates by IMF, projected economic growth rate of BRICs in 2008 is as follows: 5.2 per cent for Brazil, 6.8 per cent for the Russian Federation, 7.8 per cent for India, and 9.7 per cent for China.

[7] On the importance of the substitution effect between investment abroad and home, see for instance the study by E. L. Yeyati, U. Panizza and E. Stein (2007), which supports the view that the substitution effect dominates the income effect (unexpected earnings and losses) during expansions and recessions.

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economies, and coordination between home and host country financial supervisors.

While achieving financial stability should be the immediate goal, policymakers ultimately need to work toward strengthening multilateral insurance systems: this would allow emerging economies to reap the benefits of international integration while limiting the potential risks from greater external financial integration.

In these unpredictable circumstances is hard to say that the crisis has lead to a clear set of measures either favorable or not to FDI. But, having in mind the fact that the crisis discovered some structural deviations in the global economy performance, we can also expect that this crisis can maximize implementation of the public or government policies aimed at increasing FDI flows which will have positive impact on further development. Investment promotion agencies could also play a key role in implementation of promoting policies aimed at retaining existing activities by TNCs and in implementing targeted investment promotion programs on promising activities.

Despite growing concerns and political debate over rising protectionism, the overall policy trend remains one of greater openness to FDI. However, the proportion of changes that were less favorable to FDI has been increasing over the past few years. Most of the new restrictions introduced were concentrated in the extractive industries. Several governments, including those of the United States and the Russian Federation, adopted stricter regulations with regard to investments in projects that have potential implications for national security.

Government concerns also appear to be directed towards investments in certain infrastructure areas and those undertaken by State-owned entities.

Most of the national policy changes of the transition economies in 2007 were in the direction of greater openness to FDI.

To conclude, 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.

The European Union and the Integration Challenges

As the financial crisis deepens and its destructive effects are experienced throughout the world, the EU begins to deal with the most difficult challenges in its history. Undoubtedly, process of European integration faced with several crises within the **EU.** The history of Europe is well known for dissolutions as well as unifications. In the same way, the European integration has successfully overcome serious political and economic crisis in the past half century. Moreover, many crises have been well evaluated by European politicians and risks have been successfully converted into chances.

Approaching the issue from this perspective, in principle there is not such an obstacle before converting the global financial crisis into a new chance for Europe. However, it is hard to speak optimistically about the process when looking at the content of the Europe-wide political debates. Moreover it can be said that many specialists acquire question marks in their minds regarding the future of European integration. EU countries' nation-based approaches are mostly protectionists towards the problem and EU's developing solutions are considered as: "at the expense for the others". All this leads to abandoning the single market concept.

From the other side, the unions are developed in period of prosperity, and disintegrated in periods of crisis, fact that needs additional efforts and solidarity for its maintenance. Recovery programs for mitigation of crisis consequences taken by countries-old EU members, primarily indicate the more care for own economies, less than for common economy. Without unique approach to the global crisis, the free movements of goods, services and capital flows, can be very soon put under question mark. Central and East European Countries are very important trade and investment partner on Euro zone. The annual trade suficit of the Euro area with new member states and with non member states in the Europe exceeds amount of 70 billion Euros. Countries that are large investors and have a biggest export in central and east Europe (Austria and Germany) are very much interested for economic recovery and stability of this region. Interest of the other, is less. Does it going to achieve a certain level of unity in process of stability of this part of Europe, we will see soon. In any case, economic collapsing of Central and East Europe would deepen and prolong the crisis in EU in the same time, and acquire question marks regarding EU sustainability.

Protectionist approach and elements in the antirecession programs taken from developed EU countries are opposite with essentials of integration,

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free movement in import and export and with national treatment of goods and capital of other member states[8]. The freedom remains but stimulus for increasing of demand for domestic products is sharply acquired. Nothing is new. All crises till now have leads to protectionist behavior. However, every country despite that the crisis has a global effects, can't wait some global or regional common solution and measures – or in this case European solutions. Every country rescues its own economy and society.

The six Balkan countries (Macedonia, BiH, Croatia, Albania and Monte Negro), are express their common statement regarding straitening of process of their integration in EU. They are unanimous in association (affiliation, aggregation) of all efforts and capacities in aim to avoiding first of all bilateral disputes, and second economic challenges caused by global crisis. This six countries asks the EU does not negligible the region because of global economic crisis, which they consider that hasn't have a negative impact on the transition of Balkans countries as well on the their European integration. In Prague in February this year, on the foreign affairs ministerial conference on the member state of the EU, EU re-confirmed their commitment to the process of integration of the Balkans countries into EU given 120 million Euros for that aim.

Macedonia and the crisis

The realized capital inflows based on direct investments in 2008 in **Macedonia** (412.5 million Euros), significantly exceeded the expectations, thus financing a significant part of the deterioration in the current account. By the end of the year, the trends are in a direction of further growth in the inflows based on foreign investments (although the uncertainty is increased due to the global events), as well as more intensive use of foreign currency by the banks, which will enable financing of a larger part of the deficit in the current transactions.

Most of the current account deficit financing was made through the net-inflows in the capital and the financial account, which in 2008 equaled Euro 801 million, or 12% of the estimated GDP (increase of Euro 251.6 million on annual basis). Within the capital and financial account, almost half of the inflows come from direct investments, which, although significant, they decreased by 16.7% in 2007, standing at Euro 422 million. The direct investment structure on net basis shows that most of the inflows are share

[8] http://www.nacional.hr/clanak/54184

in capital (50.2%) and credits and loans among connected entities (43.5%). The direct investments register divergence, i.e. the amount of net-inflows is lower than expected, due to the global financial crisis which brought about higher restraint from new investment (through project cancelling or postponing) due to insufficient available financial resources and investors' perceptions for high global risk. The portfolio-investments, over the entire year (except for July), registers a disinvestment trend, and at the end of 2008, the net-outflows totaled Euro 50.6 million, compared to the net-inflows of Euro 114.4 million in 2007. According to the latest available data from the Macedonian Stock Exchange, this disinvestment trend continued in the first two months of 2009. In February, the share of foreign investors on the sale side (48.04%) is higher than their share on the purchase side (33.93%), which leads to further net-outflows based on portfolio-investments. Such developments diverge from the projections, which assume moderate inflow from portfolio-investments in 2009. Observing the other constituent components, currencies and deposits item is relevant, which in 2008 enabled additional financing of the deficit in the current transactions in the amount of Euro 207.5 million. This is mostly due to the decrease in the banks' net foreign assets of Euro 234.6 million, as a result of the decrease in their foreign assets. Observing the loans, additional net inflows of Euro 172.4 million were registered in 2008, primarily due to the higher usage of foreign loans and lower annual repayments. Larger divergence from the projection was registered in this category, as well, i.e. higher inflows than expected. Such developments stem from the higher debt of the private sector based on long-term credits and loans, i.e. from the higher withdrawn funds, and lower repaid liabilities than projected. The translational effects from the global crisis to the domestic real sector, and particularly the export oriented segments, became evident in the last quarter of 2008 and continued to be felt even stronger in the first month of 2009. Thus, in January 2009, the total foreign trade totaled Euro 381.2 million and dropped by 22.3% on annual basis (compared to the fall of 3.6% in November and 15.1% in December 2008), given the faster decrease in the value of both the exports and the imports[9].

[9] More information available in "Monthly Information 2/2009", from the National Bank of the Republic of Macedonia, April 2009 (www.nbrm.gov.mk)

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Estimations for Macedonia for 2009

Regarding level of development and size of the economy, as well as insufficient integration in the global economy, Republic of Macedonia wasn't affected by the first wave of the crisis. First estimations, according the Government, when signals that the crisis can be overcome with quick intervention in relatively short period started to arrive, came into consideration that consequences from the crisis will be minor. But, day-to-day estimates started to show that Macedonia will also be affected from the wave. It is clear that effects from the crisis started to show in total business environment. Stronger spill-over effects from global recession in Macedonian economy and adjustments of expectations and behavior of domestic companies lead to revision of projections for growth of domestic economy for 2009 from 4.4% to a negative rate of -0.4%[10].

Since last projection of economic growth (December 2008), conditions in real and financial sector are significantly changed. In such conditions, presumptions for projection of economic growth were leading to: 1. additional deterioration of foreign demand and slowing down capital inflows; 2. higher negative adjustments of labor market; 3. stronger tightening of credit conditions; 4. higher reluctance in conditions of higher uncertainty, especially about future income, which slows down the demand.

Recession in most developed countries, including countries that are our significant trade partners, is expected to have significant consequences on external sector of Macedonian economy. Downward revisions of projected world economic growth and entering of part of developed economies in recession are expected to have direct impact on Macedonian export. Consequences are higher in metal industry, where, besides decrease of demand, additional effect has decrease of world price of metals. Thus far, realization in external sector showed significantly higher decrease of export, compared to initial expectations for the first quarter of 2009, with highest digression in metal industry. Annual change of export for the first quarter of 2009 predicts decrease of 32.8%. Decreased export activity means also declension of import. In the first quarter of 2009, lower export than projected, slower domestic growth than projected, additional deterioration of expectations of domestic companies, lower amounts of

[10] All data regarding of estimations for Macedonian economy are content in the *Quarterly Report of the National bank of the Republic of Macedonia, from April, 2009*; p.59-68

foreign investment, and higher decrease of import prices lead to change of forecasted annual growth of import from 1.8%, to an annual decrease of 17.2%. Even if it is expected these movements in the economy to have higher effect in the second half of the year, still, it is possible that there will be decrease of growth of import of final consumption products and investment, and slowing down domestic demand in the first quarter of the year.

According to revisions made on some components, it is expected that current account deficit of balance of payment in the first quarter of 2009 to be around 19% of projected GDP for the first quarter.

According to global uncertainty, lack of international liquidity and general stagnation of investment, revision was made also on net-inflow of capital and financial account (mostly with direct investment and foreign assets of banking sector). In such conditions, financing the deficit of current transactions is expected to be combination of direct investment and trade credits. Still, it is expected some part of financing needs to be covered through foreign exchange reserves.

For net-inflow of private transfers, it is expected that they will continue to decrease. At the same time, for income on direct investment, net-outflows are expected, and that will lead to further decrease of current account deficit to 29.3% on annual level.

In absence of indicators for faster outcome from global financial crisis, lower net-inflow from direct investment and foreign liabilities is expected, and also net-outflows are predicted as a result of high foreign assets of banks deposited abroad. Until the end of 2009, current account deficit is expected to be 13.8% of projected GDP, ant that is worst than 2008 for 0.7 percentage point. It is expected that trade deficit in 2009 will be 24.6% from GDP.

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Table 1: Direct investment in the Republic of Macedonia*

- in Euro million

Period	Total	Equity capital and reinvested earnings	Other capital	
			claims	liabilities
	1=2-3+4	2	3	4
2003	**100.4**	**109.2**	**1.1**	**-7.6**
2004	**260.7**	**124.4**	**-11.2**	**125.1**
2005	**77.2**	**123.6**	**38.9**	**-7.5**
2006	**344.8**	**304.3**	**2.6**	**43.1**
2007	**506.0**	**369.2**	**25.7**	**162.6**
I.2008	30.7	4.0	-1.5	25.1
II.2008	60.0	21.7	1.1	39.4
III.2008	26.9	21.2	0.6	6.3
IV.2008	25.0	12.4	1.1	13.7
V.2008	61.2	17.3	1.9	45.8
VI.2008	44.4	8.4	0.6	36.6
VII.2008	22.4	10.4	0.8	12.8
VIII.2008	47.9	36.2	1.5	13.2
IX.2008	20.9	38.6	1.9	-15.8
X.2008	20.1	23.4	0.9	-2.4
XI.2008	18.9	1.9	1.5	18.5
XII.2008	34.2	33.7	-3.4	-2.8
2008	**412.5**	**229.0**	**7.1**	**190.6**
I.2009	25.2	41.2	15.1	-0.9
II.2009	28.5	20.4	-2.8	5.2
2009	53.7	61.6	12.3	4.4

* Data are disseminated on net basis.
Source: National Bank of the Republic of Macedonia (www.nbrm.gov.mk)

Conclusion

This is tuff time for real or approximate estimates. Also its ungrateful time for assessing governments measures for protection of certain segments of society and economy, taken by their own. Government and Central Bank are working on finding way to arrange politics and conditions for credit support with commercial banks. The Government should decrease all budget income from companies, as much it is possible, and this should be followed by Local Government, too, so companies would be able to think of their current business activities, beside own development. So, at the moment, most important is to mobilize all institutions, in order of efficient resolving of the most important priority: mitigating negative consequences on the economy. Previous experiences could not be of use in such circumstances, because there was no such crisis in the world since the Great economic crisis in 1923. This crisis nowadays is with greater proportions because of the globalization in the world. In world analyzes, there is opinion that, after ending the crisis, world of economy that we know will not exist. Hardest consequences were felt at the end of the last and beginning of this year. Actually, analyzes of worlds' most influent financial institutions that continuously revise already made projections for trends in the global economy and separate countries, do not encourage themselves to predict detailed percents or how long the crisis will take. Beyond question is that the Government should find solution to ensure support of the companies, most of all for liquid assets, so the companies could mitigate problems of internal debenture and accelerate economic activities. In the face of a global economic recession, tighter credit conditions, falling corporate profits, and dark prospects and uncertainties for global economic growth, many companies have announced plans to curtail production, lay off workers, and cut capital expenditures, all of which tend to reduce FDI. The impact of the crisis varies widely depending on region and country, with consequently varying impacts on the geographic patterns of FDI flows.

In the very short term (2009), various factors lead to anticipate that the offsetting factors will have much less impact than the downward forces. Companies are more likely to undertake divestments than to seize investment opportunities during this initial phase of the downturn[11]. This is

[11] See Baghai, Smit and Viguerie, M&A strategies in a down market, op. cit., *the McKinsey Quarterly*, September 2008.

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why a further decline in FDI in 2009 can be expected. It is also very likely that FDI flows to developing countries – which up to now have exhibited resilience overall – will slow down more markedly than has been observed to date.

Despite relatively high external vulnerabilities, candidate countries for EU, until now, are not directly affected by financial turbulences; thanks to limited inter banking markets and lack of complex financial products. Still, risks for candidate countries are increasing, especially for those countries that financed their current account deficits through lending by foreign banks and which are import dependent.

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