FOREIGN DIRECT INVESTMENTS DURING FINANCIAL CRISES

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The fundamental idea of International capital flows is that short-*term* flows can be easily reversed, while flows on a longer time horizon are more stable. Crises are associated with withdrawals of short-*term capital* flows and growth of *the foreign* direct investment flows. The current crisis has meant a major decline of international capital flows*, also of the foreign* direct investment. The analysis in this article tries to establish *if and under which* conditions *foreign direct investments can* bring greater stability during the crisis, comparing the evolution of foreign direct investments in the current crisis with their response in previous crises. We show that during previous crises foreign direct investments *were* stable, behaving differently from other types of capital. Yet, during the current crisis, foreign direct investments have proven to be not so stable and all the components declined, raising questions *about the resumption of the positive trend. The stability of foreign direct investments* in the past was *given by the increase of* mergers and acquisitions during the crisis, reflecting fire-*sale* FDI. This feature is not found in the current crisis *as mergers and acquisitions were severe affected by the crises a*nd recorded a major decline. *The current paper is realized in the* doctoral program *entitled* "PhD in economics at the standards of European knowledge- DoEsEc", *scientific coordinator Prof. PhD Rodica Zaharia, institution The Academy of Economic Studies Bucharest, Faculty of International Business, period of research 2009-2012.*

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I.Introduction

Potential positive effects generated by foreign direct investments(FDI), such as technology transfer, human capital formation, creating a more competitive business environment lead countries to create an investment climate more attractive to investors as above features, contribute to the economic growth and economic development. Short-term capital flows, as opposed to long-term flows, are considered to be reversed easily, being driven by interest rate differentials and exchange rate fluctuations leading to volatility in capital. FDI are associated with economic characteristics that involve a long time horizon, becoming more stable flows. (Bird and Rajan 2002: 2)

The present research aims to analyze the evolution of FDI during current financial crisis 2007-2010, making a comparison with the evolution of FDI during past crises and is part of the author's future PhD dissertation paper on the subject: "Foreign direct investments and their role on the economic development of Central and Eastern Europe. Comparative study Romania versus Poland." The current paper is realized in the doctoral program entitled "PhD in economics at the standards of European knowledge- DoEsEc", scientific coordinator Prof. PhD Rodica Zaharia, institution The Academy of Economic Studies Bucharest, Faculty of International Business, period of research 2009-2012.

Increasing activity of multinational companies determine the importance of FDI in the global financial crisis. Alfaro and Chen (2010) highlights the fact that in 2007 FDI accounted for 17.2% of capital formation in developed countries and 12% in developing countries, while production of the foreign affiliates was 12% of global gross domestic product(GDP) and exports about one third. (Alfaro and Chen 2010:3)

Financial Crises generates both positive and negative effects on the activity of transnational companies in the economies affected by the crisis. Athukorala(2003) identify three positive effects of the collapse of currencies on FDI. Massive depreciations reduce local production costs and countries become more attractive for export-oriented foreign investments, FDI becoming in this way more profitable. A second effect would be the reducing investment costs due to reduced costs of the assets, as the demand decreases. Last but not least, anti-crisis package and new legislation regarding foreign control can create new opportunities for acquisitions and mergers. The negative effects refer to negative effect on domestic market-oriented foreign investment(Athukorala 2003:4-5)

Alfaro and Chen (2010) analyzing the behavior of subsidiaries of transnational companies during crisis, show that they are more stable compared to local firms, even if during normal periods, no major differences were found . The foreign companies respond much better to crisis than local firms do, even if they have the same economic features. Vertical links with the mother companies prove to be more powerful during crisis, while in case of horizontal links there is a greater risk of volatility. Foreign firms usually receive a financial support from parent companies if the case of worsening financial and credit conditions in the host country. During crisis taking place only at the level of host countries links with parent company provide higher stability, as the mother company is not affected by local crisis. (Alfaro and Chen 2010:2-6)

II. Previous crises and the evolution of FDI

Foreign portfolio investments are motivated by immediate financial gains and investment decisions don’t have a long-term time horizon, thus the are very volatile, therefore foreign portfolio investments volatility can strongly affect capital flows during crises.

FDI is not a simply transfer of capital. They are associated with technology transfer, new marketing practices or management techniques. All this aspects involve a relationship on a long time horizon and their mobility is limited, being more stable than the remaining components of capital flows.

Although most of the literature highlights the fact that FDI is more stable than other forms of capital, there are studies that suggest otherwise. For example, Claessens et al. (1995) show that FDI volatility is as high as of any other type of investment.

At individual country level, Reinart and Rogoff (2008) analyzes the characteristics of the financial crisis erupted in 18 developed countries. As the importance of these crises is relatively low, the authors focused more on crises erupted in five states, which consequences were more important: Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1992). The conclusions of the research show that financial crises have three common characteristics: a drastic reduction in asset prices, an important reduction in production and the rising of unemployment, and the increase of the public debt to alarming figures. (Reinart and Rogoff 2008:2)

Lipsey (2001) analyzed the evolution of FDI in Mexico during the 1994 crisis. He highlights that between 1992-1993 FDI have doubled, but in the crisis year(1994) they fell by 15% and just over three years, in 1997 they returned to the pre-crisis values. But in this case, the portfolio investments fell by 75%, a much stronger decline than the one recorded by FDI, indicating that the latter are more stable (Lipsey 2001:7)
The most important global crises were considered by Poulsen and Hufbauer (2011) four in number: 1975, 1982, 1991 and 2001. In all these periods, are identified three common characteristics that have led to crises: global GDP has fallen below 2%, GDP fell by 1.5% compared to the average of the last five years and was at a minimum level compared to the levels earlier or over next 2 years. In these crises, following the oil shocks and recession during the '90, FDI have returned to pre-crisis levels after a period of approximately three years, but they were strongly supported by measures of global liberalization. (Poulsen and Hufbauer 2011:8)
Latin American currency crisis of 1982 led to a decline in investment flows to the region, FDI remaining still positive, although only in 1988 it will reach the levels recorded before the crisis. Instead, portfolio investments recorded negative values in 1983 and begin to recover only in 1988. (Lipsey 2001: 4-5).
The crisis in Southeast Asia 1997-1998 was the subject of numerous investigations. The way FDI and portfolio investments have evolved during the crisis are similar to the ones in Mexico in 1994: portfolio investments decreased by 40%, while FDI only by 13% in 1995.(UNCTAD, 2009).
According to Kiminsky and Reinhart (1998) Latin America has suffered during 1970-1995 more financial crisis than any other developing region, with 50% more compared to the countries in Asia or Eastern Europe. Although the characteristics of the crisis differ from one region to another, the crisis in East Asia borrows many of the characteristics of the Latin American crisis (volatile capital flows and a weak financial system) (Kiminsky and Reinhart 1998:1-5).
The literature regarding the link between FDI flows and financial crises brings up the phenomenon of "fire-sale FDI": the fact that FDI increase during crises. FDI are carried out on a long time horizon and are attracted by cheap assets arising during the liberalized regime crisis. 1997-1998 East Asian crisis has confirmed this theory, with the except of Indonesia, which has witnessed both a political and economic crisis. (Hill and Jongwanich 2009: 2)
If during the crisis in Latin America, FDI have fallen much less than other types of investments, the crisis in Mexico was similar, the FDI flows decreased but much less respecting to other form of capital and never became negative. In contrast, in East Asia, FDI inflows have registered a modest decline in 1998 but recovered in 1999 (Lipsey 2001: 15)
During financial crisis, the FDI to East Asia fell by 15%, this demonstrates that the massive withdrawal of capital was due to the other forms of capital, such as portfolio investments and bank loans, which dropped by 102% and 220%. (Athukorala 2003: 6-8).
Studying the behavior of foreign direct investments and foreign portfolio investments, Achayra et al (2009) show that in countries affected by the 1997 Asian crisis, there is a strong correlation between the two types of investments, which is a positive correlation during non-crisis periods and a strong negative one during the crisis, concluding that the financial crisis in Asia has not represented a massive reduction in FDI to the countries of

the region, but only a modest decline. Massive capital outflow was driven by other forms of capital: portfolio investments and bank loans (Achayra et al 2009: 20 -22)

III. Foreign direct investments during the 2007-2010 financial crisis

The crisis erupted in 2007 represented the collapse of foreign direct investments, being the biggest financial crisis since the Great Depression of 1930. It is characterized by rapid contagion to all world countries, the high speed with which it occurred, different intensities had over time, as well as over various components or different regions. (Milesi-Ferretti and Tille 2010:7-8) Began in the U.S.A, as a sub-prime crisis, has affected the entire financial structure of the country and then rapidly spread to non-financial sectors worldwide.

The global financial crisis led to a collapse of foreign direct investment flows worldwide. After reaching a new historical record in 2007, 2 trillion dollars as a result of four years of continual growth, foreign direct investment fell in 2008 by 14% at global leval (UNCTAD 2009: 3). If developed countries were most affected, with a decline of 30% in 2008, the developing countries continued to attract FDI, 17% higher respecting to 2007. FDI continued to decline, the decrease being 30% globally in 2009 compared with 2008, while developed countries recorded a decline of 44%. Although in the previous year 2008, FDI to developing countries seemed not to be affected by the global crisis, in 2009, this category registered a decline of 24% (UNCTAD 2010: 3). All FDI components were adversely affected by the crisis, and countries have not only tried to attract new investment, but also tried to keep the existing ones.

Milesi-Ferretti and Tille (2010) identify three periods of crisis. The first starts in August 2007, once the beginning of the problems for Lehman Brothers when international capital flows declined in the banking flows in developed countries. Between late 2008 and early 2009, takes place the second stage of the crisis, characterized by the repatriation of capital flows, especially the baking loans. The last period of the crisis that began in the second half of 2009, representing a slight revival of non flows and banking in Asia and Latin America.(Milesi-Ferretti and Tille 2010:2)

As the financial crisis has affected the U.S.A and Western countries initially and then propagated at global level, FDI to developed countries fell the most, contributing heavily to the decrease in mergers and acquisitions by 67% in 2008 (Poulsen 2011:3). The reduction of mergers and acquisitions in the current trend is contrary to previous crises, when, by the nature of “fire-sale” phenomenon, the acquisition and mergers increased.

All FDI components recorded reductions, but the most important one was the one registered by equity investments, this being a signal that the revival of FDI flows may last for some time (Poulsen 2011:3)The decrease in global FDI since 2008 is the result of many factors, including global financial crisis, reduction of corporate profitability, the decline of the stock market, reducing of the global demand and reducing funding capabilities due to increased cost of credit (UNCTAD 2009,2010).If during the Asian crisis portfolio investments fell sharply, reaching even negative values, the period 2008-2009 is slightly different. Portfolio investment began to decline only in the second half of 2008, not being so volatile and began to rise slightly in 2009. (Hill and Jongwanich 2009: 18)

IV.Conclusions

Comparisons with past crisis can be considered insignificant because the magnitude of the current crisis is much higher than the previous ones. Foreign direct investment during current crisis dropped by significant values and reacted faster to the crisis respecting to the other forms of capital flows, showing that they are not so stable and can be as volatile as any other type of flows if the global economy is affected.

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