Foreign Direct Investment and Financial Crisis

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Abstract

International business and growth literatures have conceptually and empirically established strong positive relationship between inward foreign direct investment (FDI) and economic growth of host economies. In the last two decades FDI has emerged as a significant catalyst in the growth process of developing and emerging economies, by transferring knowledge, technology and capital among the investing countries. Favourable investment climate and stable macro-economic conditions are essential but not a necessary prerequisite for inward FDI. Often, inward FDI is influenced by short term factors. After the global financial crisis of 2008, inward FDI to India and across world have shown a considerable decline. It is well documented in literatures that financial crisis affected FDI flows directly. Financial crisis is a phenomenon that is hard to capture through a single variable, but the magnitude of the financial crisis started in 2008 in Unites States, amplified the effects, so the crisis had a powerful negative effect on many economies, including India. This phenomenon raises many concerns like, how to make inward FDI sustainable, are inward FDI is driven by short term factors like profit, cost driven or long term factors like technology absorption, knowledge exchange, etc. This paper makes an attempt to conceptually document role played by financial crisis on FDI and the way forward for creating a sustainable FDI

***Keywords**: Foreign direct investment, financial crisis and sustainable foreign direct investment.*

INTRODUCTION

In the last two decades FDI has emerged as a significant catalyst in the growth process of developing and emerging economies, by transferring knowledge, technology and capital among the investing countries. Favourable investment climate and stable macro-economic conditions are essential but not a necessary prerequisite for inward FDI. Often, inward FDI is influenced by short term factors. Nations across the globe, especially the developing nations are on the race for gaining more inward FDI, as they believe only through FDI they can bring in foreign knowhow and can create development and can create dynamism in business, thereby ensuring higher gross domestic productivity and income.International business fraternity of FDI is flooded with literatures claiming that most of the developing countries have a strong and positive correlation between inward FDI and development. There is also the existence of strong causality relationship moving from inward FDI and economic growth.

The amount of inward FDI a nation receives is determined by many factors. Favourable investment climate and stable macro-economic conditions are expected conditions for inward FDI. Often, inward FDI is influenced by short term factors. After the global financial crisis of 2008, inward FDI to India and across world have shown a considerable decline. It is well documented in literatures that financial crisis affected FDI flows directly.

Financial crisis is a phenomenon that is hard to capture through a single variable, but the magnitude of the financial crisis started in 2008 in Unites States, amplified the effects, so the crisis had a powerful negative effect on many economies. This phenomenon raises many concerns like, how to make inward FDI sustainable, are inward FDI is driven by short term factors like profit, cost driven or long term factors like technology absorption, knowledge exchange, etc.

FINANCIAL CRISIS &FDI

The term financial crises can be defined as a disturbance to the financial markets in which situation financial institutions and assets lose their value rapidly (Charles, Kindleberger and Aliber, 2005). The history of financial crises goes back to sovereign defaults, also known as external debt crisis, and private bank failures, which were the main forms of crisis prior to 18th century (Reinhart and Rogoff, 2010). Then financial crises were featured with both domestic and external debt default after the 18th century. Since the 20th century, financial crises became a regular phenomenon. Many economists have come up with attention on the impact of financial crises on all dimensions of economic environment. Literatures on this topic, mainly from the theoretical perspective, began to develop rapidly during the last decades. The literatures initially investigated currency crisis in the 1970s, then banking crisis, inflation crisis, debt crisis of 1980s, and finally the sudden stops in capital flows in the 1990s (Bogach and Noy, 2012). Very little focus is given to the impact of financial crisis on foreign direct investment. Krugman (1979) suggested that it is necessary to understand the causes and effects of financial crises when formulating a clear hypothesis on the impact of financial crises on FDI.

Financial crises occurred in recent decades have been characterized by a resilient FDI in a number of host countries. Acharya and Shin (2011) defined such a resilience of FDI flows during financial crises as fire sale FDI. Fire sale FDI occurs when a sudden decline in the domestic price, combined with greater access to finance by foreign investors, leads to bargain sales of domestic assets to foreign buyers, typically by means of cross-border mergers and acquisitions (M&A) (Poulsen and Hufbauer, 2011). When financial crises entered mainly into the emerging market, foreign investors in developed market were not affected by liquidity constraints during these episodes and still have access to financial resources. Hence, they can take advantage of cheaper investment opportunities in financially-constrained domestic markets. Consequently, there is an increase in foreign acquisitions in crisis-affected countries. This phenomenon has been observed in number of emerging markets. For instance, affected by the Asian financial crisis of 1997-1999, the average number of M&A deals per quarter had increased by around 50% to 60% in Latin America countries (LAC) during the second half of 1998 (Calderon and Didier, 2009).

Evidence can also be found in the Association of Southeast Asian Nations (ASEAN) region during the global financial crises of 2008-2012 where FDI inflows remained positive although portfolio flows turned significantly negative during the period (UNCTAD, 2012). Even though the fire sale FDI is evidenced in some countries during financial crises, it may not share the similar pattern when other nations or financial episodes are concerned. During the 2008-09 global financial crises, for instance, the number of M&A deals in LAC has fallen by nearly 60%, from around 105 deals per quarter in 2007 to only 44 in 2008 (UNCTAD, 2010). The value in cross-border M&A also decreased from about 11.6 billion US dollars in the second quarter of 2007 to only 4.6 billion US dollars in the last quarter of 2008.

Besides the Latin American countries, similar pattern was observed in other regions. For example, the number of cross-border M&A deals declined by 25% in East Asia and nearly 70% in Eastern Europe between the second quarter of 2007 and the fourth quarter of 2008. In contrast with the Asian financial crisis, the 2008-09 financial crisis, which is originated in the United States, was a worldwide financial meltdown. Calderon and Didier (2009) claimed that when the financial crisis spread to the rest of the world, both the owners of firms in developing countries and the potential foreign buyers in developed countries have been affected by the severe liquidity constraints. Consequently, FDI inflows in some emerging economies decreased significantly during the crisis. A similar pattern should be observed in the United States since the main inward FDI flows to the United States comes from developed countries. It has been confirmed by the decreased number in cross-border M&A deals which declined by nearly 70% in the quarter of 2008 compared with the second quarter of 2007 (Contessi and Pace, 2011).

DISCUSSIONS & CONCLUSION

Rather than desperately scrambling to increase the volume of FDI flows, officials might instead use the downturn as an opportunity to take a step forward and reconsider their thinking. In recent decades and including during times of crisis many nations FDI policies have largely focused on increasing the volume of inward investment. In the case of many countries, this is indeed still necessary. But not all FDI promotes development; larger quantities of FDI flows cannot be the sole indicator of a successful development policy. To increase the positive impact of FDI for economic development, and avoid the adverse consequences, officials should instead consider a “sustainable FDI” strategy, which enhances not only the quantity of investments, but also the “quality” (Vale Center and WAIPA, 2010).

Acknowledging that administrative and political constraints will prevent wholesale reforms of FDI regimes – particularly as the crisis demands a focus on other more pressing policy areas for most governments – a prudent and more realistic approach would be to target the most binding constraints on sustainable FDI promotion (Hausman et al., 2007).

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