

Foreign Direct Investment and Global Economic Crisis

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ABSTARCT – In the article author defines globalization its features and effects. Furthermore, it presents the characteristics of foreign direct investment with its crucial role in the process of globalization and development of national economies. Then author discuss the reasons of the latest world economic crisis and its dissemination all over the world. In the light of economic crisis the article presents the role played by foreign direct investment in global economy. Author also presents changes in the juxtaposition of top sources and influx countries of foreign direct investment. Finally, author considerate government actions accelerating influx of foreign direct investment.

Globalization of world economy and foreign direct investments

Contemporary world economy is completely different from the economy of twenty or thirty years ago. One of the most important differences is the intensification of the process of globalization. This trend results in the widening influence of international capital on national economies and the changing characteristics of company operation. The location of production plants, research and development, as well as other activities of companies more and more often becomes independent of the existing national borders. (Buiter, Lago, Stern 1997; Nowicka-Skowron, Kot 2003)

Globalization is not a new phenomenon; it was a long time ago that people and corporations began to engage in long distance trading. What is more, for thousands of years people have invested into economic enterprise in foreign countries. Actually, the waves of globalization observed nowadays are very similar to those observed in the past. However, the politics and technological development of the last several decades has caused an extraordinarily accelerated development of foreign trade, cross border investments and migration of population in comparison to what was observed in the past. For instance, since 1950 the value of world trade has increased twenty times, and the value of foreign investments between the years 1997 and 1999 nearly doubled, increasing from \$468 billion to \$827 billion. Having these facts in mind, Thomas Friedman summarized the present wave of globalization with the words "further, faster, cheaper and deeper." (Friedman 2002)

Globalization is defined in a variety of ways. According to A. Szymański, "the process of globalization refers to the increase in free flow of capital, goods and production factors among countries. Thus, it is a gradual disappearance of economic borders and a sharp quality improvement in the mobility of production factors." (Szymański 2001)

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G. Gierszewska and B. Wawrzyniak define globalization as “the process of changing the national perspective from which one views the rules and regulations of conduct, occurrences, behavior, activity, and principles held, into a global perspective [translation mine].” (Gierszewska, Wawrzyniak 2001)

Globalization can be defined as the process of interaction and integration among people, enterprises and governments of various countries, a process shaped by international trade and supported by information technology, and influencing the environment, culture, political systems, economic development, and the quality of life of societies all over the world. (www.globalisation101.org)

Regardless of a definition of and an approach to the phenomenon of globalization (e.g. J.A. Scholte describes it as a five-dimensional phenomenon (Scholte 2005)) it can be proved that globalization functions within two main spheres: economic and social one. The first of these comprises finance, technology (in connection with research and development as well as the knowledge-based economy), market and market strategies (especially competition). As for the social sphere, it comprises culture, lifestyle, consumption models, management, legal regulations, and also political concepts. (Pakulska, Poniatowska-Jaksch 2008)

On the other hand, A. Zorska points out the following characteristic features of globalization (Zorska 2007):

- in the sphere of foreign direct investments (FDI) there have occurred the changes in the structure of their branches and geography, and all over the world there has been recorded an increase of their share in general gross investment expenditure with reference to fixed assets;
- the expansion of the process of globalization is possible due to an intensity of international connections within branches and sectors of industry, etc.;
- the range of forms of steady cooperation between companies is widening (joint venture, strategic alliances) in all value chain links and the partnership enterprises in the international market;
- the number and significance of transnational corporations is growing in the economic structures of the world, entailing the change of relations between the state and the corporations (more and more often corporations influence the decisions of governments in particular countries).

These are the foreign direct investments that play a crucial role in the process of globalization, at the same time supporting the development of national economies. The flow of capital in the shape of FDI facilitates an access to technologies, know-how and management skills, accelerating the integration of national economies with international markets, production and distribution networks, and strengthening the international competition of companies and whole national economies (UNCTAD 2002).

Foreign direct investment (FDI) is the most advanced way of entering foreign markets, being an international transfer of capital in order to open an affiliated company in another country and exercise control over it. First of all, FDI is about capital investments, but also about intra-company re-invested profits and loans. The word “direct” indicates that the foreign investor has an influence over the activity of a company abroad. This fact differs FDI



from a portfolio investment, which does not make it possible to influence the activities of companies abroad. (Pakulska, Poniatowska-Jaksch 2004)

Foreign direct investment is a type of investment which entails long-term relationships and continuous involvement and control of an entity which has its headquarters in one of the national economies towards another entity, which has its headquarters in another country. In the case of FDI the investor can directly influence the management of a company in another country. The invested capital amounting to 10% of shares constitutes a defining feature of a FDI (UNCTAD 2004, Kot 2006).

Foreign direct investment is not only a simple transfer of financial capital aiming solely at making profit within the framework of the global company strategy. It is more accurate to say that the financial capital constitutes an instrument which renders it possible to transfer across borders a set of production factors in order to exploit them in a more effective manner, and also facilitates making a better use of competitive advantage in the foreign market. Thus, apart from the transfer of capital, there takes place also the transfer of technology, knowledge, management methods and the marketing.

There can be distinguished two basic forms of foreign direct investment: (Krzak 2005)

- greenfield investments (independently starting new operational facilities from the ground up);
- brownfield investments (taking over an already existing company and restructuring it, or a cooperation with a local partner in the form of a joint venture enterprise).

Greenfield investments are characteristic of developing countries and consist in a foreign investor building new facilities from the ground up in the host country. Each country looks forward to greenfield investments, since this type of investments entails increasing production assets and creating new jobs (assuming that the national competition is not eliminated in this way). (Krzak 2005) On the other hand, brownfield investments in the shape of mergers and takeovers are a dominating form of investment in developed countries and usually take place when the controlling interest in one business entity is acquired by another business entity, or when two entities, situated in two different countries, agree to join their activities. If the invested capital is utilized to purchase the already existing assets, there follows modernization and more rational organization of work.

Foreign direct investment at the time of global economic crisis

The still growing economic, financial and social interdependencies which result from globalization have twofold consequences. On the one hand, these consequences are positive: influx of foreign capital, scientific and technological development, expansion of potential customers' market, increasing effectiveness of economic activities, investment boom, and economic growth. On the other hand, a disadvantage of globalization is the fact that national economies become very sensitive to economic fluctuations in geographically distant regions. This is especially noticeable in the sphere of finance. The present world economic crisis has its roots in the subprime mortgage loans. Over the years of economic boom, the intermediaries responsible for organizing mortgage loans, given the incentive of high commissions, persuaded the people with small loans to accept mortgage loans with low



upfront fee or no upfront fee, and without checking out the loans. A serious crisis in the field of subprime mortgage loans started in July 2007, with the bankruptcy of two hedge funds (making their profit on small disparities in the exchange rate of various currencies) of the American investment bank Bear Stearns (The Economic Times, 2008). The world economic market has undergone considerable change since 2007, when the continuous non-inflationary growth took place. As was forecast, the year 2008 proved that the crisis was endangering not only American economy, but world economy as well. (Sachs 2008) Towards the end of summer 2008 it seemed that the influence exercised by growing prices of energy would be diminished and the slumping economy was on its way to recovery. However, the autumn of 2008 brought a series of various interdependent upheavals. The improvement in housing economy triggered off credit crunch and continuous drop of stability in the financial market, combined with the threat of increasing inflation, dramatic fluctuations in the price of petroleum, and raising prices of goods accelerated by the weakening of American dollar. The results of all these factors became even more severe with a sudden rise in food prices (Committee on Economic... 2008). Between September 2008 and March 2009 the economy was receding at the pace of 5.5%. Financial institutions lost trillions of dollars, euros and French francs. Financial liquidity of a majority of institutions became threatened and the stock exchanges suffered severe drops. Central banks provided the support of hundreds of trillions worth, and the scope of their intervention was not limited to supporting markets but also included preventing the bankruptcy of individual institutions.

According to the forecasts of a majority of economists, the crisis had to influence mainly "ripe" economies, such as the ones found in western Europe, since they were tightly connected financially with the USA. However, in reality the crisis has made an impact on the whole world. (Jahnsen 2008)

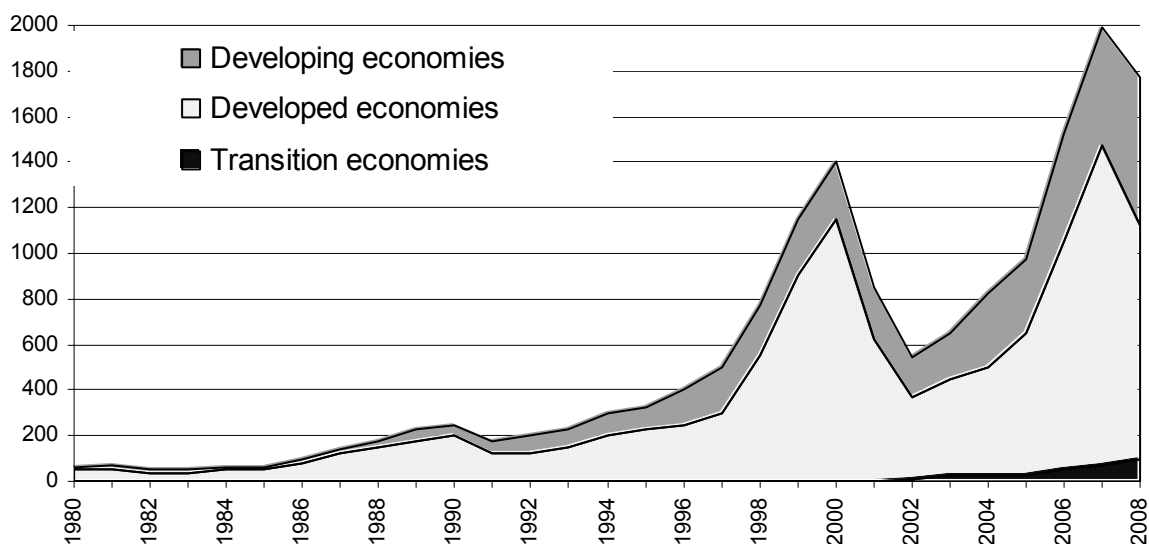
One of the results of the crisis in the mortgage market in 2007 in the USA was the unprecedented influx of investment funds into developing markets and markets which were undergoing a transformation. In September 2007, the funds investing money in the frontier markets gathered 15.7 billion dollars net from the investors. This was the largest sum in the history of this type of investment. Between early September and 25th October 2007, the funds in question gathered nearly 34 billion dollars, i.e. more than during the whole 2005 and 2006. (Jóźwik 2007) Therefore, it can be concluded that in 2007 there already took place another increase in portfolio investments. The funds which attract the most money of the investors are especially those which invest in Asia, Latin America, and specialize in BRIC countries (Brazil, Russia, India, China), and are global emerging funds.

The year 2006, when the tendency for growth was observed, was actually the third year in a row of the increase in foreign direct investment, the situation being a worldwide phenomenon (UNCTAD 2007). In 2006, the considerable influx of foreign direct investment (FDI) amounted to USD 1.3 trillion, which meant the increase by another 38% in comparison with 27% in 2004 and 29% in 2005, as well as reaching the level close to that observed in 2000, when the record value of 1.3 trillion dollars was set up for FDI. The influx of FDI was noticeable in all major subregions: in developed countries, developing countries, and in countries undergoing transformations, i.e. in southeastern Europe and in the Commonwealth of Independent States. The growth tendency discussed above has been present throughout the last 26 years. However after uninterrupted growth in FDI activity in



the period 2003–2007, global FDI inflows fell by 14% in 2008 to \$1,697 billion, from a record high of \$1,979 billion in 2007 (see Figure 1).

Figure 1. FDI influx worldwide and in particular groups of economies, 1980-2008 (bln USD)



Source: Author's elaboration based on UNCTAD FDI/TNC database

FDI flows fell further as the financial crisis entered a tumultuous new phase in September 2008 following the collapse of Lehman Brothers (one of the largest financial institutions in the United States), and as major developed economies fell into, or approached, economic recession. In contrast, developing and transition economies saw FDI inflows rise in 2008 to record levels for both.

Worldwide foreign investment reached the value of USD 12 trillion; the type of investment in question was made mainly by transnational corporations (TNC). The group of transnational corporations comprised about 82 000 parent companies and 810 000 foreign affiliate companies. (WIR 2009) According to business forecasting, the turnover, value added and export of the TNC in 2006 increased by 18%, 16% and 12% respectively. While the influx of FDI into developed countries increased by 45% and reached the value of USD 857 bln, the influx into developing countries amounted to USD 379 bln (21% increase), and the influx into economies undergoing a transformation amounted to USD 69 bln (68% increase), reaching the highest level in history. However, the international stature of TNC has not insulated them from the worst global recession in a generation. The 4.8% reduction in inward FDI stock worldwide was reflected in the decline in value of gross product, sales and assets, as well as employment of TNCs' foreign affiliates in 2008, a marked contrast to huge double-digit growth rates in 2006 and 2007.

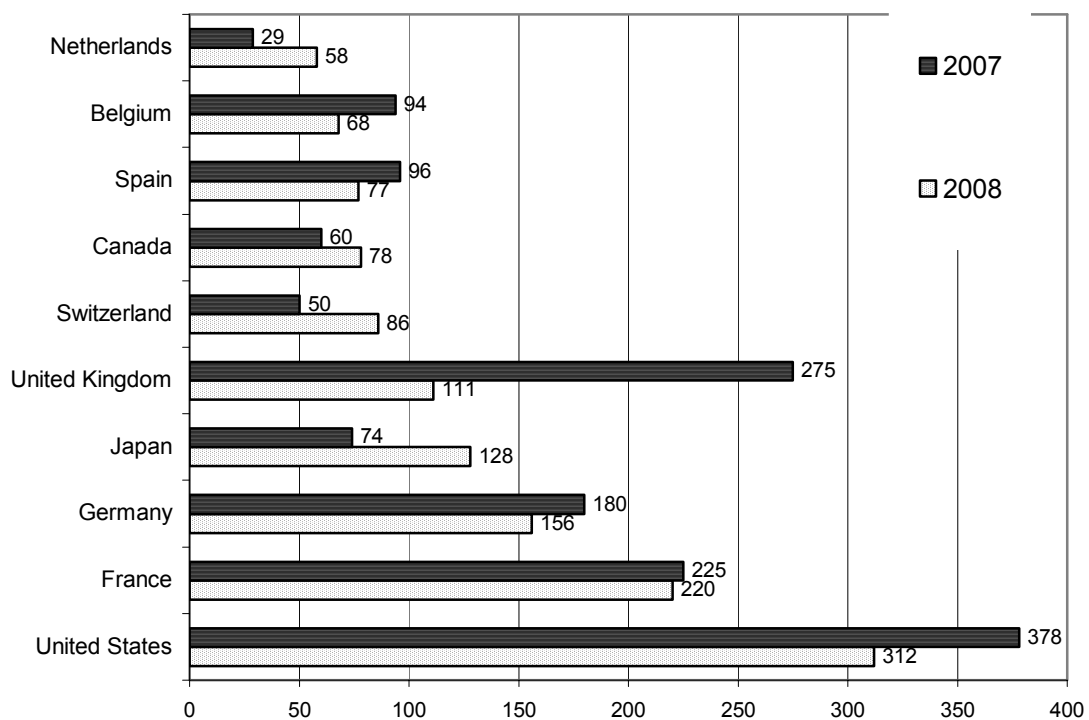
The United States regained the leading position with reference to the influx of foreign direct investment, leaving behind Great Britain and France. Among developing countries



and the countries whose economies were undergoing a transformation, nearly all regions noticed a considerable increase in the influx of FDI in 2006. Only in Oceania, South America and the South African Republic there was an outflow of FDI. In the group of developing countries the influence of FDI was the most significant in China, Hong Kong (China) and Singapore. As for the economies undergoing a transformation, the largest influx of FDI was observed in Russia.

Developed countries still remained the major source of investments (84% of all investments made). In 2006, the largest exporter of foreign direct investments were the United States (USD 217 bln). The USA was followed by the EU countries, i.e. France (USD 115 bln), Spain (USD 90 bln) and Great Britain (USD 79 bln). The role played by developing economies and economies undergoing a transformation as a source of foreign direct investment was still growing. In the group of developing economies, the most important part was played by Hong Kong (China), with USD 43 bln, and in the group of economies undergoing a transformation the most important role was played by Russia, with USD 18 bln. The value of foreign direct investments flowing out of these two groups of countries amounted to USD 193 bln, i.e. 16% of the overall world outflow of FDI. United States stayed still on the top FDI source country all over the world after crisis effects dissemination but there are changes on next places of the juxtaposition of top sources of FDI outflows. There are France, Germany, Japan and then United Kingdom as a main FDI sources (see Figure 2).

Figure 2. Developed countries: top 10 sources of FDI outflows 2007-2008 (bln USD)



Source: Author's elaboration based on UNCTAD FDI/TNC database



Conclusions

Governments actions are very important in FDI acceleration, it is especially important in case of crisis. The governments implemented measures accelerating the influx of FDI during 2006 and at the beginning of 2007, however, at this time in some sectors of industry, especially those of "strategic" significance, there were introduced new restrictions with reference to takeover of assets by foreigners, or such measures which assured a larger share of governments in the profits. Such tendencies were observed especially in mining industry. In 2006 there were made the total of 147 government decisions making a given country more FDI-friendly, while the 37 government decisions were made to the contrary, in 2008, 110 new FDI-related measures were introduced, of which 85 were more favorable to FDI, compared to previous year, percentage of less favorable measures for FDI remained unchanged (WIR 2009). In 2008 and the first half of 2009, despite concerns about a possible rise in investment protectionism, the general trend in FDI policies remained one of greater openness, including lowering barriers to FDI and lowering corporate income taxes.

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