

# **Analysis of developments in the fields of direct investment and M&A - 2010 Report**

**Final Report to EC DG Internal Market & Services**

**EXECUTIVE SUMMARY**

Prepared by



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## About London Economics

London Economics is one of Europe's leading specialist economics and policy consultancies and has its head office in London. We also have offices in Brussels, Dublin, Cardiff and Budapest, and associated offices in Paris and Valletta.

We advise clients in both the public and private sectors on economic and financial analysis, policy development and evaluation, business strategy, and regulatory and competition policy. Our consultants are highly-qualified economists with experience in applying a wide variety of analytical techniques to assist our work, including cost-benefit analysis, multi-criteria analysis, policy simulation, scenario building, statistical analysis and mathematical modelling. We are also experienced in using a wide range of data collection techniques including literature reviews, survey questionnaires, interviews and focus groups.

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## Part I: Recent developments

### Developments in EU27 FDI in 2009

- The preliminary figures released by Eurostat in June 2010 show that, after falling sharply in 2008, inward FDI into the EU27 from third countries recovered somewhat in 2009, posting an increase of 11.5% to €222 billion. A decline in M&A activity held back inward FDI while greenfield inward FDI recovered in 2009.
- In sharp contrast to the general pattern observed at the level of the EU27, inward FDI into the 12 New Member States from third countries fell by 46%, reflecting the weaker economic conditions in New Member States from Central Europe.
- Moreover, both outward FDI to third countries and intra-EU27 FDI flows continued to decline in 2009, falling respectively by 24.3% and 57.5%.
- Outward EU27 FDI in 2009 was at its lowest level since 2005 and intra-EU flows were at their lowest level in 10 years.
- As in previous years, the mix of sources of inward investment was far from uniform in 2009.
- In fact, the most important source countries of inward FDI into Member States in 2009 were typically other Member States as only Austria, Cyprus, Hungary, Luxembourg and the United Kingdom received a larger share of inward FDI from third countries than from other Member States.
- FDI remains heavily influenced by distance. In 2008, the last year for which comprehensive data are available, EU Member States accounted for 69% of the total stock of inward FDI into EU27 Member States, and 56% of this stock of inward FDI was accounted for by inward FDI from neighbouring Member States.
- However the new inward FDI that occurred in 2008 originated from source countries somewhat further afield with third countries accounting for almost 40% of the total inflow and neighbouring Member States for only 45% of the total inward FDI originating from the EU27.
- Particularly remarkable is the contribution of the BRICs (Brazil, Russia, India and China) which together accounted for 16.5% of the total inward FDI from third countries into the EU27 in 2008.
- The distribution of the total stock of inward FDI into the EU27 from third countries and other EU27 Member States is heavily concentrated with the services sector accounting for about three quarters of the total stock and manufacturing only slightly less than 15%.
- Moreover, the financial sector is largest sector in terms of the inward FDI stock, accounting for between 56% and 58% of total stock of inward FDI in the services sector.

- Reflecting the extremely weak economic environment of 2009, total cross-border M&A into the EU27 from third countries and EU Member States fell by 53% in terms of deal value and 31% in terms of number of deals. In terms of the deal value, this was the lowest level since 2003.
- In line with the improving economic conditions, the first eight months 2010 saw a stabilisation of M&A activity with deal value increasing by 14% (an annual rate) during this period and the number of deals by 4%.
- However, the stabilisation is entirely due to sharp growth of 195% (an annual rate) in the deal value of cross-border M&A from outside the EU27 into the EU27 as the deal value of intra-EU cross-border M&A continued to fall, posting a further decline of 51%.
- Mirroring the growing importance of third countries as a source of inward FDI flows, non-EU destinations for outward EU FDI accounted for almost 45% of total FDI outflows in 2008. Among the third countries, the United States and Switzerland were the largest two destination countries, accounting in total for 42% of outward FDI to third countries and the BRICs for 11%.
- Of the 55% of outward EU FDI flows that remained in the EU, 71% went to countries neighbouring the source country

### **World-wide FDI in 2009**

- The developments in FDI into and from the EU27 have to be seen in the context of a downward slide in worldwide inward FDI, which started after the high of 2007 and continued into 2009. Having already fallen by over €300 billion in 2008, FDI inflows fell by more than €400 billion in 2009, down to under €800 billion and the lowest level since 2004.

### **International capital flows in 2009**

- The worldwide trends in FDI in turn have to be viewed in the context of the broader trend in international capital flows. As a result of the financial crisis, the rapid rise in world-wide inflows of financial resources observed between 2003 and 2007 has reversed since then. After a very dramatic decrease in 2008, the pace of decline slowed in 2009.
- Between 2007 and 2008, total world-wide gross financial inflows fell by over €7 trillion. This very large slide was followed by a further estimated decline in 2009 of about €0.5 trillion to a low of just over €1 trillion, a mere fraction of the high of over €8.5 trillion in 2007.
- The very sharp contraction in international capital flows reflects the unsettled state of the financial markets following the collapse of Lehman Brothers in September 2008.



## **Part II: The role of the free movement of capital in a period of crisis and recovery**

This special report (Part II of the study) focuses on the role of free movement of capital and open investment regime in mitigating the effects of the financial crisis that began in 2007 and the subsequent economic crisis and promoting the economic recovery and sustained European economic growth.

### **Foreign ownership of European companies during the economic crisis and the recovery**

- Foreign ownership of the equity of the major publicly listed European companies is quite common and accounts, on average, for a significant share of companies' capitalisation. This share ranges from 40% to close to 100%.

### **Openness to international capital flows and economic growth: a literature review**

- The economic literature on the link between capital openness and economic growth highlights the potential role that capital openness could have in fostering economic, but the extent of this link is unclear as it is influenced by various factors.
- The empirical research suggests that the impact of restrictive capital controls depends on whether the economy is developed or developing, the economic climate (crisis or non-crisis period) and the external finance investment dependence of the industrial sector.
- The academic findings are that, in the case of developed countries, the beneficial growth effects of openness to capital flows are limited to non-crisis periods. The impact of financial openness has also been found to vary by industrial sector and the degree to which it relies on external finance. Industries that depend more on external finance tend to contract more in recessions, particularly where institutions are weak. Capital account openness allowing financially-dependent firms to still access foreign finance during the crisis may mitigate the contraction effect.
- Notwithstanding these influencing factors, academic research yields generally positive findings in respect of the effect of financial liberalisation on economic growth, with several studies finding that more liberalised economies tend to lose less during a crisis.
- Patterns of inward FDI, greenfield investment and M&A into the EU27 from third countries differ in the run-up to the 2008 economic recession and during the recession itself in 2009. Total inward FDI from third countries reached a peak in 2007, fell sharply in 2008 and recovered slightly in 2009; inward greenfield investment from third countries followed the same pattern. In contrast, inward M&A from third countries fell sharply in both 2008 and 2009.

- The private gross fixed capital formation financed by residents (i.e. total private gross fixed investment minus greenfield inward FDI) shows very different patterns in 2008 and 2009. Private gross fixed capital formation by residents fell in 2009 after having posted positive growth in 2008. In contrast, greenfield investment fell in 2008, as the financial crisis reached its apex, but then recovered already in 2009.
- Thus, real growth in GDP in the EU27 was reduced in 2008 by the collapse in inward greenfield FDI in the wake of the financial crisis.
- But, in contrast and more importantly, the recession in 2009 would have been almost half of a percentage point deeper in the absence of the recovery in greenfield inward FDI.

### Openness to international capital flows and economic growth: an econometric analysis

- We estimated the relationship between capital market liberalisation and economic growth using a (dynamic panel) regression model of macroeconomic variables (including the Chinn-Ito KAOPEN index of capital openness) on growth of GDP per capita at country level, with data from five-year periods beginning in 1988 to 2003. Sensitivity analysis showed the results to be robust to model specification.
- The results of the empirical analysis show that the benefit to an economy of having had open capital markets in 2008 and 2009 and over the coming years will be approximately 1.73% growth in GDP per capita over a five-year period.

### Conclusions on how the EU's open investment regime will help support the economic recovery

- The key finding is that both the analysis of the contribution of inward FDI to economic growth in 2009 and the econometric analysis show that free capital movement supported the EU economy during the recession.
  - Our analysis showed the clear importance of greenfield FDI as a driver of inward FDI and economic growth. Whilst only a very small proportion of total private gross fixed capital formation, greenfield inward FDI supported the EU27 economy in 2009 by offsetting, in part, the weakness emanating from other parts of the economy.
  - Moreover, the empirical analysis suggests that, in the context of an external crisis, an economy characterised by capital openness will experience growth on a per capita basis that is approximately 0.133% higher than an economy that is not open to capital flows.



