

**Analysis of
development in the
field of direct
investment and M&A**

Executive Summary

**EC Internal Market
and Services DG**

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4 November 2009

Part I - Developments in FDI and M&A in 2008 and the first half of 2009

- The financial crisis, which erupted in 2007, turned into a full-fledged economic and financial collapse by autumn 2008. This sharp turnaround in economic prospects had a profound effect on international capital flows and more particularly, foreign direct investment.
- After peaking at US \$10.9 trillion in 2007, preliminary estimates suggest that total net financial inflows plunged to about US\$ 1 trillion in 2008.
- This sharp decline reflects the combination of:
 - a narrowing in current account imbalances following the collapse in commodity prices in mid 2008 and the pronounced decline in exports in late 2008; and,
 - a sharp decline in international capital flows due to the paralysis which gripped financial markets following the collapse of Lehman Brothers in September 2008.
- After reaching a record level of US\$ 2 trillion, the latest UNCTAD figures show that inward FDI fell back to US\$ 1.7 trillion, still about 16% higher than in 2006.
- Preliminary figures available for a number of countries suggest that inward FDI continued to drop through the first half of 2009.
- The drop in world-wide inward FDI in 2008 is entirely accounted for by decline of inward investment into the EU Member States, both from other Member States and from the rest of the world.
- In contrast, the United States and Japan and all other regions of the world saw inward FDI increase in 2008.
- The decline in inward FDI into the EU Member States is largely explained by a substantial decrease in cross-border mergers and acquisitions into the EU Member States.
- Outward FDI from the EU Member States and also from the USA, declined substantially in 2008, falling by 30% and 18% respectively. In contrast, Japan and Canada saw their outward FDI grow by 62% and 30% respectively. The BRICs also experienced an increase in outward FDI of 54%.
- The main factor behind the decline in outward FDI in 2008 in the USA and the EU Member States is a substantial deterioration in the financing capability of transnational corporations, due to both the tightening of credit conditions during the financial crisis and the economic recession which reduced the volume of own funds available for investments at home and abroad.
- With regard to the EU27 area, total intra-EU inflows fell from €592 billion in 2007 to €321 billion and inflows from outside the EU27 fell from €360 billion to €173 billion.
- However, so far, the 12 New Member States have been only lightly affected as total inward FDI (intra-EU and from outside the EU) into these countries fell by only about 8%, from €82 billion in 2007 to €76 billion in 2008.
- Cross-border mergers and acquisitions activity also fell sharply in 2008 in the EU27. The value of cross-border deals into the EU27 from other EU27 Member States and from

countries outside the EU is estimated to have fallen by 24.8% and the number of deals by 5.4%.

- Moreover, data available for the first eight months of 2009 suggest that, for the year as a whole, the annual value of cross-border merger and acquisition deals could be as low as €55 billion, 65% below the level observed in 2008.
- At the end of 2007, the total stock of inward investment into the EU27 stood at €7,453 billion, of which 71% originated from other Member States. On average, about one third of the stock of inward investment in Member States originated from neighbouring Member States
- In terms of the sectoral distribution of inward investment into the EU27, it is the service sector which has attracted the bulk of inward FDI into the EU27. In 2006, this sector accounted for 78% of the total EU27 inward FDI stock.
- Within the service sector, financial intermediation is by far the largest sector in terms of inward FDI in the EU27. In 2006, this sector accounted for almost 44% of the total stock of inward FDI into the EU27 originating from other EU Member States or outside the EU27.

Part II Analysis of the Impact of the Economic Crisis and Protectionism on Capital Flows

Introduction

- This report presents London Economics' Final Report in respect of the Special Themes within the Study Contract ETD/2007/IM/F1/136 commissioned by the European Commission (DG Internal Market and Services). The Special Themes involve economic analyses of (1) the impact of the international financial crisis (the 'crisis') on capital flows and (2) the risk of protectionism arising from the crisis and its likely impact on capital flows.
- Both themes are interrelated and the report provides quantitative and qualitative analyses regarding (a) trends in capital flows before and after the onset of the crisis (in the latter half of 2007) and (b) how emergency and non-emergency measures adopted in response to the crisis may affect capital flows (if at all).
- The capital flows examined include foreign direct investment (FDI) flows, portfolio investment flows (which broadly comprise equity and debt flows) and other investment flows (net flows). The geographic coverage of the study includes the 27 Member States of the European Union (EU-27), the eurozone (changing composition basis, as outlined in Section 2 of the main body of the Report), the US and Japan plus emerging economies (the 'BRIC' countries, comprising Brazil, Russia, India and China).

- The current crisis has elements of both the Great Depression and the more recent systemic banking/financial crises from the 1990s. However, what sets the present crisis apart is the scale of the emergency measures in the financial and real sectors of many developed countries.
- The experience of the Great Depression illustrates the damage that can be caused during a major international recession due to governments engaging in protectionism (in relation to direct and portfolio investment as well as trade protectionism). Both forms of protectionism proved to be extremely counterproductive for many years after the Great Depression, demonstrating that protectionism is unlikely to be valid or rational economic policy.
- The more recent financial crises illustrate that policymakers have generally eschewed protectionism and, as a result, the countries affected have generally emerged relatively quickly from crisis. For example, countries that responded by permitting the entry of foreign banks and/or foreign investment more generally tended to emerge quicker and more robustly from crisis than those that prohibited or continued to limit such entry or reform of their banking/financial sectors. Finland, Mexico, Thailand and Korea liberated rapidly following crisis and recovered relatively quickly in comparison with Argentina and Malaysia, where capital flows were restricted and recovery proved to be slower.

Quantitative Analysis of Capital Flows and the Crisis

- Among the salient findings in respect of the trend analysis of **FDI flows** are the following results. First, there was a significant decline in inward FDI flows to the EU from the rest of the world following the onset of the crisis (within which there has been a significant decline in equity flows). The decline for the EU was much greater compared with that for the US and Japan. Second, a striking feature of the post-crisis era is the very significant fall in FDI from the US to the EU. Third, in terms of inward FDI to the EU from the major emerging economies, Russia accounted for much of the FDI from this source prior to the crisis, with inflows falling sharply in its wake. The value of FDI inflows originating from Brazil appear to have risen since the crisis, while FDI inflows to the EU from India and China have become larger but also more volatile. Fourth, regarding FDI flows between the rest of the world and emerging economies, the beginning of the crisis saw a significant spike in FDI outflows from Brazil, India and China and the longer trend reveals that outward FDI flows from these countries has increased since the beginning of the decade, albeit the trend is highly volatile. The same is also true of FDI inflows to these countries, reflecting increased FDI in and out of them in recent years. Fifth, the patterns of FDI flows in respect of the eurozone and the rest of the world also reflect those between the EU-27 and the rest of the world.

Portfolio investment flows into the EU-27 from the rest of the world have exhibited a downward trend since 2004 and there does not appear to be evidence of a break following the onset of the crisis in the latter half of 2007. In contrast, following the crisis, EU investors appear to have become more averse to acquiring portfolio investment

assets outside the EU following the crisis. Portfolio investment flows (inflows and outflows) in respect of the US and Japan have been broadly similar to those for the EU in recent years, although portfolio investment flows in respect of China and Russia have been more stable compared with the EU.

As regards **other investment flows**, overseas assets and liabilities relating to the EU have both fallen since the beginning of the crisis. Developments within the eurozone have mirrored this trend. Flows from the eurozone to the US appear to have been adversely affected by the crisis. Flows to the eurozone from the US have also fallen sharply, as have those from Russia and Japan. Reserve assets held by EU monetary authorities were falling prior to the crisis. The pace of their decline appears to have slowed following the onset of the crisis.

The main findings of the **panel data econometric analysis** of capital flows are summarised as follows:

1. Trade openness and market capitalisation are the most important explanatory variables accounting for FDI inflows, both exerting a positive influence of FDI inflows (as expected on *a priori* grounds). Stock market returns are also important but were found to exert a negative effect on FDI inflows.
2. Trade openness and market capitalisation are also the most important factors in explaining FDI outflows, where our analysis also identifies the level of government debt as important – higher government debt is associated with lower FDI outflows.
3. Considering portfolio investment flows, trade openness was again found to be a statistically significant determinant of both inflows and outflows. As with FDI inflows, stock market returns were found to be statistically significant, however stock market returns were found to have a positive impact on PI Inflows. Inflation was also found to increase PI Inflows, with the LIBOR spread having a negative impact. There was also evidence of a time trend.
4. In relation to portfolio investment outflows, along with trade openness, market capitalisation and the level of bank deposits in the home country were found to have a positive effect the level of PI Outflows.
5. Changes to the specification of the regression models were found to have little impact on the results.
6. According to the econometric analysis, the effect of the crisis was found to be statistically significant in just one of the capital flow variables, outward FDI. It is important note that the econometric analysis has compared the period after the crisis (from the third quarter of 2007 onwards) with the period prior to the onset of the crisis (up to but not including this quarter). While the trend analysis suggests a structural break around this quarter for many of the capital flow variables, the econometric analysis captures longer-term effects each side of 2007Q3 (including the apparent ‘recovery’ in capital flow variables in 2009) and this may be a factor in the absence of a statistically significant crisis effect from this time.
7. There is therefore only very weak evidence from the econometric analysis that the crisis has caused a structural break or a fundamental change in the relationships between variables. With few exceptions, most of the interaction variables were not significant. Further, the main explanatory variables, such as market capitalisation per GDP and trade-openness per GDP, remained significant in the structural break as well as the initial regression without a structural break, suggesting our analysis is reasonably robust.

Qualitative Analysis of Protectionism and Capital Flows

- We have also outlined a complementary, qualitative approach (Section 3) that analyses the likely impacts on FDI and portfolio investment flows of current economic policies and developments in response to the crisis (including the emergency measures in the real and financial sector with potentially structural implications).

Protectionism is generally associated with specific measures curtailing international trade and there is widespread consensus among economists that trade protectionism damages welfare, is self-defeating and thus is non-credible as a policy instrument. Investment or financial protectionism, which is the focus here, may be defined as measures limiting (intentionally or not) capital flows among countries, such as FDI or portfolio investment. According to modern economic research, capital account liberalisation will tend to enhance welfare provided it is accompanied by other requisites, including sound macroeconomic stabilisation policies, effective competition policy as well as prudential supervision and regulation of financial and capital markets. In such an environment, investment/financial protectionism is generally seen by economists as damaging to economic welfare and therefore is unlikely to be a rational or sustainable policy because, like trade protectionism, it is more likely to damage than benefit those who use it.

The emergency measures taken in response to the crisis are potentially restrictive of capital flows and risk giving rise to investment/financial protectionism, which would limit FDI and portfolio investment flows and reduce access to capital and liquidity by individuals and firms.

There is some evidence that, prior to the crisis, restrictions on capital flows were increasing in developed economies (including the US, Japan and the EU generally) and decreasing in major emerging economies, China and Russia. Other evidence reviewed in Section 3 shows that the proportion of 'less favourable' national regulatory changes affecting FDI decreased between 2007 and 2008. Recent evidence from the OECD, UNCTAD and the IMF, which are monitoring such policy changes, indicates that the international environment facilitates capital flows and there is no evidence of a rise in protectionism that would curtail FDI, portfolio investment and other capital flows (at least to date).

Another positive development for capital flows are initiatives led by the OECD, UNCTAD and other international organisations (including the EU) to improve understanding of sovereign wealth funds, including enhancing transparency, governance and accountability of SWFs.

A number of key conclusions emerge from our qualitative analysis of the likely effects of emergency and other measures on capital flows.

One is that countries have a large degree of *discretion* regarding the application of emergency measures and this could have positive or negative effects on capital flows and the timing of the international recovery. It is possible that, in the next 2/3 years, some countries will still have emergency measures in place while others will have removed them. Such *asymmetries* in the duration of emergency measures could have significant repercussions for the distribution of FDI flows in particular among countries. In the EU, such asymmetries could impair the process of integration of financial services

markets. Coordinating the emergency measures, including their timing as well as ensuring that they do not give rise to protectionism and adverse competitive effects, will therefore be important.

There is also a risk that the emergency measures currently in place could give rise to protectionist tendencies *at a later date*. As the international economy recovers, the ending of emergency measures could trigger a period of increased international investment, which could in turn spark calls for protecting 'national champions' from foreign takeover.

Finally, in terms of which measures may be most damaging to the Internal Market, our analysis suggests that government aid to certain sectors and emergency financial sector measures are likely to carry the greatest risk. These measures therefore require close, ongoing monitoring by the Commission.