THE IMPACT OF FINANCIAL INSTABILITY ON FDI DYNAMICS

Assist.Prof. Vesna Georgieva Svrtinov, Faculty of Economics"Goce Delcev" University – Stip, Republic of Macedonia, vesna.svrtinov@ugd.edu.mk

Assist.Prof.Olivera Gorgieva Trajkovska, Faculty of Economics"Goce Delcev" University – Stip, Republic of Macedonia, olivera.trajkovska@ugd.edu.mk

Assist.Prof. Aleksandar Kostadinovski, Faculty of Economics"Goce Delcev" University – Stip, Republic of Macedonia, aleksandar.kostadinovski@ugd.edu.mk

Abstract

The main goal of this paper is to briefly analyze the impact of financial instability on the dynamics of FDI (Foreign Direct Investment) and vice versa. There is a widely accepted opinion among academic economists and economic policy makers that FDI are a lot more stable in periods of financial crisis as opposed to all other capital inflows. Their stability is based on the fact that they can be more difficultly withdrawn from the receiving country, unlike other investments. Yet, the situation differed during the last global financial crisis, which caused a colapse of the global FDI flows. FDIs were significantly reduced and reacted a lot faster to the crisis compared to other forms of capital flows. This indicates that they are not as stable and can demonstrate volatility as all other types of capital flows if the global economy faces substantial financial instabilities.

Key words: financial instability, foreign direct investment, financial and economic crises.

Introduction

The experience from different episodes of financial and economic crises, at least until the beginning of the global crisis from 2007 to 2009, confirm that FDI in relation to portfolio investments, represents far more stable form of international capital flows. The conventional wisdom is that crises are largely due to swings in short-term capital. Short-term inflows (or 'hot money') can be easily reversed, while longer-term flows cannot. FDI is determined by long-term fundamental economic characteristics which are more stable. Indeed, FDI is often presented as being relatively irreversible in the short run. Hence, economies that finance their current account deficits mainly via foreign direct investment are seen as being less susceptible to a crisis. Short-term capital volatility has been seen as lying at the heart of recent financial crises (Bird and Rajan, 2002)

Foreign direct investments and financial stability

Lipsey (2001), in his study:„ Foreign Direct Investors in Three Financial Crisis“, has investigated the behavior of the FDIs during three episodes of financial crisis – the crisis in Latin America in 1982, the crisis in Mexico in 1994 and the crisis in East Asia in 1997. While investigating, he came to the conclusion that FDIs behave a lot different than other forms of capital flows.

During the crises in Latin America in 1982, the inflows of the portfolio investments declined a lot more than the inflows of FDIs. Similarly, in

Mexico, in 1995, the inflows of foreign direct investments were reduced, but a lot less than the other forms of capital inflows and they were renewed a lot faster. The example of East Asia was not different as well, where the gross inflows of foreign direct investments declined just a little in 1998, while in the next year, 1999, they reached the pre-crises level. Different from them, the other forms of capital flows were drastically reduced and even an outflow of the portfolio investments occured (Lipsey, 2001).

Such empirical evidence supports the hypothesis that FDI flows are more stable than all other forms of capital (Lipsey, 2001). Joseph Stiglitz also noted : *Foreign direct investment is also not as volatile – and therefore as disruptive – as the short-term flows that can rush into a country and, just as precipitously, rush out”* (Stiglitz, 2000: 1076). Their stability is based on the fact that they can be more difficultly withdrawn from the receiving country, unlike other investments. Due to this, countries tend to encourage this kind of inflows with an aim to protect themselves from the sudden changes of the capital account. As an example, the FDIs in certain countries such as: Argentina, Indonesia, Brasil, Russia and Thailand were the only capital inflows present just after the termination of their individual crises, while the portfolio inflows and the other private capital flows had already dissapeared (Brukoff and Rother, 2007).

As a result, during 2007, global FDI flows reached a historical high of around $2 trillion, which marked the peak of a four-year upward trend in FDI flows. As of 2007, FDI inflows represented nearly 17.2 percent of total capital formation in developed nations, and 13 percent in developing economies. Multinationals foreign affiliate production was equivalent to 12 percent of thr world‘s total GDP, with exports accounting for one third of the world’s total exports (Alfaro and Chen, 2010).

The situation drastically changed with the beginning of the recent global financial crisis, which caused a colapse of the global FDI flows. In 2008 global FDI began to fall-by 16 percent, and when worldwide output contracted in 2009 for the first time in 60 years, FDI declined a further 40 percent. During 2010, FDI levels stagnated just above US$1 trillion. 2009 was therefore the year when the FDI recession became truly global in character (Poulsen and Hufbauer, 2011).

If we make a comparison with previous episodes of financial crises, it can be noted that the recent global crisis has left a lot more serious consequences on FDI. FDI were significantly reduced and even reacted faster to the crisis differing than other forms of capital flows. This indicates that they are not as stable and they can demonstrate volatility, if the global economy faces financial instabilities (Vintila, 2011).

It is evident that it is a relatively new phenomenon which should not be undervalued. It is a phenomenon which should always be taken into account by the creators of economic policies (Svrtinov and Temjanovski, 2013).

According to research by UNCTAD, the dive in global FDI in 2008–2009 is the result of two major factors affecting domestic as well as international investment. First, the capability of transnational firms to invest has been reduced as access to credit has tightened and corporate balance sheets have deteriorated. Second, the propensity to invest has been affected negatively by economic prospects, especially in developed countries that has been hit by severe recession (UNCTAD, 2011).

Having in mind all the previously mentioned positive effects for the country which is a recipient of the FDIs as well as their behavior during the last global crisis, the countries, besides in terms of the benefit, should also consider the influence on the financial stability of the country.

The inflow of the foreign capital, in a form of FDI, is considered a more stable flow, different from the portfolio investments because with the latter, the investors can more easily and quickly withdraw the capital from the foreign country. However, there are arguments which point that the assumptions which refer to the FDIs as stable capital inflows are not always correct. Namely, the difference between foreign direct and portfolio investments lately, as a result of the appearance of the financial derivates and the protective (hedge) funds, are weaker and weaker. According to this, the long-term investments can be easily turned into solvent means as well. The investors of FDI can use their immovable property as collateral, with an aim to loan in the foreign country and get their capital in the domestic country, causing rapid capital outflows in the country which is recipient of the FDI. Very often, in the FDI balance, there are maintained profits, which could be easily taken out of the country recipient of such investments (Pavlovic, 2008).

In the same time, as well as all the other sources of financing, the FDIs can enter in a certain country in big amounts and can cause appreciation of the foreign exchange rate and a reduction of competitiveness of the sector for trading goods and services. On the other hand, the FDIs inflow (in a form of fresh investments) and the FDIs outflow (in a form of payment of dividends or repatriation of a profit) can be inconsistent in certain periods. Such incompatibility, even for a short period, can easily cause a liquidity crisis in the country in which it is invested.

Beyond this, FDI can cause social costs. For example, these investments can influence the reduction of employment (due to a transfer of the work force in companies which are under foreign ownership) or to push out the domestic, less successful companies (Grcic, 2008).

As previously stated, developing countries can have benefit from such investments due to the transfer of modern technology and due to other positive economic overflows. Still, the local companies can increasingly lag in technological and managerial development and not be in possibility to imitate the technology which is applied by the foreign investor. The increase of productivity of local companies through the transfer of technology and managerial skills, as well as the stimulation of the development of the financial sector in the country recipient of FDIs, happen only in countries which have developed physical infrastructure, a stable business environment, as well as the possibility and capacity for absorption of the positive FDIs spillovers. Thus, the key challenge is not only in attracting the FDIs, but in the improvement of the local conditions, which are needed in order to utilize all the advantages and gains offered by such investments[1].

In the last decades, including the years of global crisis, the countries exercised different policy frameworks for the encouragement of a bigger scope of foreign investments. The crisis will most probably change such attitudes because the latest events indicated that not all direct investments promote economic development and the big amount of FDIs shouldn't be an indicator that there is successful policy in terms of such investments. In order to increase the positive influence of FDIs on economic growth and to reduce the negative consequences on the financial stability, the authorities should consider one sustainable FDIs strategy, which will increase not only the quantity, but also the quality of such investments. Yet, the sustainable regime of FDIs on the national and international level might not influence the reduction of the recession of these investments in a great deal, but it will surely have a significant effect for the economic and social welfare in the long term (Poulsen and Hufbauer, 2011).

The crisis will probably change such attitudes, since what happened recently indicated that not all direct investment promotes economic growth, and the large scale of FDI should not be considered as an indicator of successful economic policy. Therefore, in order to increase the positive impact of foreign direct investment on economic growth and to decrease the negative consequences on financial stability, the authorities should consider a sustainable FDI strategy, which would increase not only the quantity, but also the quality of these investments.

In some cases, large and rapid liquidity funding was provided by international institutions in order to compensate for the decline of private capital

[1] For more details see: Borensztein et al (1998).

outflows (including FDI) in 2008-2011. For example, in EU they took a form of rescue loans for Greece, Ireland and Portugal from foreign governments and arranged through the European Financial Stability Facility. Acominotti and Eichengreen (2013) in their paper draw parallels with similar episode just before the Great Depression, when the biggest capital importers before the countries were Germany, Austria and Hungary. The decline in private capital inflows to Greece, Italy, Portugal, Spain and Ireland in 2008-2011 was larger than that experienced by Central European countries in 1927-1931. However, the rise in official inflows was also larger, making the resulting current-account adjustment less severe for the capital importers. As Acominotti and Eichengreen put it: “To some extent, then, the Euro system has provided collective insurance against sudden stops”.

Conclusion

Empirical evidence broadly supports the view that FDI flows are generally more stable than portfolio and other investment flows. However, the recent global financial crisis (2008-) has shown that FDI may not be as stable as academic economists and Governments think. During the crisis, FDI significantly declined and reacted as fast to the crisis as other forms of capital flows. 2009 was therefore the year when the FDI recession become truly global in character.

The experience from the recent crisis confirms the need for rapid and large liquidity funding by international financial institutions in order to compensate for the decline of private capital outflows (including FDI). For example, rescue loans for Greece, Ireland and Portugal made the resulting current-account adjustment less severe for this countries.

Despite the temptation to recourse to protectionism and economic nationalism, so far politicians generally has avoided „beggar-thy-neighbour“ solutions. But it seems that for the policymakers in pos-crisis period would not be enough only to continue with further liberalization of FDI regime.

To increase the positive impact of FDI for economic development, and avoid the damages, officials should instead consider a „sustainable FDI“ strategy, which enhances not only the quantity of investment, but also the „quality“ (Vale Columbia and WAIPA, 2010) A very important factor is not just the overall size of FDI inflows, but also their structure.

The situation is different during the last global financial crisis which caused a colapse of the global flows of FDIs. If we make a comparison with the previous episodes of financial crises, it can be noted that the last global crisis has left a lot more serious consequences on FDIs.

Having in mind all positive effects for the country which is recipient of FDIs, due to the transfer of modern technology and due to other positive economic overflows, as well as their behavior during the last global crisis, besides in terms of benefit, should also be considered in the relation to the financial stability of the country.

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