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FOREIGN DIRECT INVESTMENTS IN EUROPE AFTER THE CRISIS OF 2008

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Summary

Introduction

In the globalized world in which we live, investing abroad is not an unusual activity for countries. From 2000, we have observed increasing exchange of foreign direct investment flows between countries, and even if the crisis initially slowed down such flows, recently these have recovered and now this phenomenon is stronger than ever.

When we consider investments abroad, we usually distinguish between two classes: foreign direct investments and portfolio investments. Generally speaking, portfolio investments are mostly about financial interests, while foreign direct investment are mostly about management and technology skills and long-term fundamentals such as country size and potentialities, financial market development and degree of openness. While portfolio investments are extremely sensitive to financial crises and economic slowdowns that could affect returns, no matter what the source is, and their volatility is extremely high, foreign direct investments respond to a crisis only when it is thought that it can affect the receiving country in the long run. For this reason, we think it is interesting to evaluate the reaction of FDI to the crisis of 2007-2008, analysing their behaviour in Europe and focusing on the position of Italy in this scenario.

In the period before the crisis, Europe had kept the lion's share of foreign direct investment flows, especially because of large interchanges of capital between the countries of the European Union, given the high level of economic integration of the area and the participation to this agreement of ten new members, all developing countries with good perspectives of growth. Furthermore, the trend toward appreciation of the euro with respect to the dollar in that period and the substantial control of price encouraged investment in Eurozone, while the European Union showed a higher rate of growth in terms of gross domestic product than other advanced economies. When we look at the general level of interest rates, which is extremely relevant for investors to estimate the value of investments projects and the markets' country-risk perception, we note that before the outbreak of the crisis the Eurozone and advanced countries of the European Union exhibited lower rates than the United States, and significantly more convenient than the ones shown by developing countries such as Russia. Considering figures, in 2005 the 25-member European Union was the favourite destination of FDI across the world, with inflows of $499 billion (almost half of the world's total); in 2006 the predominant role was still played by the European Union, where inward FDI grew by 9%, to reach $585 billion (41% of total global amount). In 2007, the European Union attracted two thirds of the total flows to developed countries, receiving $854 billion, about 44% of the total FDI reported for that year, and confirming to be the most important pole with the European Monetary Union (or Euro zone), at that time including 13 countries, playing a central role with inward FDI growing in a year by 62% to $553 billion.

But in 2008 when the financial crisis broke out resulting in a huge impact on investments, Europe lost part of its appeal. The Union started to reveal signs of weakness: not only the growth of GDP in the years after the crisis was lower than in other advanced economies, but States with structural problems and high stock of public debt accumulated (such as Italy) exhibited statistics, especially regarding the interest rate, diverging from other economies of the Union, discouraging investments from international corporation. In the majority of EU-27 countries foreign direct investments fell, with a reported decline of 37%, to a total of $542 billion considering the whole region. The trend continued in 2009, when FDI flows into the 27 European Union countries dropped by 34% (to $357 billion), but for that year the region showed on average a much lower rate of decline than those of North America and Japan. In 2010 the trend turned for most developing countries but not for Europe: while in North America inflows of FDI showed a strong recovery with a 44% increase over 2009, inflows to Europe were down by 19%, -11% recorded in the European Union.

During the whole period considered, Italy substantially followed the same trend, with inward foreign direct investment growing in 2005-2007 from $23 billion to $43,8 billion and falling with the occurrence of the crisis. In particular, Italy suffered a net disinvestment flow in 2008, -$10,8 billion, the second worst result behind Ireland in the common currency area. In 2009 we observe a partial recovery, with inward flows of $20 billion, which is about the level reported in

2004; the following year, in contrast with the positive trend shown by Europe, foreign direct investments to Italy declined to $9 billion, -54% with respect to 2009. In general Italy has never been a country with a high level of internationalization compared with other developed economies, considering both inflows and outflows, and the crisis has exacerbated this feature; as the country has started to reveal its main weaknesses, such as a substantial stagnation in growth dynamics and high level of public debt over GDP, the perception of high risk of its future perspectives has contributed to deflate the interest of foreign investor.

In the first Chapter of this thesis, we have considered the principal theoretical aspects of foreign investments, both direct and of portfolio, focusing on the reasons behind these and the possible implications for the receiving economy. In the second Chapter, we have analysed the global pattern of FDI in the three years before the crisis, with particular attention on Europe and on the variables that enabled such a region to get the lion’s share of total FDI. In the Third Chapter, the investigation is about the behaviour of investments in the three years after the crisis, keeping attention on Europe and its decreasing relevance in the global patterns of FDI, the variables which signal the structural weaknesses of the area and its lower attractiveness for investment activity. In the fourth Chapter, we focus our attention on the position of Italy in the configuration of international exchange of FDI, both before and after the crisis, analysing the variables that are making the country even less interesting for international investors and trying to quantify the increasing presence of investors from developing countries.

1. Theoretical facts about capital flows

When we talk about investments abroad, we usually consider two macro classes: Foreign Direct Investments and Portfolio Investments.

Foreign Direct Investments are defined as the “net inflows of investment (inflow minus outflow) to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor, and it is measured as the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments” (def. by World Bank). FDI are likely to offer high returns to the investor, as they allow for ownership and control and presumably are managed efficiently, despite involving significant transactions costs and a specific risk connected to the particular sector.

From the point of view of the receiving country, the link between FDI and competitiveness is a complex issue. The presence of foreign firms in a market means that domestic companies lose market shares, sometimes risking a takeover. But, at the same time, the global productivity increases and the environment is more competitive, with potential technology spill overs.

If we analyse the FDI, there are two main ways to take control of a firm, and thus enter in a particular business of the target country: by buying a company (acquisition) or by expanding the operations of an existing business in that country.

On the one hand, by acquisition (or merger), we mean that an investor buys a large amount of shares, to be able to control the foreign firm. The main advantage of this modality is that the new investor is allowed to enter rapidly in the foreign country, through an existent business, exploiting the network and the know-how of an already functioning firm.

On the other hand, we have Greenfield investment, which is defined as an investment in a manufacturing, office, or other physical company-related structure in an area where no previous facilities exist. In this case, the main advantage is that the investors are able to set up the features of the objective-firm that match their own needs better. But the constitution of a company whose ownership is entirely foreign can be restricted in many countries by regulation and, in general, by a more complex bureaucracy.

One of the most common ways to invest abroad is through joint ventures, deals in which two parties agree to develop, for a finite time, a new entity and new assets by contributing equity. Both parties exercise control over the enterprise and consequently share revenues, expenses and assets from the beginning of the constitution of this enterprise. In this way, the investor has the possibility of building a firm with the features preferred and, at the same time, having local support in a partner who knows the objective market better.

The other common form of investing abroad is Portfolio Investment, an investment in securities which does not entail active management or control. Investors who decide to take part to these kinds of assets are not particularly interested in being involved in the management of a company, but only in purchasing of financial interest. Generally these types of portfolios are diversified to eliminate specific risks, and the investment horizon is short. These offer on average a lower return than FDI, since the latter are managed directly and more actively, while FPI management is delegated to outside parties. However, the liquidity of portfolio investments is higher than direct ones, since these are more tailored to the specific exigencies of the investor.

It can be said that portfolio investment deals with financial interests, while foreign direct investment deals with management and technology skills and, in general, long-term fundamentals such as country size and potentialities, financial market development, degree of openness.

We are interested in this theoretical distinction basically because FDI react differently to a crisis. Portfolio investments fall immediately when financial crises and cyclical slowdowns occur, while direct investments, representing a long term interest in companies, are more likely to be affected only in the activities directly related to the sectors which are suffering the crisis more. This class of investment will also be affected whenever the shock is sufficiently strong to force the company to readjust its projects because of liquidity problems in the market, insolvency of clients or unreliability of suppliers. In particular, banking crises, inflation and hyperinflation crises, and external debt crises can lead to a significant decline in FDI inflows, since the global stability of the economic environment will be affected. Given that Foreign Direct Investments are a more stable source of foreign funds and employment for countries, governments are normally more interested in the behaviour of this kind of flows rather than in FPI, trying to build a favourable macroeconomic environment to attract them.

From a macroeconomic point of view, there are several reasons why capital moves through countries. Some of these are related to factors in the countries of origin, others depend on the characteristic of the receiving country.

The first are called push factors, and describe why a country is driven to invest abroad rather than internally. Push factors are related to the level of economic activity of the investing country and to alternative investment opportunities in other economies. The analysis of such external factors explains why the economic conditions of capital-exporting countries (normally the developed ones) influence capital inflows in developing countries. Because many countries invest in others led by favourable global conditions, these reasons are said to capture “common factors”. Global factors that can influence this kind of decisions are the international interest rate, generally approximated by those of the United States (since developed counties are financially integrated), and world growth rate; from these factors we can study the opportunity cost of investing in countries with different features. According to neoclassical theory, low profits achievable in developed countries are the most significant cause of capital flows toward countries where profits could be higher.

With such an external nature, investment flows driven by push factors are more vulnerable to world-wide shocks: if investing countries are subjected to new liquidity constraints they could withdraw their existing investments or not to accomplish the promised ones, so a country that relies on foreign funds can be affected although its internal conditions remain stable.

The second class of factors looks at the internal situation of the country where such capital flows. The country-specific factor reflects "pull factors", and it is driven by the receiving country's economic fundamentals (or, more precisely, the market’s perceptions about them). To analyse country specific determinants of capital inflows and investment we have to consider a large range of variables such as the domestic cost of capital, the institutional quality, the political risk, the amount of exported goods and non-factor services (as indicators of general economic openness), the level of inflation, the infrastructural quality. Investors also take into account the future trends of the exchange rate as a crucial factor, since future appreciation means that, by converting the gains in home currency, they can achieve higher profits.

Also, the availability of human capital can be an important resource that investors request, as it means that there is a potentially high-educated work force, possibly at a lower cost compared to the home country.

Moreover, if we talk about developing countries, it could be said that there are potential markets to exploit which are already saturated in developed countries.

Schmitz (2009), observing the experience of Eastern European Countries during the 90s, points out financial liberalisation and financial deepening as a driver in attracting net inflows. Financial development may increase private investments by improving the access to capital, reducing transaction costs, liquidity problems and informational asymmetries.

These can be particularly important to determine whether a country is trustworthy: only if it provides transparent and true data about its economy foreigner investors will feel sufficiently confident to invest far from their home market. We should consider that the risk sentiment is very important, since the assumption that individuals who take decisions in a totally rational way and are indifferent to risk is far from the truth. FDI location decisions require a huge amount of information, a large number of small sequential decisions are made many people during a long period, and the invested capital remains relatively immobile and is focused on long term decisions. During the investment period, economic conditions in the host country and worldwide are likely to change in unpredictable ways so that decision makers are themselves affected by rather different events. In this sense, the better the information available, the more willing foreign investors are to operate in another country. This is particularly true for small countries, because, normally having little availability of assets, they also offer fewer investments opportunities and poor connections with other sectors that could interest a potential investor. With risk-adverse investor, volatility is considered a weakness of the market for a given expected value. For this reason, a stable macroeconomic environment is favourable for investment projects, creation of value added, and productivity and, as in domestic investment, current and future market potential are a main driving force for international investment.

Generally speaking, capital flows from capital-abundant countries to those which have potentially productive assets, but where capital necessary to employ them is scarce, as long as there is the equalization of marginal returns to capital among countries; so, the higher the profitability of the capital in a country, the greater the inflows of capital will be. This should happen in developing countries, where the scarce availability of capital (with respect to labour), together with the decreasing marginal productivity of this input, makes it possible, as suggested by the neoclassical theory, that the investments offer a higher rate of return. So Foreign Direct Investments are more likely to be relevant in developing countries rather than in developed ones. This is not necessary true for portfolio investments. In fact, in theory the result should be the same, but we have to take into account that the financial market, where FPI take place, can be more inefficient in these countries. Due to an underdeveloped financial system, in the South of the world both households and firms are severely constrained when borrowing. As a result, households save excessively to self-insure themselves against unpredictable shocks, and firms have to rely heavily on internal cash flows to finance fixed investment. Since the system is not efficient, fixed capital is scarce in the production sector while savings are abundant in the household sector. In such world, the rate of return of financial assets can be significantly lower than that of fixed capital.

With this situation, net savers in developing countries prefer to invest abroad if they choose to enter the financial market, while the capital for local industry arrives from other countries, and thus FDI and FPI can follow different patterns. But this fact is not confirmed by data (Lukas paradox), since we can observe that capital flows to developed countries also in form of foreign direct investments, indicating that other factors such as technological development and human capital cannot be easily transferred and so the potential return of an investment in advanced economies is higher.

It is still a controversial issue whether or not capital inflows are welcome. On the one hand, we can see that they assist in the proper allocation of global resources and thereby increase the availability of capital in the recipient country, leading to higher investment and potential growth. “They are instrumental in transferring technology and management skills, allowing for a good level of risk shared with the rest of the world, greater external market discipline on macroeconomic policy, broader access to export markets through foreign partners, greater liquidity to meet domestic financing needs and improvement of financial sector skills. On the other hand, foreign investments are sometimes seen as the main cause of currency appreciation, reduced scope for independent macroeconomic policy actions, greater exposure to external shocks, demands for protection in local markets, some loss of control of foreign-owned domestic industry, disruption of national capital markets, asset inflation, increased volatility in financial and exchange markets, high sterilization costs” (World Bank, 1995).

In particular, we have to consider that, whenever an economy is too dependent on foreign funds, it will be more sensitive to external shocks, especially when such funds are driven by external factors, such as a low rate of return in the developed world. This can influence the internal policy in its decisions, led by the necessity to keep these funds. And if, on the one hand, foreign investments could be a source of employment in a country, on the other hand it is true that foreign investors could prefer to consume the gains in their own country, leaving no wealth where they invest. Furthermore, as mentioned above, the presence in the home market of foreign investors will increase the competition that local producers have to face. Also, the frequent interchange of amounts denominated in the different currencies can lead to a more liquid market, but also add a new uncertainty in the exchange rate that could affect the trade and add a constraint to macroeconomics policies.

So, while the opportunities and the openness led by trade are generally recognized as good ones, it is not confirmed for investments.

2. The situation before the crisis in Europe

a) *A global framework*

During the three years preceding the crisis the global amount of Foreign Direct Investments flows grew impressively to reach record values; in particular, Europe showed the most important numbers.

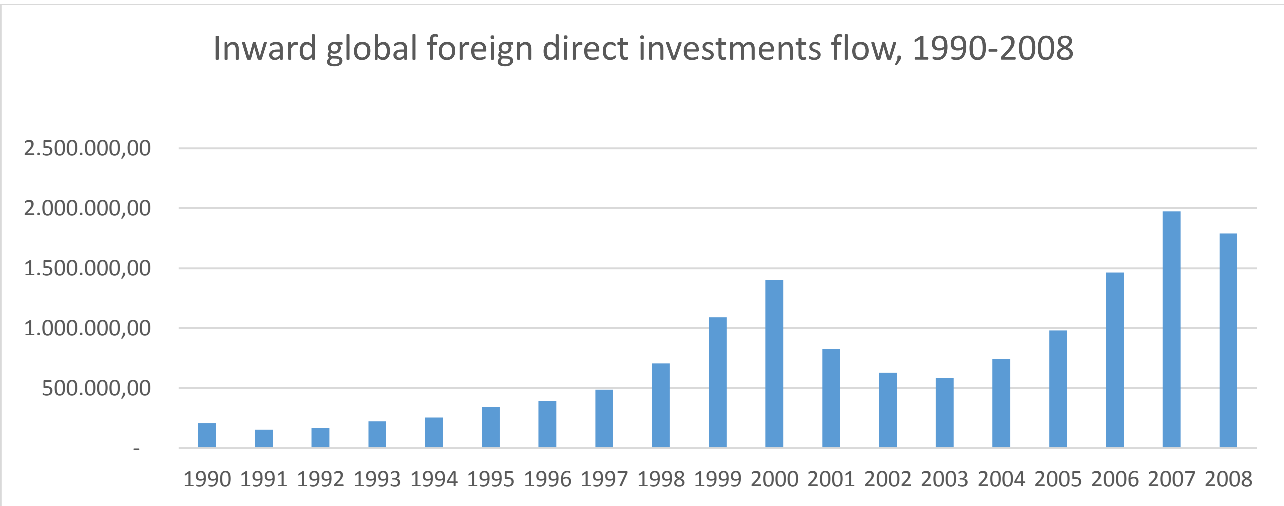
In 2005, given the combination of positive global economic conditions and favourable regulatory changes in many countries, we observed for the second consecutive year a growth of foreign direct investment: according to the World Investment Report 2006, the global inflows of FDI rose by 32% – up to $980 billion[1] – having already increased by 27% in 2004. The role of Europe was particularly central: the 25-member European Union (EU) was the favourite destination, with inflows of $499 billion (almost half of the world total); this significant increase (nearly twice the amount of the previous year) was due to a rise in intra-EU FDI. The picture varied considerably among the 25 EU members, depending on their level of development and their economic prospects. Some large-scale cross-border M&A deals also influenced the geographical distribution of FDI inflows to EU, driving the United Kingdom to emerge as the first country for inward FDI, with a total of $176 billion, for the first time since 1977. The role of the emerging countries of Central-Eastern Europe notable: the 10 new EU members together attracted $34 billion, a rise of 19% with respect to 2004, mainly due to high levels of reinvested earnings, while if we go east, we can observe the predominant role of the Russian Federation, Ukraine and Romania, which accounted for nearly three quarters of the (stable) total inflows to South East Europe. In this region of Europe, a large increase in capital outflows occurred, with the Russian Federation alone accounting for 87% of such outflows, as oil

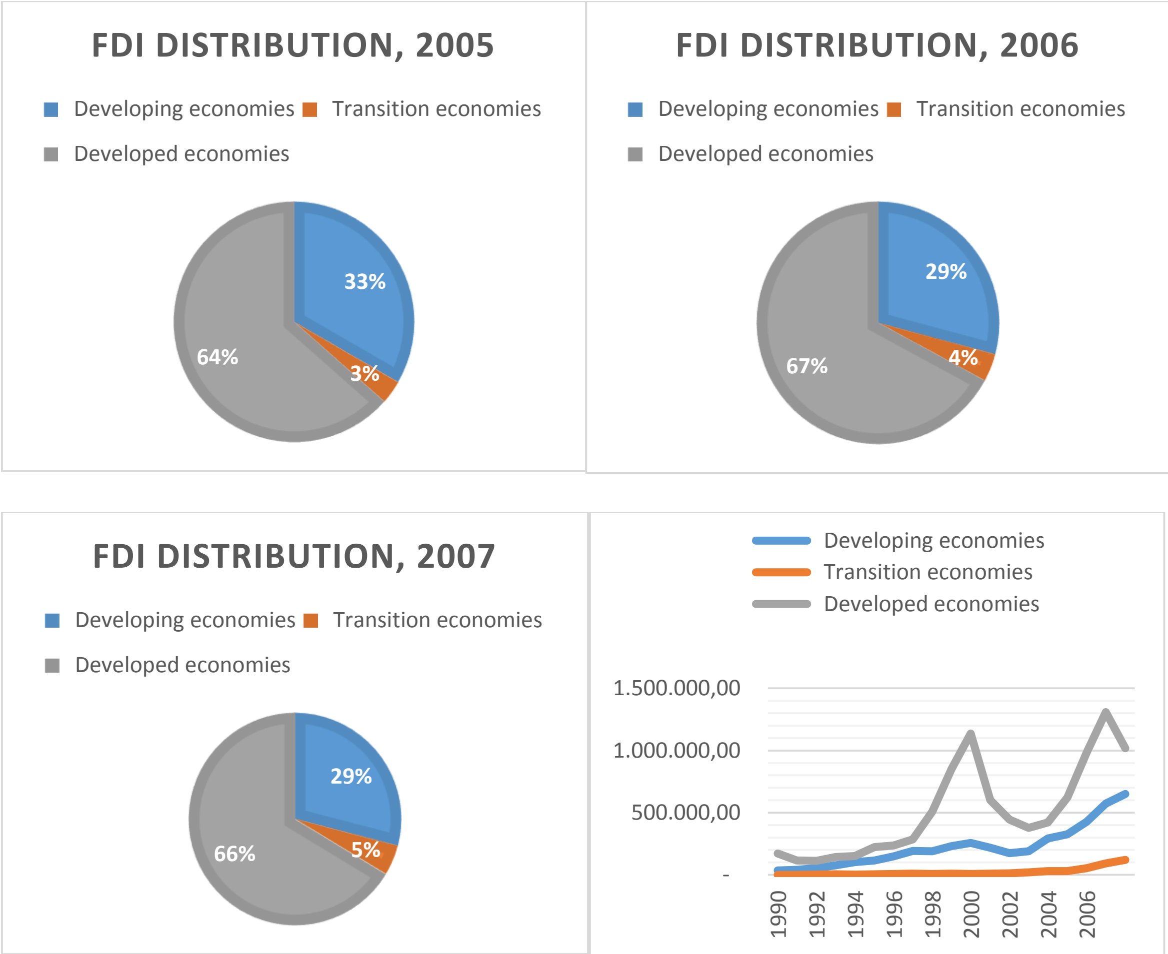
[1] Data from World Investment Reports about inflows have been adjusted according to UNCTAD data base to consider further information, current value of dollar and current prices

prices and competition for resources encouraged Russian TNCs to maintain a high level of investments abroad.
When we consider the investments from the point of view of outflows, developed countries remained the principal source of such funds, with the Netherlands (basically because of the huge merger of the British company Shell Transport and Trading with Royal Dutch Petroleum), France and the United Kingdom as leaders. Generally, FDI outflows from developed countries grew in 2003 and 2004 after a two-year decline, but fell again in 2005 by 6%, to $646 billion, because of a considerable decline in outflows from United States FDI in response to special tax incentives offered by that country's Government.

In 2006, with the persistence of such favourable conditions the global amount of Foreign Direct Investments flows rose, for the third consecutive year, by 49%, reaching a total volume of 1,463 billions of dollars, quite close to the former record of $1,400 billion achieved in 2000 (World Investment Report 2007), giving jobs to 73 million workers employed in foreign affiliates of TNCs in 2006, nearly three times more than in 1990. The increase involved all the areas considered: in developed countries, the growth was about 58%, reaching $982 billion (leading to a world share increase by 4%, up to about 66%), while flows to developing countries and transition economies attained their highest levels ever: $427 billion (a 31% increase over those in 2005) and $54 billion (a 76% increase) respectively. For this year, the United States turned out to be the largest host country with $237 billion of inflows (especially from the euro area and Japan), followed by the United Kingdom and France. In contrast with the trend of the former two years, South-East Europe and the Commonwealth of Independent States registered a large increase in inward investments, plus 76% up to $54 billion, with the five most important recipient countries (the Russian Federation, Romania, Kazakhstan, Ukraine and Bulgaria) accounting for 82% of total inflows as in 2005; for the fifth consecutive year, outflows also increased, reflecting the profitability of corporations in these countries, while the figures about inward investments have to be ascribed to European countries, responsible of 70% of the total value of investments, to accomplish projects in this area. For this region, like for all the other developing countries, the arrival of these types of capital was and has been the largest component of total resource flows since 1994, and their share in 2006 was 51%. Considering the global patterns of outflows, developed countries still conserved their leading positions with outflows higher than inflows, giving source to 84% of total outflows of capital to other countries; but we can observe that the transnational corporations from developing countries also tried to expand their businesses abroad, with the leading role of Hong Kong and the Russian Federation. Among developed countries, the predominant role was still played by the European Union, which generated almost half of the total global outflows, in particular by France, Spain and the United Kingdom; inward FDI in the 25 EU countries grew by 17%, to reach $585 billion (41% of the total amount), with a great relevance of intra EU FDI flows to the common currency area (that alone accounted for $343 billion) and a leading role played by the United Kingdom. In general, it seemed that the geographical pattern of FDI started to change, showing new trends, with new countries emerging as significant host and home economies and south to south FDI growing. In particular, a few bilateral relations that previously had accounted as the largest amount of total FDI (especially between United States and others advanced economies like United Kingdom and Canada) in 2006 turned out to be more multifaceted, given the proliferation of international agreements between adjacent countries.

In 2007 the global flows of Foreign Direct Investment reached its highest level, at $1,975 billion, 35% more than in 2006, despite the beginning of the financial and credit crisis, which had started in the second half of that year, as the economic growth and the corporates' profit had still remained high. Even taking into account the depreciation of the dollar against the main currencies, the result is still impressive. The growth occurred in all the regions considered by the World Investment Report 2008: developed, developing and transition economies. Again, developed countries turned out to be the most attractive markets, capturing $1,019 billion (an annual increment by 33%) of total reported inflows, with the United States standing out as the largest recipient country (also because of the relative convenience of dollar-denominated investments for people holding other currencies) with $215 billion, followed by the United Kingdom and France; but if we consider areas rather than countries, the European Union still attracted two thirds ($854 billion) of total flows to developed countries, confirming to be most important pole with the European Monetary Union (or Euro zone), at that time including 13 countries, playing a central role and growing by 62% to $553 billion in a year. Emerging countries too received the highest FDI inflow ever, with an amount of about $574 billion, an increment of 34% with respect to 2006, and China and Hong Kong stood out as the most attractive economies. Also flows into South-East Europe and the CIS surged in 2007, increasing by 67% in a year and gaining share in the global distribution of FDI, up to about $91 billion, with the dominant role still played by Russia, which alone accounted for $52 billion, and with Europe still being the most relevant source of funds. However, given the higher growth rates of FDI inflows to developed countries compared to the developing countries' one, the share of developing countries in FDI inflows fell to 29% from 33% reported in 2005. South-East European countries, especially the Russian federation, performed well as investors, with more than twice the capital outflows of 2006 ($51 billion, 46 of which from Russia); but, as in previous years, developed countries maintained their position as the largest net outward investors, as outflows soared to a record $1,692 billion showing a rate of growth of 56%. In this case, the United States, the United Kingdom and France resulted to be the largest sources of FDI, but also German and Spain kept a central position in global investment patterns; from a larger perspective, the European Union provided $1,142 billion of the world total amount of outflows. Developing countries, showing a lower rate of growth of outflows, saw their share in Foreign Direct Investments declined from 16% to 13%.



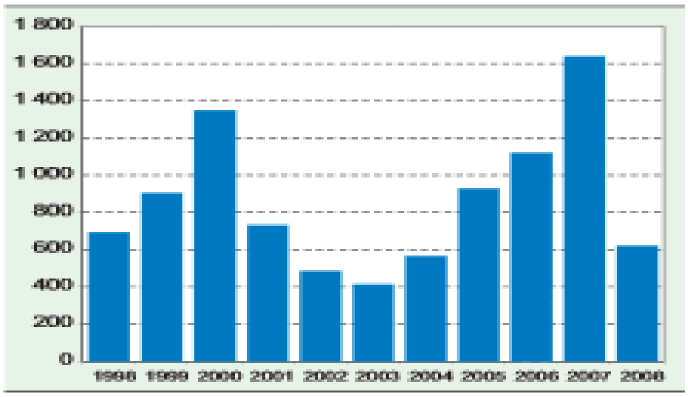


Graphs made with data from UNCTADstat[2]

If we consider the form these investments took, the report relative to 2005 notices an increase of 88% with respect to the previous year in cross-border M&As, especially those involving companies in developed countries. Between 2005 and 2006 mergers and acquisitions maintained their role as the main vehicle of FDI, raising both in value (by 23%, to reach $880 billion) and in number (by 14% to 6,974), approaching the previous M&As peak which was reached in 2000; transactions were spread worldwide among sectors, with the United Kingdom in a notable positions in Europe as the main target country and Spanish firms as the acquirer. But also the number of greenfield and expansion investment projects increased by 13% involving 11,800 projects, especially in developing countries and in the services sector. Again, in 2007 the growth in FDI flows was driven by cross-border M&As activity, which expanded in scope across countries and

[2] Note that data here are expressed in US Dollars at current prices and current exchange rates, in million

sectors. During this year the total value of international mergers and acquisitions jumped to $1,637 billion – 21% higher than the record value of 2000; this strong growth was due to a record number of mega deals[3], which grew to 10,145. At the same time, in contrast to cross-border M&As, the number of greenfield projects in developed countries fell slightly in 2007 (a total of 6,037 compared to 6,198 in 2006), mainly because of the decreased number of projects in the European Union. Additionally, if we look at the investors' nature, we can observe a large participation of collective investment funds, mainly private equity and related funds, which preserved this role in the following years, while in 2007 the expansion of sovereign wealth funds (SWFs)[4] was observed year by year.



Source: UNCTAD, cross-border M&A database (www.unctad.org/fdistatistics).

Note: Data for 2008 are only for the first half of the year.

Cross-border M&A evolution 1998-2008, Graph taken by World Investment Report 2008

In the sectorial distribution, we find that services generally take the largest share of FDI, which was 59%[5] in 2005, with a key role played by finance, telecommunications and real estate, while in South-East Europe cross-border M&As were more evenly distributed between manufacturing and services; a significant growth in the number and volume of FDI in the primary sector was mainly concentrated in developed countries. In 2006 this tendency continued, since looking at cross-border M&A activity across industries, significant M&As

[3] As mega deals we consider deals with a transaction value of over $1 billion

[4] Special investment funds has been created by national governments have created to hold foreign assets for long-term purposes

[5] As specified by the World investment Report 2006, the observations are extrapolated from data relating to cross-border M&As, which accounted for a significant share of inflows

were recorded in the consumer goods and service industries (including financial services), but also in energy supply and basic materials (mining, quarrying and petroleum – extractive industries in developing and transaction countries), in sharp contrast with the 90s trends, which were mainly focused on media and technology services. Despite of the overall growth of FDI in all sectors, the shares of the primary and manufacturing sectors in inward FDI stock worldwide continued to decline. However, in 2007, despite the predominant role of services in transactions, primary sector still accounted for a large part of FDI, with a key role of the extractive industries, and a consequent increase in the share of that sector in global FDI flows and stock, mainly led by Greenfield investments.

b) Focus on Europe

We are partcularly interested in the behaviour of such flows in Europe. Given the very high entries of Foreign Direct Investments in this region in the period 2005-2007 with the constant growth of the flows in each year observed, we ask what economic conditions made that area so attractive for investments. As the bulk of FDI were concentrated in the European Union, we mainly analyze this region, with particular interest to the Euro area and the new member States.

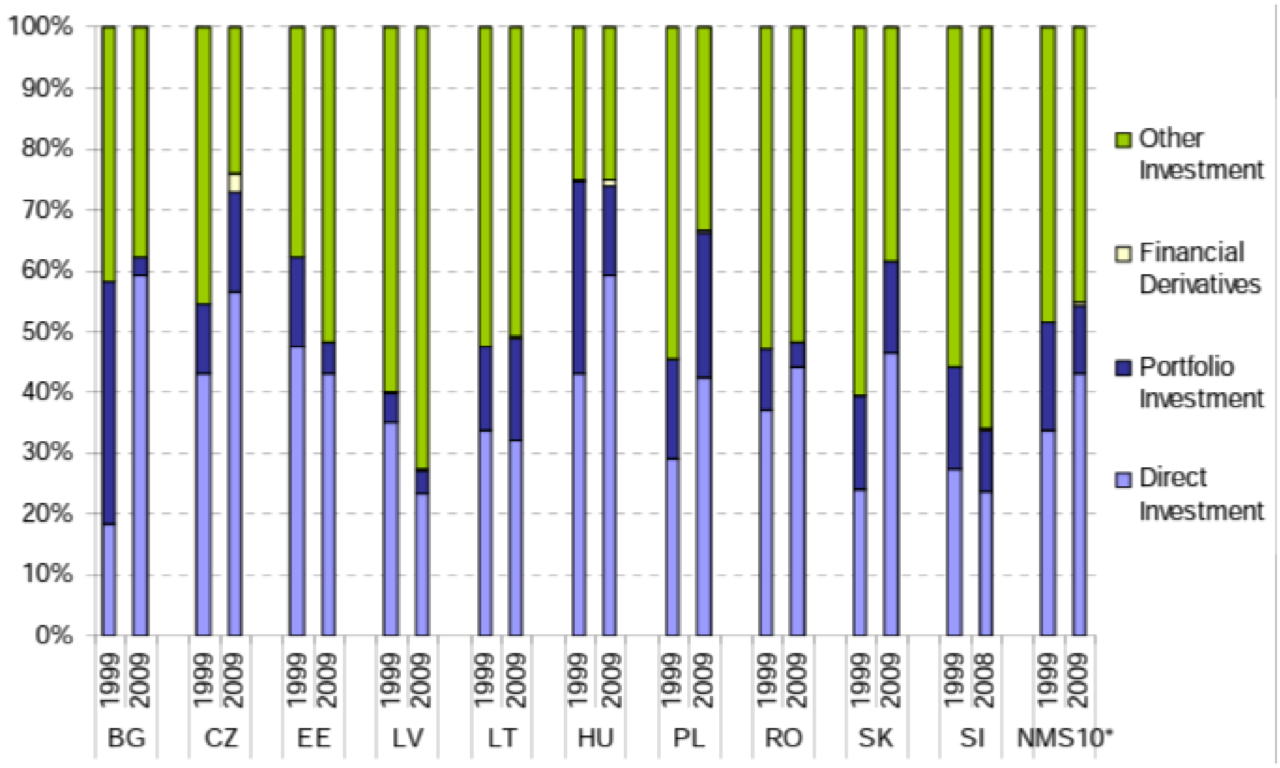
The European Union is is an economic and political union that nowadays includes 27 member states; in 2005 it accounted for 25 countries, while Romania and Bulgaria entered later in 2007. The main economic proposition of the EU is ensuring the existence and development of a common market, which allows free movement of goods, services, capital and people. For this reason, there are no barrier or other impediments to trade and investments within countries, and basically it explains the large exchanges of capitals within the member States: governments cannot discriminate firms from other member countries and the regulation in many fields is uniformed by several directives. It makes investments within the area easier: in 2005, more than $499 billion out of $542 of FDI occurred in EU-25 countries, with internal cross-border M&A accounting for $287 billion, three times the flow of the precedent year, mainly because of the high volume of reinvested earnings, derived from the good profitability of corporations in the whole developed world. The United Kingdom played the most relevant role for that year because of important international M&As, and also emerged as an investor, with its firms responsible for a lion's share of cross-border M&A purchases of United States firms, including bigger ones. The situation of Denmark, where there was an upturn in FDI inflows to $5 billion in 2005, after the disinvestments trend in 2004, with $11 billion flowing out the country, was remarkable too. In 2006, the 25 countries of the EU accounted for about 41% of total FDI inflows; flows to most countries in Europe remained stable or rose as compared to those in 2005. In that year, Germany and France turned out to be the largest investors in the US (the largest recipient country), making European countries particularly relevant from the point of view of the outflows: more than half of total outflows from developed countries in 2006 were from those countries, altough the total amount fell slightly to $572 million. In general, FDI flows into the 25 EU countries rose by 17% in 2006, to a total of $585 billion, and also for that year intra-EU FDI was responsible for an appreciable proportion of inflows into EU member countries. The internal trends can be summed up with lower flows to the United Kingdom (-11%, but still the most important recipient in the continent) and the Netherlands and increased flows to Belgium, Germany, Italy and Luxembourg. In 2007, despite the beginning of the financial crisis, three EU countries (the United Kingdom, France and the Netherlands, in that order) received record FDI inflows, while European companies took advantage of the low value of the United States dollar with respect to the euro, that made acquisitions in the United States relatively cheap despite the financial turmoil affecting the banking industry in that country. FDI flows into the 27 EU[6] countries rose by 46% in 2007, to a total of $854 billion, driven by the high level of reinvested earnings, derived from the good profits of European firms; the United Kingdom retained its position as the largest FDI recipient in Europe in 2007 with inflows increased by 26%. In the same period, outward FDI from the EU countries nearly doubled, to $1,142 billion. The new dynamic of FDI outflows from the EU subregion after stagnation in 2006 reflected the financial strength of many European corporations that undertook several very large foreign acquisitions.

[6] In 2007, two countries joined the Union, Bulgaria and Romania

Interesting facts emerge from the analysis of capital flows to the new Member States from Central and Eastern Europe (named NM10)[7]. All these countries recorded large private capital inflows from the late nineties until 2007, resulting a turning point when the financial crisis broke out. These arrivals were coherent with the neoclassical model: capital flowed from advanced to developing economies driven by higher returns on invested capital and encouraged by the prospect of EU accession, which became actual between 2004 and 2007; this enlargement meant economic and financial (especially banking) liberalisation and an overall lower risk perception. As Jevcak, Setzer and Suardi (2010) observed, "persistent large current account deficits and negative foreign asset positions in some countries appeared associated to consumption and investments, which made these countries extremely vulnerable to foreign capital reversal"; in particular, they found that such inflows were pushed by global driving forces, exposing these countries to international crises. However, we cannot forget that this area started to be attractive because of relatively low labour cost, increased institutional and political stability and capital liberaliziation.

With the exception of Slovenia in 2002, all NM10 were in a net external borrower position from 1999 until 2008, when external borrowing started to decrease in Baltic countries and in Romania. After the 2004 enlargement of European Union, un-weighted average external borrowing accounted for 6,7% of GDP in 2005 and 10,6% in 2007. The composition of these liabilities varied among countries, with the FDI getting more and more important year by year.

[7] The countries considered are Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia



Composition of Gross Foreign Liabilities in 1999 and in 2009, graph taken from Jevčák, Setzer and Suardi (2010)

Focusing on the years before the crisis, FDI inflows into the 10 new EU member countries rose in a year by 19% in 2005 to $34 billion. Most of this increase in inflows went to the Czech Republic, with inward FDI rising by $5 billion to reach $11 billion in this country, which turned out to be the third largest FDI recipient in Eastern Europe, just behind Poland and Hungary in terms of stock. Hungary registered record FDI inflows of $6.7 billion, and it is worth knowing that both in Hungary and the Czech Republic FDI have progressively shifted towards high-tech activities, including R&D. By contrast, FDI inflows into the other, large new EU country, Poland, declined but remained at a relatively high level of $8 billion. In 2006, FDI inflows to the NM10 retained their upward trend, accounting for a total of $39 billion resulting mainly from a continued rise in reinvested earnings. Poland was the top recipient country of the considered group, with record flows of $14 billion. FDI inflows to these countries joined the value of $65 billion in 2007. Inflows were unevenly distributed, with Poland, Romania, Czech Republic and Bulgaria in that order standing out as the top recipients, accounting for more than two thirds of the group's total, with investment from European companies dominating.

Within the European Union, the Economic and Monetary Union (EMU) represents a further step in the integration of economies: "it involves the coordination of economic and fiscal policies, a common monetary policy, and a common currency, the euro."[8] In 2005 this area accounted for a big part of the investments within the European Union, $257 billion out of $499, a huge increase compared with the data of 2004, amounting to $135 billion. Adopting the same currency, the exchange rate risk has been eliminated, making the investments in another country safer, and this explain why a large part of the foreign direct investments in Europe took place within the monetary union. In this area, the most remarkable facts in 2005 were FDI inflows into France, which more than doubled in a year, from $33 billion to $85 billion, the highest level since 2001, driven by an economic growth higher than its larger neighbouring countries (Germany, Italy) and an increasingly proactive policy to attract foreign investments. Inward FDI in Austria nearly tripled to $11 billion in 2005, mainly due to an increase in inflows of equity capital ($6 billion); in this country, as in past years, German companies were the largest investors accounting for 70% of FDI inflows and taking advantage of a favourable economic climate, lower wage levels than in other EMU countries and the country's geographical proximity to the new EU members. Also in Germany and the Netherlands there was a rebound in FDI inflows: in Germany it amounted to $47 billion, compared to -$10 billion in 2004, while the Netherlands received $39 billion in FDI flows in 2005, a good increase when compared to the value of $12 billion reached in 2004; in both cases, small inflows in 2004 were due to large repatriations of capital by foreign affiliates to parent companies. But in that year we also observed countries in contrast with this trend: FDI inflows to Ireland kept negative due to the repayment of loans to parent firms, flows to Belgium nearly halved and inflows into Spain also declined. In 2006, inward FDI flows to the 12 countries forming the European Monetary Union grew significantly, rising by 33% to $343 billion; inflows to Belgium almost doubled, while, for the third consecutive year, inward FDI flows to Ireland resulted negative at -$5 billion. A few EMU-12 countries, namely Austria, France and the Netherlands, saw a decrease in FDI inflows in 2006: France saw its inflows reduced by 15%, but kept

[8] http://ec.europa.eu/economy_finance/euro/emu/index_en.htm

its leading position, while in the Netherlands inflows amounted to $14 billion in 2006, down from $39 billion recordered in 2005. In 2007, inward FDI flows to the 13 countries of the Euro zone grew by 62% to $553 billion; a large part of the inflows was intra-EMU FDI, spurred by favourable economic growth, with European firms in the common currency area continuing to consolidate their activities. Seven of the 13 countries recorded a significant increase in FDI inflows; for example, inward FDI in the Netherlands grew considerably to a record $119 billion, while France increased the results of the precedent year by 34%, and also FDI into Spain grew for that year. However, in three EMU-13[9] countries (Greece, Luxembourg and Portugal) inward FDI flows declined in 2007, with Luxemburg accounting negative results (-$28 billion).

c) *The macroeconomic environment*

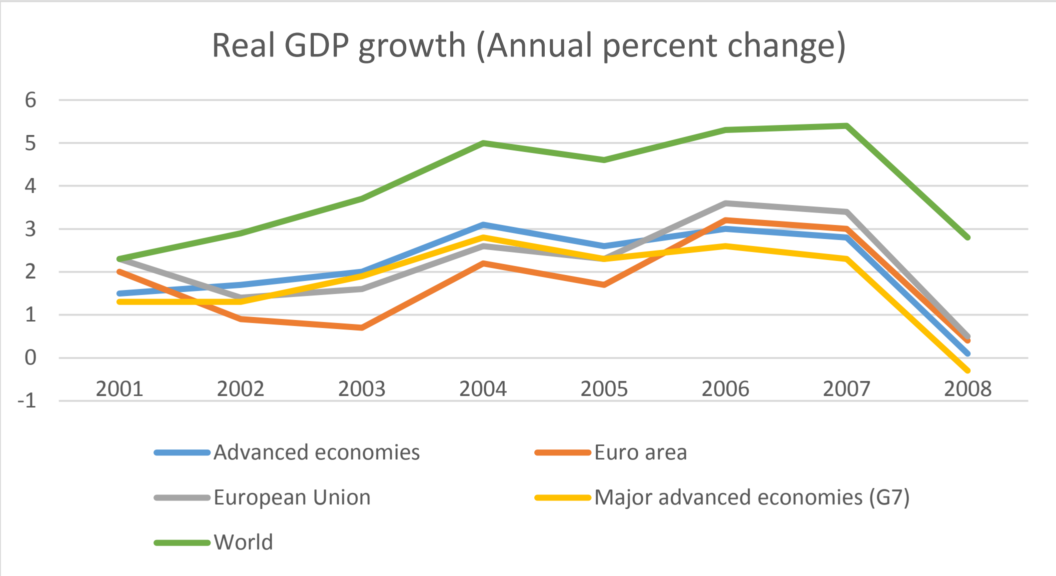
There are several elements that made Europe an attractive pole for investments. As we have seen, according to neoclassical theory capital should flow from advanced to emerging economies to exploit the higher return of capital teorically offered by developing countries. This is not confirmed by data, as we have seen that Europe was, in the period immediately before the crisis, the largest recipient area, with most inflows deriving from an exchange of capital between countries within the European Union. Beyond the uniformity ensured by this kind of agreement, economic theory also provides an explanation for such a pattern: the gravity model. According to this theory, bilateral trade flows are based on the economic sizes of and distance between two units, and this theory has been successfully tested for capital flows too. In particular, Hattari and Rajan (2011) found that “distance affects FDI relatively more than FPI”, so that geographic proximity is a key factor in explaning such types of investments, especially, according to the authors, when they are greenfield. In fact, when distance is reduced, transaction and information costs can also be lower.

According to the gravity theory, the richer the host and source countries the greater the volume of exchanges, implying, according to what has been found by Hattari

[9] Slovenia has adopted Euro since 2007

and Rajan, that FDI increase relatively more than portfolio investments. Given that EU contries are among the most advanced economies in terms of gross domestic product, also this fact is confirmed by our data. When we study the growth of the continent in the considered period, we find favourable statistics. Analyzing the growth of real GDP in those years, we find that for 25 countries of the European Union the aggregate increment between 2004 and 2005 was only 2,3%, slightly lower than the average for the advanced economies (2,6%) and significantly slower than the growth of some emerging economies like developing Asia (9,5%) and Central-east Europe (5,9%). But if we look at the growth between 2005 and 2006, we can observe an increment of 3,6%, lower than the one faced by developing countries but higher than the 3% on average faced by advanced economies. One year later, the increment of the GDP in the EU was recorded at 3,4%, still higher than the 2,8% of the other developed economies (2,3% if we limit the investigation to the G-7 countries). In those years, looking at the advanced economies, the European Union seemed to be the region with the best perspectives. If we focus on the euro area, data are less convincing but still interesting: a growth of 3,2% in 2006, and of 3% in 2007; it is clear that the most interesting realities in terms of growth were the Central-east Europe countries. And even when we consider the period between 2007-2008, when the crisis broke out, the perspectives of growth were better than the ones of other developed economies: 0,5% (0,4% if we limit the analysis to euro area), against the 0,1% of the others.

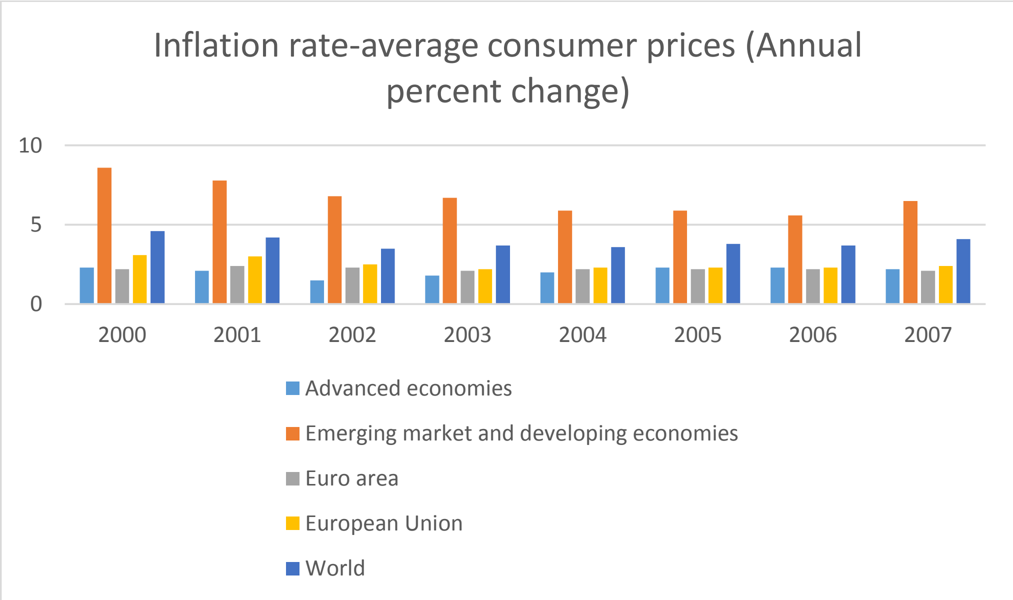
The growth in terms of gross domestic product means that an economy is healthy, that consumption is growing and that investments in technology, infrastructure and human capital are expected to be made, making an area more appetible for investors.



Graph realized with data from International Monetary Fund (IMF)

Moreover, the European region showed stability, both politically and economically, attracting investors willing to accomplish long term projects, and the ability of governments to promote sound macroeconomic policies can be expressed not only in terms of sustainable economic growth, but also by low inflation rates. In fact, if we consider inflation, we observe that the price growth in this area was substantially under control. Between 2004 and 2006 the European Union showed an inflation rate of 2,3% per year, in accordance to the one presented by other advanced economies, but significantly lower than the percentage exhibited by emerging markets, which showed rates between 5,6% and 5,9% per year. Focusing on the common currency area, we observe even lower rates (2,2% per year), coherent with the main purpose of the European Central Bank to control the growth of price (by the statute “the primary objective of the European System of Central Banks shall be to maintain price stability”, which is numerically defined as an annual increase close but remaining below 2%). In 2007, the European Union presented an increment of 2,4% of the level of prices, a little higher than the one faced on average by other advanced economies (2,2%), while the euro region showed a 2,1% increase.

This factor is very important, as it has been demonstrated that the macroeconomic instability, characterized by a high inflation or a banking crisis negatively affects not only portfolio investments, but also FDI (Kinda, 2010). In this sense, from these figures we are able to make an evaluation about the stability of the area, but also about the credibility of the central bank, which, meeting its main objective, demonstrated to be a reliable institution with a substantial control over financial and banking system.

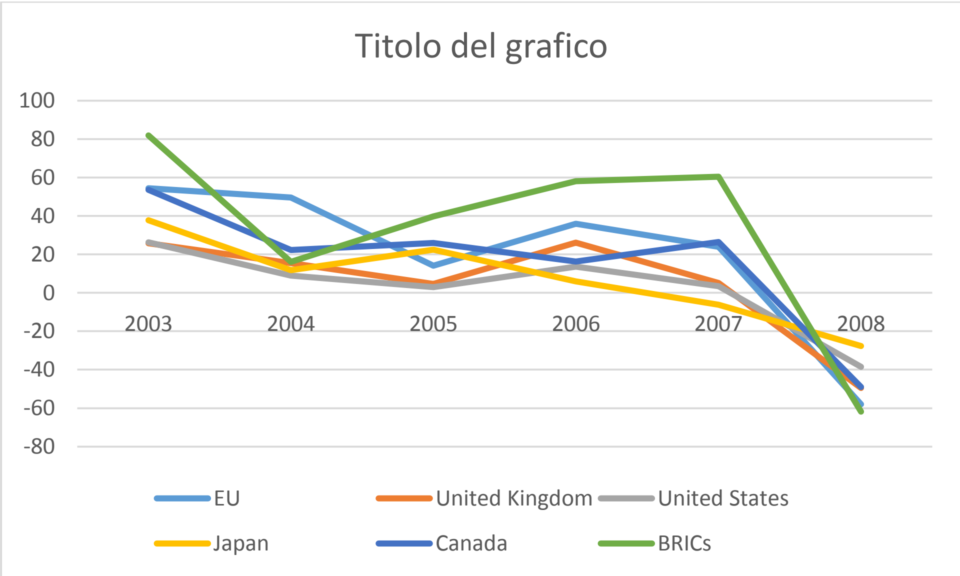


Graph realized with data from IMF

Considering the trend of its enterprises as another parameter of the attractiveness of a market, we look at the value of the stock exchange markets. If we consider the Standards&Poor Global Equity indices (measuring the dollar price change in the stock markets)[10], we find that, on (un-weighted) average, the increment of the value of the stocks of a member country of the European Union was about the 14% in 2005 (with the highest increment by 43,5% registered in Czech Republic), against an increase of 3% presented by the United States market and +4,7% performed by the United Kingdom. One year later, the increment on average for an EU country was almost 36%, with the peak reached by Slovenia (+74%), versus the 13,6% and the 26% showed respectively by the USA and the UK. In 2007, the Stock markets of the European Union performed averagely +24% with respect to the result of the previous year; even in this case, the pulling country is among the

[10] S&P Global Equity Indices measure the U.S. dollar price change in the stock markets covered by the S&P/IFCI and S&P/Frontier BMI country indices

developing ones, with Slovenia standing out as the leader by doubling the value of its stock market. In the same year, the USA recorded an increment of 3,5%, while the UK's stock market rose by about 5%. Globally, only the BRICs' stock markets on average performed better than the European Union for the years taken into consideration, with an increment of 40% in 2005, an additional growth of 58% in 2006 and an increase of 60% in 2007; but we have to consider that these last results were more volatile than the ones reported by advanced economies, with an average standard deviation of 51%[11] for the BRICs, against 34,4% for Europe and 18% for the United States.



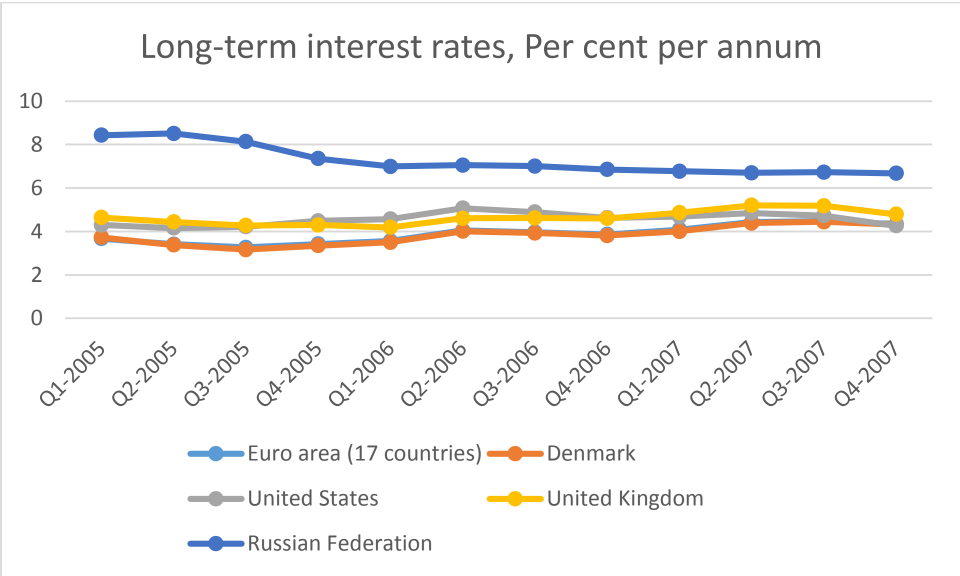
Annual % increment of S&P Global Equity Indices, per areas (average among countries), with data from World Bank

As we know, investments are inversely correlated with the cost of capital. In this case, to check these data, we use the long-time interest rate, observed by the Organization for Economic Cooperation and Development, as a benchmark for the general level of the cost of capital[12]. Moreover, this statistic is important to evaluate risk sentiments toward a country. We note that, from 2005 to 2007, the

[11] The standard deviation has been measured using as data the performances of national stock markets in the period 2003-2012

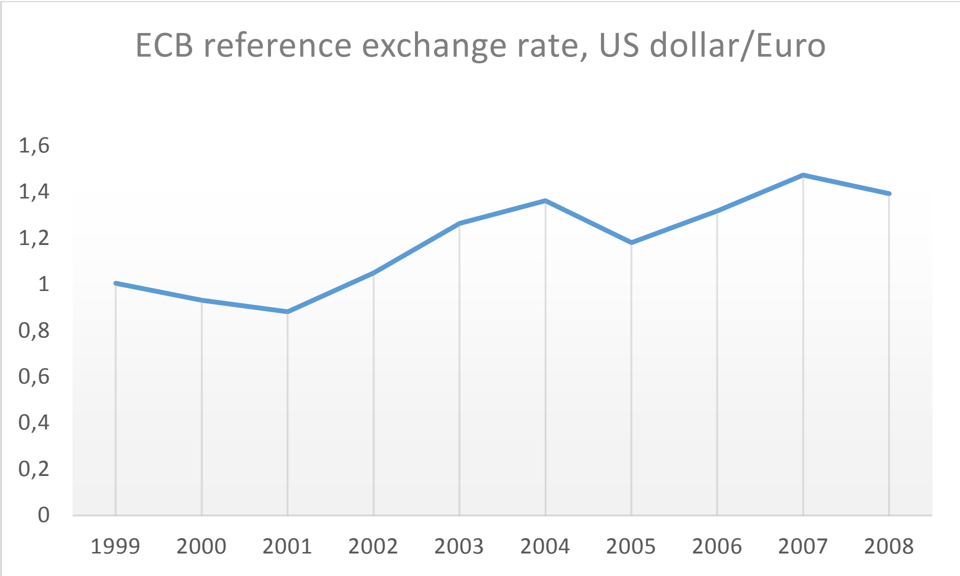
[12] According to the OECD "'long term rates are secondary market yields of long term (usually 10 year) bonds". To gather these data, the organization has used statistics provided by national central banks.

Eurozone showed low rates when compared with the United States and the United Kingdom data, while the statistics from the other countries of the European Union (like Denmark, Czech Republic, Slovak Republic, Slovenia) were quite close to the Eurozone ones; Japan is the only country displaying inferior levels, below 2% for each period considered. If we consider these data in comparison with developing countries like Russia, the difference increases.



Graph realized with data from OECD

Focusing on the Eurozone, currency is an important statistic to evaluate, also because, as growth and inflation, it is a good indicator of the soundness of policies implemented by the Central Bank. Considering the position of the euro area with respect to the other countries, we notice that in these years the strength of euro over the dollar and the other main currencies made the region attractive, given the expectation of further appreciacion. If in 2005 one euro was able to buy 1,18 dollars, in one year the exchange rate rose to 1,31, showing an appreciacion of the european currency by 11%, while in 2007 the exchange rate rose to 1,47, an increase of 12% in just a year.



Graph realized with data from European Central Bank

All these factors can be considered a proof of the stability and sustentable growth of the region, but there are other aspects that cannot be easily represented by figures and that have been adduced by economic literature as possible reason to explain why capital tends to flow to already developed countries, and so in our case, to advanced Europe, despite other economies with higher rates of growth and non-saturated markets which have not been exploited yet. As it was highlighted (Kinda 2010) with respect to infrastructure and financial development, the indeces of physical and financial infrastructure positively and significantly affect private capital flow in each of its components, FDI and portfolio investments. In fact, there is evidence of the existence of minimal standards in order to guarantee prosperity of investments and thus attract FDI, since many economic activities require communication infrastructure (telephone, roads) allowing or facilitating the access to raw and intermediate materials but also the access to markets, reducing production costs. The government usually provides financing for infrastructure since firms can hardly support the cost. At the same time, we cannot forget that human capital is a component which is hard to measure but is able to ensure higher returns to the capital invested; as demonstrated by Manzocchi and Martin (1996), among developing countries a higher rate of educational attainments can lead to larger flows, given that human capital cannot be accumulated by borrowing abroad. So it may be said that the lower level of such resources can be considered an explanation for the minor FDI to developing countries with respect to developed ones.

However, even if instability in financial markets is more likely to affect portfolio investments, we cannot forget that a large part of foreign direct investments are made today through merger and acquisitions and so, whenever there is instability in the markets where the value of equity is determined these kinds of (direct) investments can be hit, as happened with the recent crisis.

3. The crisis

The global crisis broke out between 2007 and 2008, starting from financial markets, with the increasing default cases caused by subprime mortgages, and rapidly affecting real economy. According to Filippov and Kalotay (2009) the ongoing crisis was devastating because it resulted from the coincidence of three factors: the crisis of financial markets, the structural crisis in the world economy and the slowdown of the economic cycle. As a consequence of the crisis in financial markets, caused by the presence of toxic securities in the portfolios of many institutions, large financial institutions collapsed or were bought out by the state, with governments around the world spending public funds in packages to bail out their financial systems. It has been underlined how “not only private financial institutions (such as Lehman Brothers and Morgan Stanley), but even nations (such as Iceland) found themselves on the verge of bankruptcy”. This uncertainty led to falls in stock markets prices and, as financial institutions had to deal with liquidity problems, there was a decrease in international bank lending. At the same time, the world was living a structural economy crisis: industries that used to perform well in terms of growth over a long historical period fell into deep recession as the demand slowed down. The third fact considered is the slowdown of the economic cycle, which made the effects of the crisis particularly devastating.

For all these reasons, the year 2008 marked the end of the positive trend for Foreign Direct Investments, which had increased from 2004 to 2007. The downturn was particularly adverted in developed countries, as the high integration of their financial markets acted as a catalyst for the crisis, originating from the United States. With the weak aggregate demand structural economy and the financial system facing liquidity problems, to which we add the stronger sentiments of risk aversion, many planned takeovers and greenfield projects were postponed, but a disinvestment process from existing foreign affiliates to their parent firms started to exceed new investments.

a) A global framework

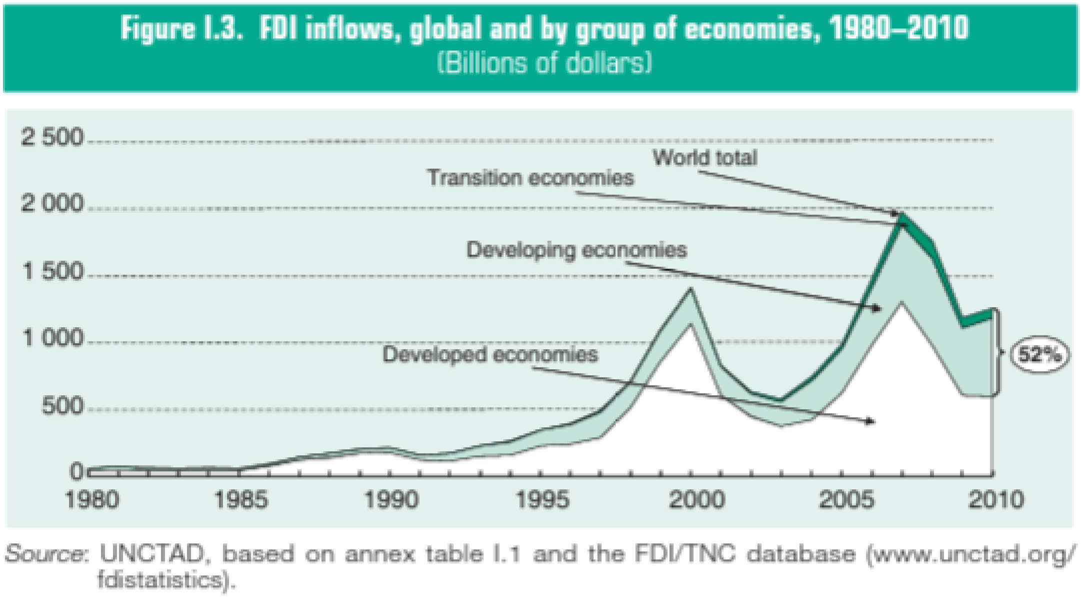
In 2008 the pattern of Foreign Direct Investments changed radically. On the one hand, the total amount of flows declined, on the other developing and transaction economies gained share in global distribution of FDI.

After four years of growth, according to the World Investments Report 2009, global FDI inflows fell from the record value of $1,975 billion reached in 2007 to $1,790 billion in 2008, a decline of 10%. As the crisis was absorbed differently in developed economies, where it arose, in developing and transition countries, the impact of the reduction in FDI inflows had different measures. That year it mainly affected developed countries, which showed a decline of 22% in FDI, mostly because of the fall in cross-border M&As, that fell by 39% in value after a five-year boom ended in 2007: in particular, Europe and Japan showed the worst statistics in this case, with falls respectively by 56% and 43% in international mergers and acquisitions. Inflows in this part of the world for 2008 amounted to $1,020 billion, and the decline occurred in all major host countries except the United States, that conserved its role of the largest recipient country. The trend followed by developing countries was different, with FDI inflows continuing to grow, even if at a slower pace than in previous years, posting a 13% to $650 billion; in this case the lion's share of the total value was taken by South-East Asia with a total amount of $291 billion. Also the transition economies of South-East Europe and the Commonwealth of Independent States exhibited positive results, with inflows rising by 33% to the record value of $121 billion in 2008. With these numbers, the overall distribution of FDI flows changed, with developing and transition economies receiving 43% of the total inflows. If we look at the outflows, the lower corporate profits prompted developed countries' firms to reduce their investments abroad; in fact outflows fell by 17%, to $1,507 billion in 2008. The decrease occurred in outflows from the United States and from the euro area, as well as from the United Kingdom, where TNCs cut their investments abroad by 60% in 2008, reflecting their deteriorating financing capabilities. However, FDI outflows from developing countries rose by 3% pushed by Asian economies, especially China, which continued to improve their position as FDI sources.

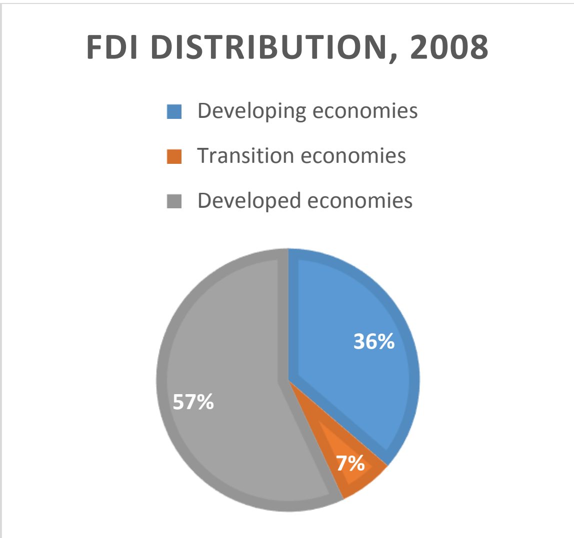
A drastic decline in FDI flows worldwide was also observed in 2009: global FDI inflows fell a further 33% to $1,198 billion. FDI inflows to developing and transition economies suffered an overall decline by 23% to $591 billion in 2009, after six years of continuous growth. But this decline was still lower than the one faced by developed countries (-41%). With this trend, for the first time ever, developing and transition economies started to represent half of the global FDI inflows. A notable fact is that in this year half of the six top destinations for FDI flows were developing or transition economies, even if over two thirds of cross-border M&As transactions still involved developed countries. Among the largest FDI recipients, China rose to second place after the United States. FDI flows to developed countries suffered the worst decline among all regions considered, contracting by 41% to $606 billion, with the decline strongly affecting North America rather than Europe. After an eight-year upward trend, FDI inflows to South-East Europe and the Commonwealth of Independent States (CIS) shrank to $72 billion, showing a 40% decline from 2008; in particular, the most important region, the Russian Federation, almost halved its inflows, although it ranked as sixth in a global overview, suffering the lower flow of resources from Europe, traditionally the most important investor in this area. It is interesting to note that, even though the current economic and financial turmoil is far more severe than the one faced in 2000-2003, this setback was not as pronounced as during the previous economic downturn. Also the new pattern of FDI outflow is similar to: outflows from developing and transition economies contracted by 21% in 2009: but the contraction was even more accentuated in developed countries, where FDI outflows shrank by 48%. In this case, the share of the outward investment from developing countries and transition economies remained smaller, but approaching a quarter of global outflows. However, developed countries still remained the most important source of foreign direct investments, with the United States conserving their leading role; from an overall point of view, outflows largely exceeded inflows in the developed region.

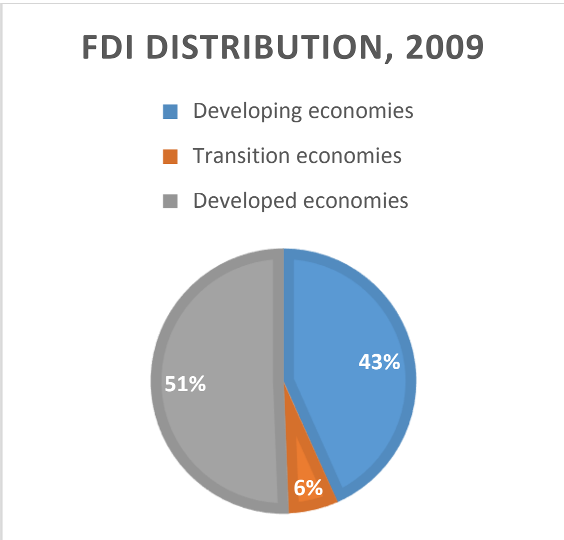
However it is worth to know that, despite the reduced pace, foreign investment continued to flow and FDI inward stock rose by 15 per cent in 2009, reaching $18 trillion.

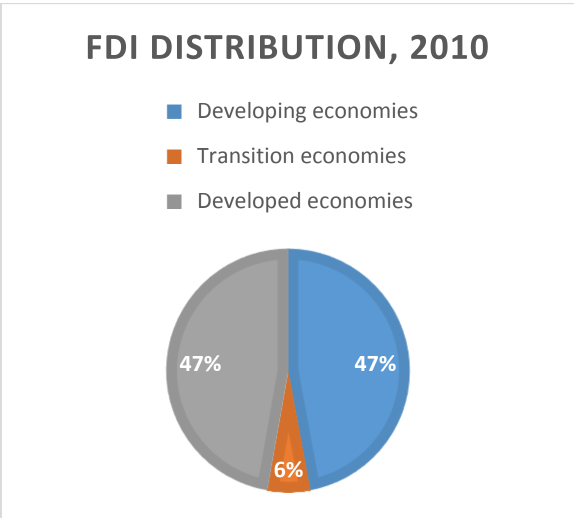
Global foreign direct investment flows rose moderately to about $1.31 trillion in 2010, showing an increase of about 9% over a year, but were still 15% below their pre-crisis average level (World Investment Report 2011). Developing economies increased further in importance in global economic balances, both as recipients and as investors in FDI, since international production and consumption shifted to developing and transition economies. Notable in this sense the role of China, whose inflows went up by 21%, to $115 billion, making the country the second largest recipient, the first in the developing world. Considering all the emerging economies, we find an increment of 19% (to $617 billion) in 2010, supported by the increasing levels of demand in those regions. Despite the recovery on global level, FDI inflows in developed countries increased only by less than 2% to $618 billion, with different pattern among sub regions: Europe, for instance, suffered a sharp fall, while the United States showed an increase of more than 40%, conserving its leading role as a receiver country. FDI flows to transition economies declined slightly in 2010, with the significant exception of Russia, which, representing a new relevant consumption market, saw its inflows raising by 19% in 2010, to $43 billion.
The downward trend in outward FDI from developed countries reversed, with a 10% increase over 2009, but this recovery pace was still slower than the one experienced by developing countries (+21%), which improved their market share, now at about 29%, as global sources of FDI.



Graph taken by World Investment Report 2011

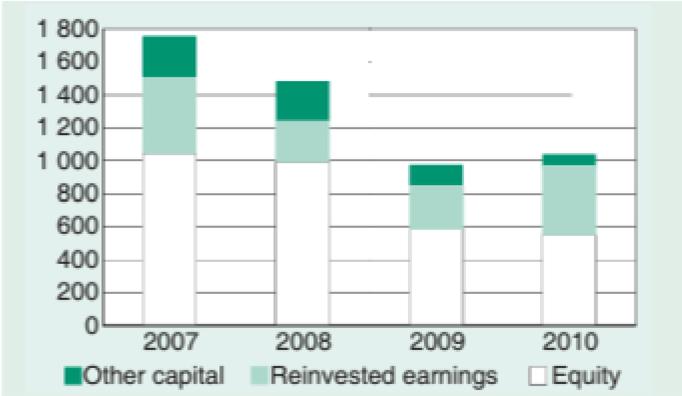






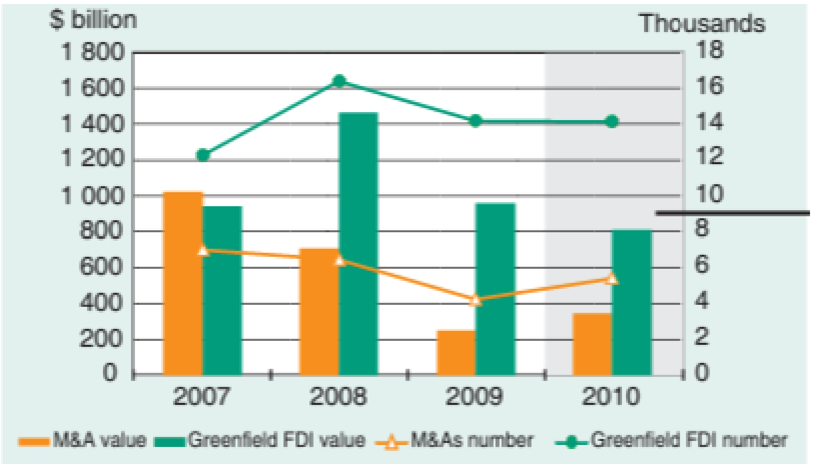
Graphs made with data from UNCTADstat

Generally speaking, significant declines occurred in all three components of FDI flows: equity investments, other capital flows (mainly intra-company loans) and reinvested earnings, where equity investments includes Greenfield investments and cross-border M&As, which were the most common way to invest abroad in the period before the crisis, especially for developed countries. The fact that the least component considered also fell is symptomatic of a deep crisis: while the other kind of investments can be related to transitory low corporate profits and short-term liquidity problems, equity investments have a long-term prospective, so a decline in these flows means a crisis affecting structurally real economy. On the one hand, considering the mode of investment, we find that for all the years after the outbreak of the crisis, cross-border M&As have been the most affected, both for the lower value of the enterprises involved (given the breakdown of stock markets) and liquidity deficiencies; this way of investing abroad is, in conditions where the financial markets are reliable and efficient, the preferred one, since the value of the targeting firm is given by the market. On the other hand, greenfield investments were more resilient to the crisis in 2008, but seemed to be hit badly in 2009. In 2008 international M&As in developed countries went down by 39%, with a significant reduction in the amount of megadeals, and by 35% in the whole world, while greenfield investments remained stable for the first three quarter of the year. In 2009 both reinvested earnings and equity investments kept this trend; for that year, the World Investment Report noted that the number of cross-border M&As transactions declined by 34%, with a 65% reduction in terms of value, while greenfield projects seemed less volatile, with a 15% decline. The recovery moment for M&As occurred in 2010, when the value of these kinds of deals increased by 36%, with an overall flow far from the peak reached in 2007; it was mainly driven by the value of cross-border M&As into developing economies, which almost doubled in one year. But in 2010 the value of greenfield investments also dropped.



Graph taken by World Investment Report 2010, UNCTAD

We can say therefore that in the period following the outbreak of the crisis greenfield investments gained the most important role when compared with mergers and acquisitions, and it is indicative of the lack of confidence in the prices determined by financial markets and the willingness of the receiving countries (now prevalently developing ones) to exercise a control over these investments.



Graph taken by World Investment Report 2010, UNCTAD

In the sectorial distribution, we observe that the crisis also changed this structure, with the bulk of transactions shifted toward primary sector and, among services, to no-financial ones. Generally speaking almost all the activities were hit, but the primary sector, especially industries related to food, saw their transactions increase. In 2008, the value of cross-border M&As[13] in the primary sector grew by 17% (a 125% increment if we focus the attention only on food, beverages and tobacco industries), while a further increase in the value of cross-border M&As investments in the mining, quarrying and petroleum industry group sectors was triggered by the relatively high prices of oil and other commodities of, up to $83 billion. Manufacturing and services M&As declined, with a strong loss in financial services (-73%). This trend continued in 2009, when all sectors, in particular manufacturing, were affected: in the primary sector the value of M&As arranged transaction fell by 47%, in manufacturing by 77% and in services by 57%. In that year, more industries started to advert the crisis, not only the most cyclical ones; for instance, a decrease in the consumption of energy that pushed down investments in this sector, normally one of the most intensely attended by international transactions, was recorded. The value of FDI projects in manufacturing rose by 23% in 2010 compared to 2009, gaining share in the global distribution of FDI per sector, but it was not as strong as before the crisis.

b) Focus on Europe

In the period immediately after the outbreak of the crisis, Europe suffered a drop in the financial market more than the United States, even if the crunch took place in this country. It is mainly due to the fact that financial markets in developed countries are strictly integrated, so European countries could not avoid a crisis originated in United States.

In general, we have seen that developed countries suffered the crisis in terms of diminishing foreign direct investments more than developing ones, and it is also true for the crunch of new economy occurred during the first years of 2000, when the course of capital flow exchanges slowed down. This volatility, if we look at the theory, should be a characteristic of portfolio investments rather than FDI, and it seems to affect more advanced economies. One possible explanation for such instability is that, from the last decades, merger and acquisition started to be a very relevant vehicle of direct investments. According to the theory and to

[13] The investment Reports use M&As, easier to compute, as indicator of the dynamism of a sector

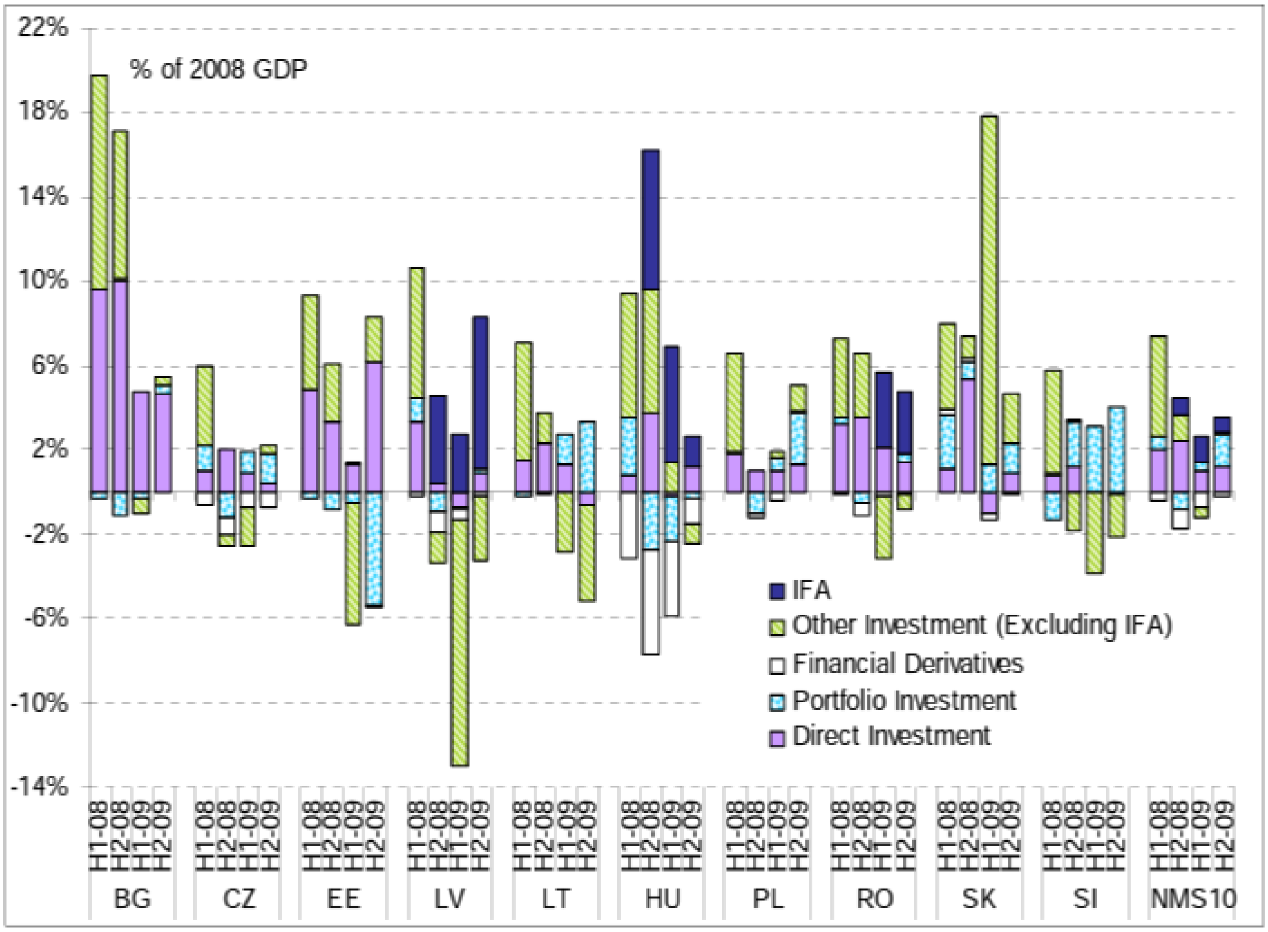
balances of payments, an equity investment is classified as direct when it involves at least a 10% value of ownership; this is a conventional threshold, and it cannot be excluded that many investments classified as direct are actually portfolio investments, and that, given the higher volatility of these, are more likely to swing at each market movement, as we have observed during the last decade. In particular, examining the reaction of FDI to several factors, such as distance, Hattari and Rajan (2011) found that the behaviour of M&A is more similar to FPI then to other forms of direct investments as greenfield projects. In fact, if we consider that for the period we are examining the majority of cross-border M&As occurred among advanced economies, we can explain why these economies suffered markets' breakdowns more than the others. Furthermore, as it has already been pointed out, this kind of equity investments occurs at the prices determined by financial markets, so that a period of instability, even when not structurally affecting real economy, will cause a contraction in these transactions given the lower reliability of markets in determination of values.

In the majority of EU-27 countries foreign direct investments fell in 2008; considering the whole region, a decline of 37%, to a total of $542 billion, was reported. Nonetheless, this area resulted in being the most important pole for inward FDI, given the high volume of intra-EU investments. In Sweden the increase in inward FDI, which almost doubled in 2008, was essentially driven by an increase in cross-border M&As, with some larger acquisitions, consequence of a recent trend to privatization, hiding the fact that the country was severely hit by the crisis, as confirmed by data in 2009. One of the countries most severely hurt by the markets' collapse was the United Kingdom, which lost its position as the largest European recipient; FDI inflows halved in 2008 to about $97 billion. The fall in inflows was mainly due to equity investments, which fell in value from $161 billion in 2007 to $91 billion in 2008 – the lowest value since 2005, while reinvested earnings of foreign affiliates in the United Kingdom amounted to $31 billion (37% lower than in 2007); also intra-company loans of foreign corporations to their affiliates in the United Kingdom became negative (-$24 billion), reducing net FDI inflows to this country. In 2009 FDI flows into the 27 European Union countries dropped by 34% (to $357 billion), mainly because of the contraction in M&As, which halved to about $116 billion; for that year, this region showed on average a much lower rate of decline than those of North America and Japan. As in the precedent year, inward FDI to the United Kingdom declined by about 22%, weakening the role of the country in the European panorama with respect to other countries such as France and Germany. Also in 2010 the trend turned: if in North America inflows of FDI showed a strong recovery with a 44% increase over 2009, inflows to the whole of Europe were down by 19%, -11% recorded in the European Union; the United Kingdom kept on following its negative trend, showing a 29% decrease.

If we consider the new members group of the European Union, on which Jevcak, Setzer and Spatafora (2010) focus their analysis, we find that these countries had attracted capital in several forms since their financial liberalization, but also that from 2008 external borrowing, which had financed the growth of these states, started to decrease, turning positive in some cases. In fact the (un-weighted) average external balance for the NMs increased from a deficit of about 9% of the GDP computed in 2008 to a surplus of more than 1% reported one year later. The most evident case was Bulgaria, one of the countries that relied most on foreign direct investment to growth, which stopped being a borrower (with external borrowings accounting for more than 22% of GDP) to become a net lender. Since in some of these countries foreign liabilities accounted for a large part of the total stock of investments (such is the case of Bulgaria, Hungary, Latvia and Estonia), the area considered was particularly vulnerable to shocks that could hit its main sources (developed countries) and were beyond local control. In fact the same study reports that about half of foreign liabilities in this zone were held by investors from the Euro area. Nevertheless, it was reported that inward FDI to the nine[14] countries that did not participate in the EMU fell only by 9% in 2008, to $65 billion, a much smaller rate of decline than that of inflows into the EU-15 countries; it was mainly due to the fact that in these markets foreign investors preferred to withdraw portfolio investments, leading to capital outflows larger

[14] Slovenia adopted the euro in 2007, but for the purpose of this analysis is normally considered together with the other 9 countries of the European Union not belonging to EMU

than the one visible through FDI and to a new, higher relative importance of direct investments as a source of capital.



Sources: Reuters EcoWin, National Central Banks

Composition of Net Foreign Capital Inflows from H1-2008 to H2-2009, graph taken by Jevcak, Setzer and Spatafora (2010)

FDI inflows to the group in 2008 were unevenly distributed: the Czech Republic, Hungary, Romania and Slovakia registered an increase in inflows, while Bulgaria, Estonia, Latvia, Lithuania and Poland saw a decrease. In this area, the four countries together accounted for the lion's share (77%) of the group's total inflows: Poland ($16.5 billion), Romania ($13.3 billion), the Czech Republic ($10.7 billion) and Bulgaria ($9.2 billion). Since many companies put off or suspended their expansion plans due to the global financial crisis, FDI inflows into Poland and Bulgaria declined considerably in 2008, as the automotive industry, which for many years had been the key driver of strong FDI inflows to the new EU member countries, started to suffer a fall in economy. In 2009 in Slovakia, Hungary and Slovenia the inflows resulted negative, indicative of the willingness of international corporations to disinvest in these countries, but generally all the states considered suffered a reduction in inward FDI. In 2010 the Czech Republic, Hungary, Latvia and Lithuania showed improvement in total FDI inflows, while the other countries considered recorded a lower inward foreign direct investment flow when compared to 2009. In particular, considering two among the strongest countries, Poland performed a -65%, while Romania got negative inflows,-$31 billion.

Focusing on the European Monetary Union (EU-15), inflows declined in 2008 by 35%, to $357 billion. As in the case of the European Union, this number was largely alimented by flows between member countries: in fact in 2008 investments from countries not belonging to the European Union fell to only €50 billion, a very small amount when compared to the €365 billion entered in 2007. Ten of the 15 EMU countries recorded a significant decline in FDI inflows in 2008; in France, FDI inflows fell by 33% from their record level of $96 billion in 2007, to $64 billion, since a big reduction occurred in intra-company loan, equity investments and reinvested earnings. Nevertheless, France ranked third among FDI recipients in 2008 in the European Monetary Union, with inflows spread across a wide range of sectors. Investments inflows fell sharply also in Germany, which showed a 90% decline, receiving only $8 billion, driven by a fall in the net equity capital component of FDI. Inward FDI in the Netherlands in 2008 turned out to fell by 96%, mainly because intra-company loans shrank. The same occurred in Ireland, particularly hit by the financial crisis, where the investments resulted negative in 2008 (-$16 billion). In sharp contrast, inward FDI to Spain increased by 20%, to $77 billion, driven by several high-value cross-border M&As. The positive trend continued also in Portugal, Luxemburg, Slovenia and Greece. In 2009 FDI inflows to France declined sharply by 62% to $24 billion, but the most affected country in terms of reduction in the volume of inward investments was Belgium, which showed a drop of $132 billion. Some EU countries experienced an increase in FDI flows in 2009; for instance Germany, whose inflows for the year considered nearly triplicated to $324 billion, resulted in being the fourth-largest host country in the EU in terms of accumulated investment stock. In 2010 France partially recovered the losses of precedent years with an increment in inward FDI by 27%, while

Belgium gained the position of larger receiving country with more than $80 billion of inflows recorded, in front of Germany, which accounted FDI inflows for the value of $47 billion. In Spain inward investments nearly triplicated, after the breakdown of 2009, when it received new flows of foreign investments for only $10 billion.

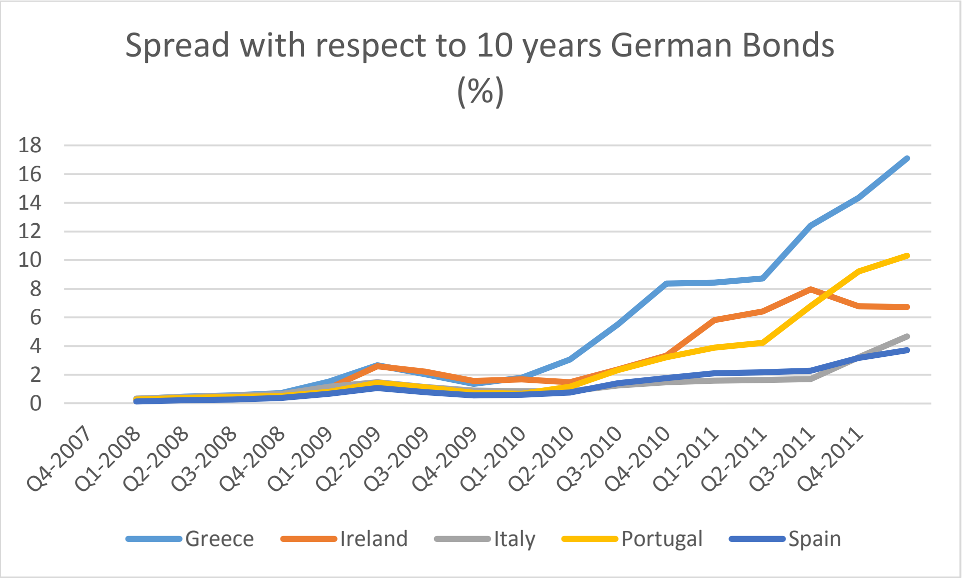
c) *The macroeconomic environment*

Given the high integration in financial markets, especially among developed countries, consequence of globalization, the crisis which originated in the United States in 2007 suddenly affected Europe too. However, with exception of the United Kingdom, Europe has a different economic system, less governed by markets with a highly marked role of governments in economic affairs. A more intensive crisis affected Europe some years later, as from 2009, it is connected with the concern that some countries in the Eurozone would not be able to repay high levels of public debt accumulated over the years.

Even if no striking cases such as Lehman Brothers failure are recorded in the Eurozone, the climate of instability has also hit this huge market, forcing governments to set up safety plans leading to an increase in public deficits offering guarantees to banks which increase the risk perceived. Furthermore, when, as a consequence of real economy stagnation, the revenues from taxes fell, States were forced to issue new debt. This could have happened in any State, but in the EMU the consequences have been alarming because countries have committed themselves to respect some fiscal standards[15] and are no longer able to use monetary policy to limit excessive borrowing. With these concerns, the climate for investments is not the safest: governments which are in trouble do not invest in infrastructures and higher interest rates make it harder for firms to keep profitable relationships with local banks and institutions.

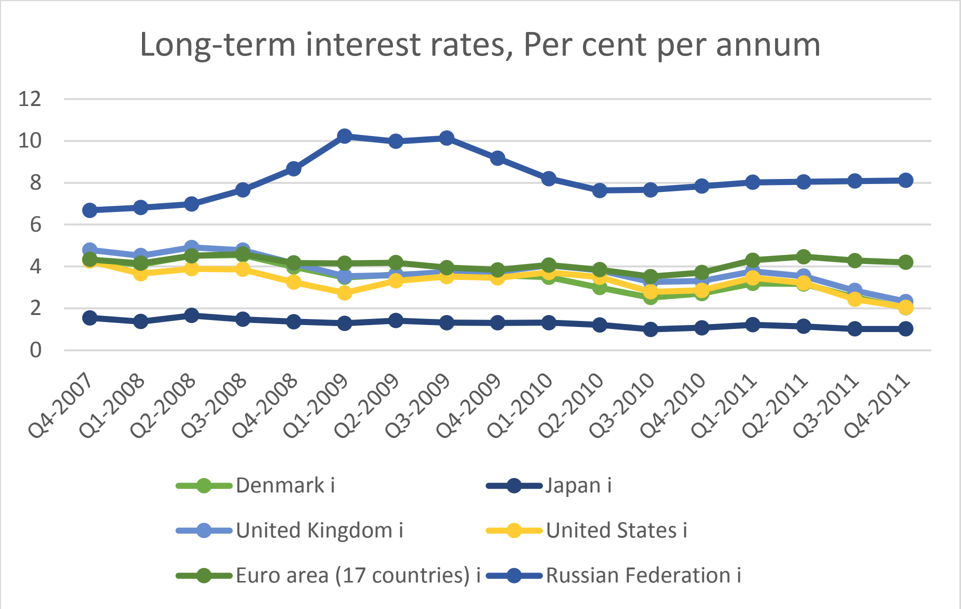
[15] According to Stability and Growth Pact fiscal discipline in the EU is ensured by setting reference values for annual national budget deficits (3% of GDP) and public debt (60% of GDP), and although the Pact applies to all EU members, it has stricter enforcement mechanisms for euro area members.

When we look at the interest rates, we find that for the so-called PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) the cost of long term debt has dramatically increased, especially if we consider the spread with the interest offered by the same kind of bond issued by Bundesbank, the German Central Bank. It was a signal that markets stopped believing that these countries were equivalent and asking different yields to finance different States according to the risk perceived.



Graph realized with data from OECD, computing the difference between the yield given by PIIGS bonds and German ones

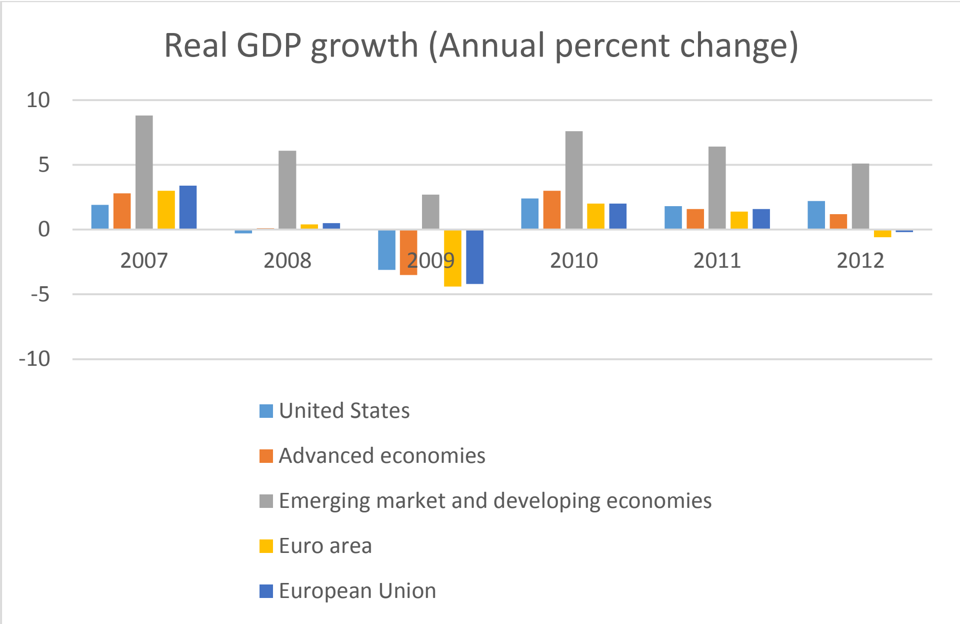
In general, considering long-term interest rate in the whole Eurozone (for bonds with 10-years maturity), we find that the averaged statistic is higher for that period than the one showed by other advanced economies such as Denmark or the United States, even if lower than the one that a developing country like Russia is required to offer. This is due to the high cost of debt of the weakest countries in the Euro area.



Graph realized with data from OECD

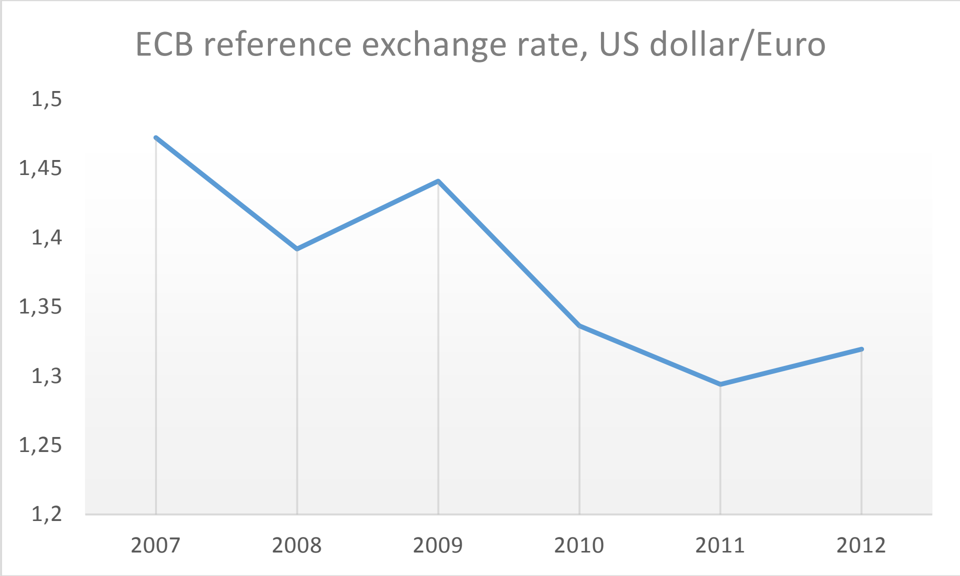
Moreover, even when we consider the perspectives of growth we note that Europe was affected later by the crisis with respect to other advanced economies. When we look at the growth of real gross domestic production in the United States in 2007, when the crisis broke out, we find that the increment was about 1,9%, considerably lower than the one showed by the European Union (3,4%) and Eurozone (3%), and generally lower than average for advanced economies (2,8%). One year later, when the financial crisis displayed its effects on real economy, we find that GDP in the United States fell by 0,3%, while Europe continued showing positive, even if only slight, results, with 0,5% increment in the EU and 0,4% in the only common currency area. But Europe started to show a negative trend in 2009, with a more severe fall in real GDP than the one showed by the United States: -4,2% (4,4% when we focus the analysis on EMU) against a less severe 3,1%. And when in 2010 the United States began to recover, with a 2,4% growth, the European Union and the European Monetary Union exhibited a lower increment in GDP, of 2%. As we can see in the graph, the trend has continued to be unfavourable to Europe also in the last two years too.

It is worth knowing that, for the considered period, developing countries exhibited high positive growth, shortening the gap with advanced economies not only in terms of investments, as seen, but also in terms of domestic production.



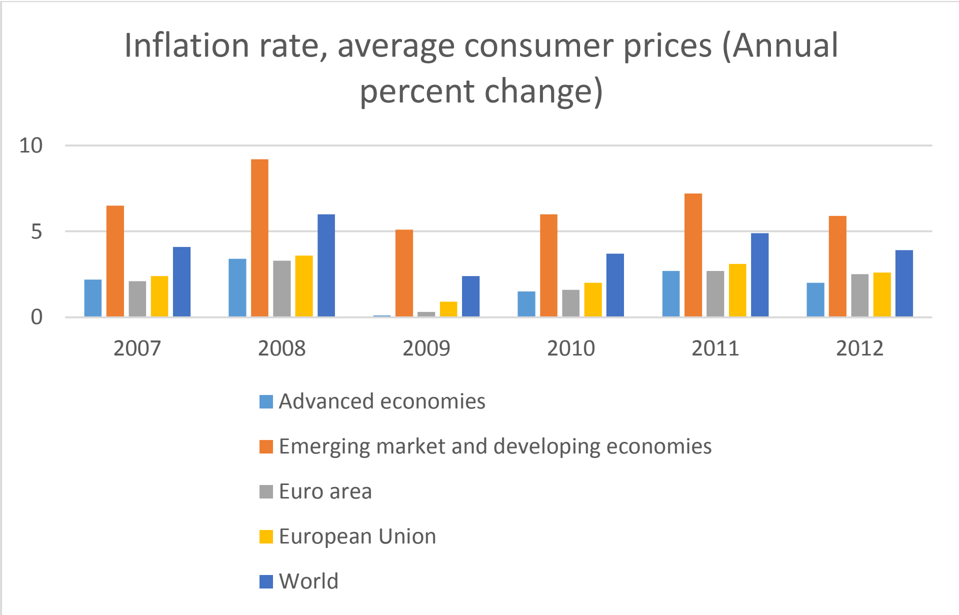
Graph realized with data from IMF

If we look at the trend followed by the common currency adopted by the European Monetary Union with respect to the US dollar, we find that in 2008 it started to weaken after years of appreciation, effect of the lower level of confidence adverted by markets with respect to investments in this area. In 2008 one euro could buy 1,39 dollars, showing a depreciation of 5,4% with respect to the value of 2007, when the exchange rate was recorded at 1,47. In 2009, as a consequence of the expansive monetary policy promoted by Federal Reserve, the dollar lost value, and at the end of the year one euro had a value of $1,44, with an appreciation of 3,6% for the European currency. One year later, the euro had depreciated again against dollar, with an exchange rate of 1,33, showing a fall of 7,6%. Since then, the exchange rate has shown to be quite stable, between 1,29 and 1,31.



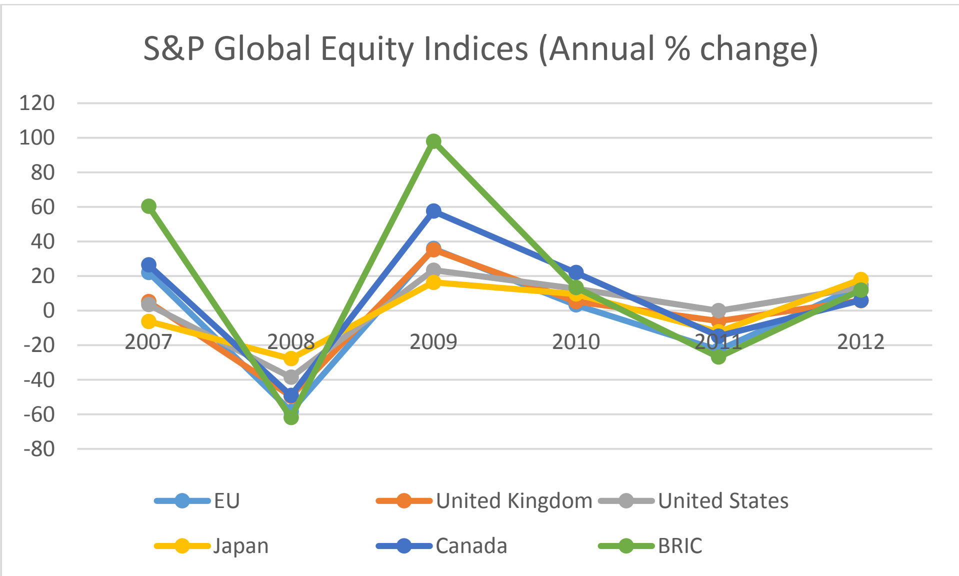
Graph realized with data from European Central Bank

If we look at the stability of the economy in Europe in terms of the control of prices, we find a substantial stability for all developed countries in 2008, with an average of 3,4% against the 6% increment of prices computed worldwide, and confirmed in Europe with an inflation by 3,6% in the whole European Union and by 3,3% focusing the analysis on the Euro area; emerging markets, however, showed a strong growth of price (9,2%). In 2009 the effects of real economy downturn, despite national monetary policies, were more evident. Developed countries exhibited an inflation rate of 0,1%, with this estimation heavily affected by prices in North America, because when we focus the attention on Europe we report a 0,9% rate for the EU and a 0,3% for the Eurozone. Looking at developing countries we find that prices did not slow down their rate of growth, showing an inflation rate of 5,1%. In 2010 expansive monetary policies in the US and other developed countries started to show their effects on prices; on average developed countries had an inflation by 1,5%, which was more marked in Europe, where the European Union exhibited an increment of 2% and EMU by 1,6%; at the same time, developing countries suffered, on average, an increase in prices of 6% with respect to the precedent year.



Graph realized with data from IMF

If we consider the behaviour of stock markets in Europe, we find that these suffered on (un-weighted) average the crisis more or less in the same measure of other economies, while developing countries (here represented by BRICs) showed more volatile results.



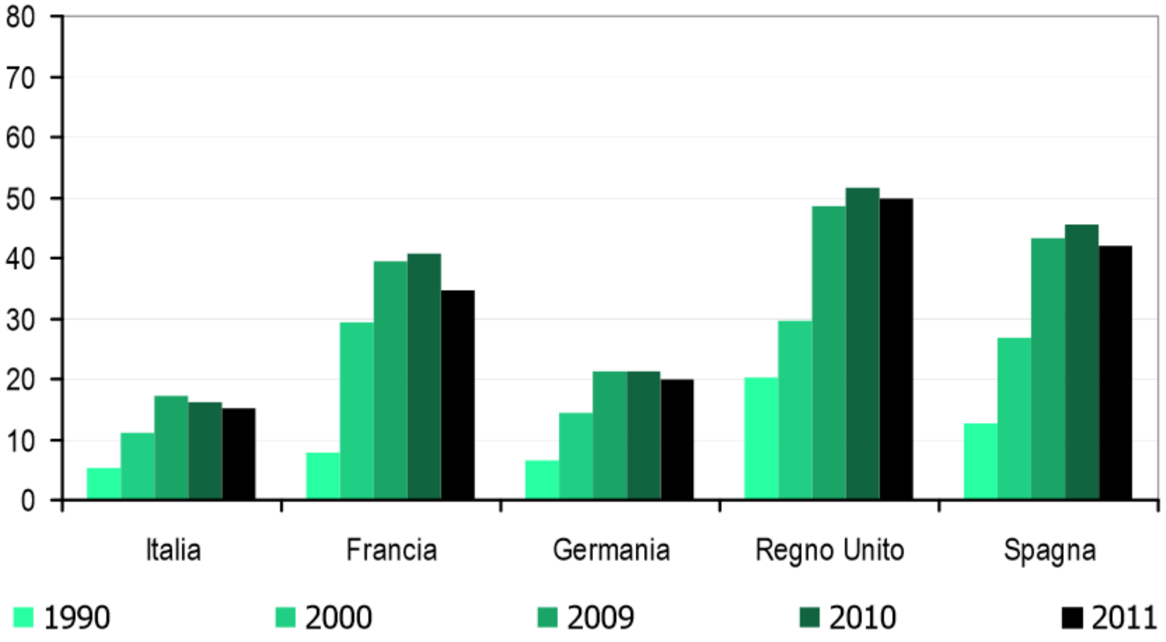
Graph realized with data from World Bank

4. Foreign Direct Investments in Italy before and after the crisis

a) *Trend in Italy in 2005-2010*

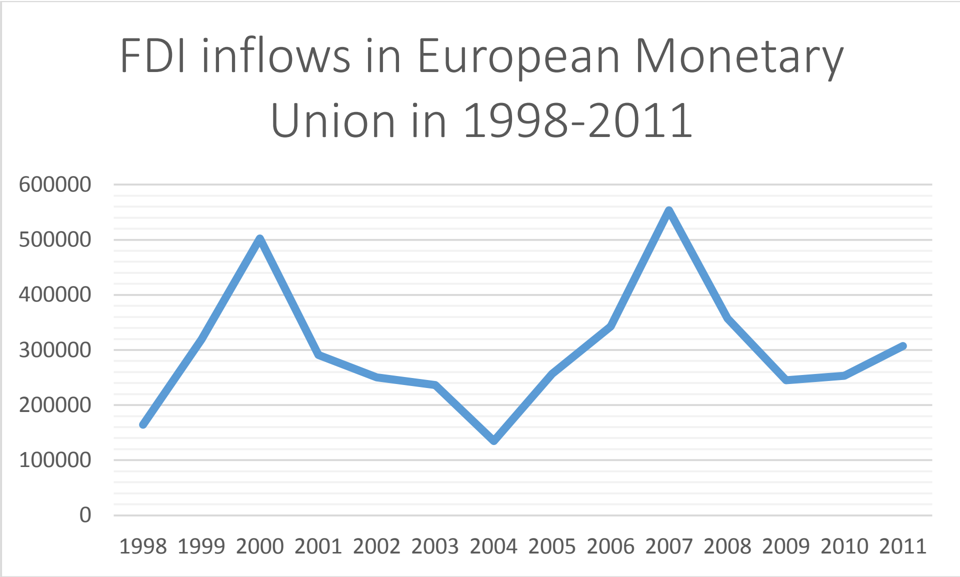
In the period considered, Italy followed the same trend of the whole common currency area: increasing Foreign Direct Investments in the years 2005-2007, bad results in 2008, when markets reacted to the crisis, and a partial recovery in 2009.

In general, the degree of internationalization of Italian firms has kept quite low. Pietrobelli, Rabellotti and Sanfilippo (2010) point out how "the reasons for this poor performance are many: structural factors such as the fragmentation of the private sector dominated by small and medium sized enterprises, specialization in traditional sectors characterized by low R&D expenditure, and the large size of the public sector". When we compare Italian data with other principal countries in the EU, we find that, despite its political and economic central position, the country does not show high outflows nor inflows of foreign direct investments. According to ICE, in 2011 the ratio between the stock of outward FDI and gross domestic product was equal to 23.4% for our country, more than halved compared to the average-Europe (55.9%) and the EU-27 (52.4%) also lower than the one showed by the country's principal neighbours, such as France (49.4%), Germany (40.4%) and Spain (42.5%). The results are similar when we compare the ratio inward FDI/GDP, as shown in the graph below.



Graph taken by ICE

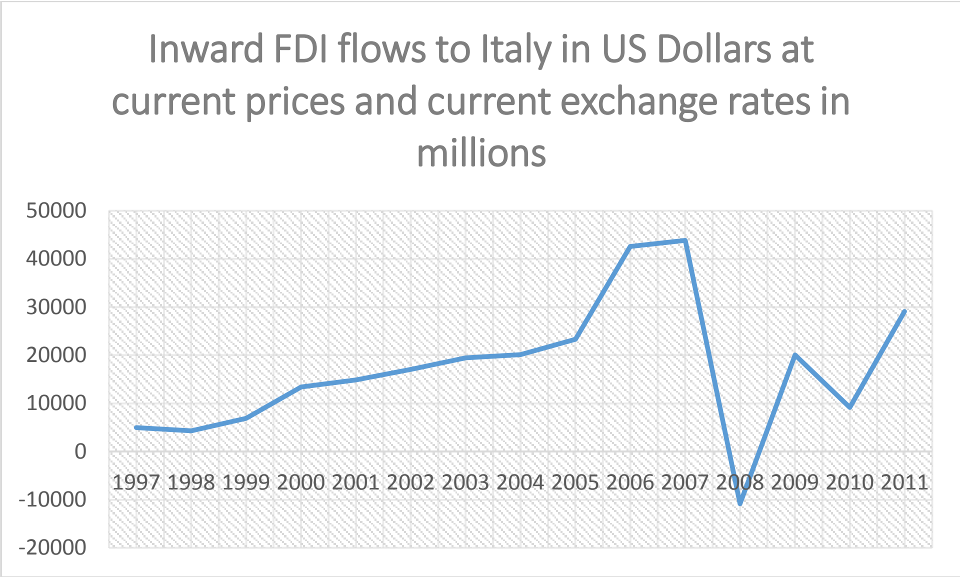
In general, from 1998 Italy showed growing flows of inward foreign direct investments, mainly due to the participation in the country to the common currency area, with the adoption of the euro in financial markets and regulation subjected to the uniformed standards of European Union, which were more liberal and oriented to international cooperation. With the downward trend during the first years of 2000, when the world was dealing with the Dot-com crisis and FDI were declining worldwide and in the common currency area, Italy still enjoyed increasing flows of foreign capital, gaining a share in the distribution of FDI in Eurozone.



Graph realized with data from UNCTAD

If we analyse statistics, we find that in 2005 international investments in Italy accounted about 23 billion dollars, showing a 16% increment with respect to 2004; one year later, the increment was more marked: capital inflows to Italy almost doubled, with the overall amount of more than $42 billion, the fourth best result in the European Monetary Union. In 2007 inward FDI slightly increased to $43,8 billion, an increment of 3% with respect to 2006.

With the crisis, Italy suffered a net disinvestment flow, exhibiting in 2008 an overall amount of -10,8 billion of dollars, the second worst result behind Ireland in the common currency area. In 2009 we observe a partial recovery, with inward flows for $20 billion, about the level reported in 2004; the following year, in contrast with the positive trend shown by Europe, foreign direct investments to Italy declined to $9 billion, -54% with respect to 2009.



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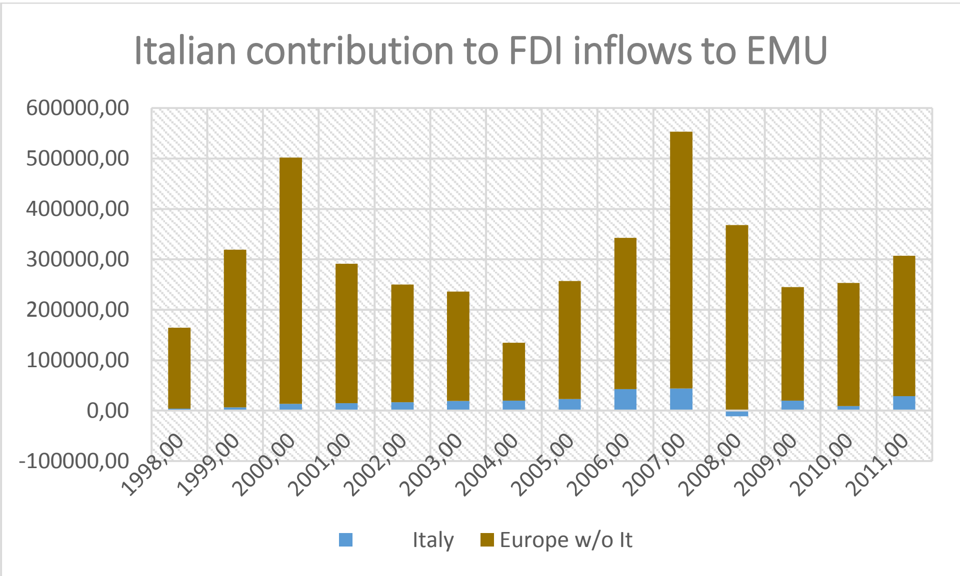
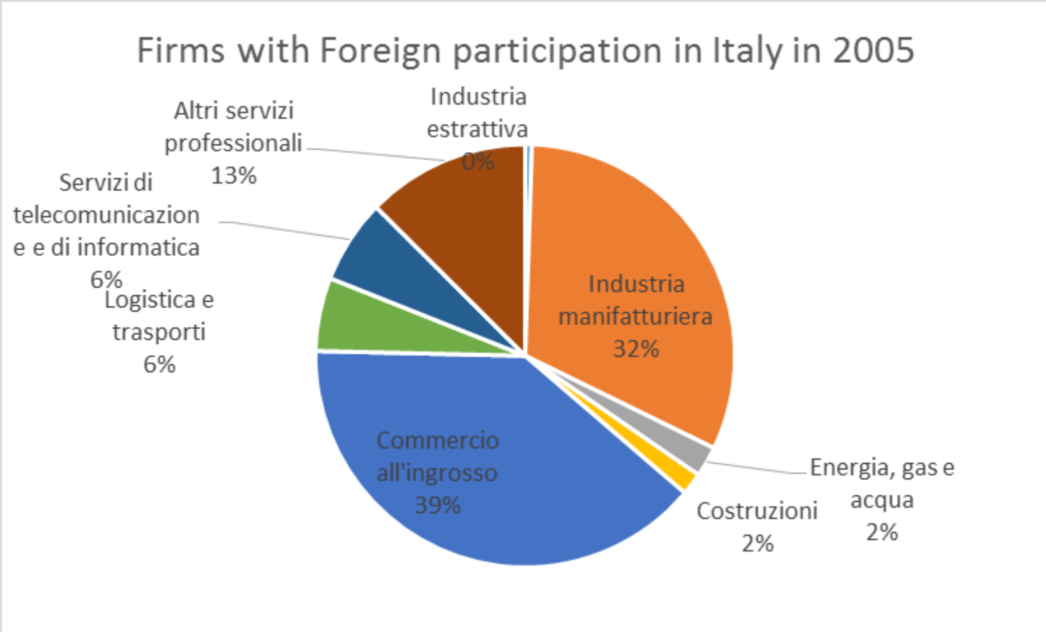
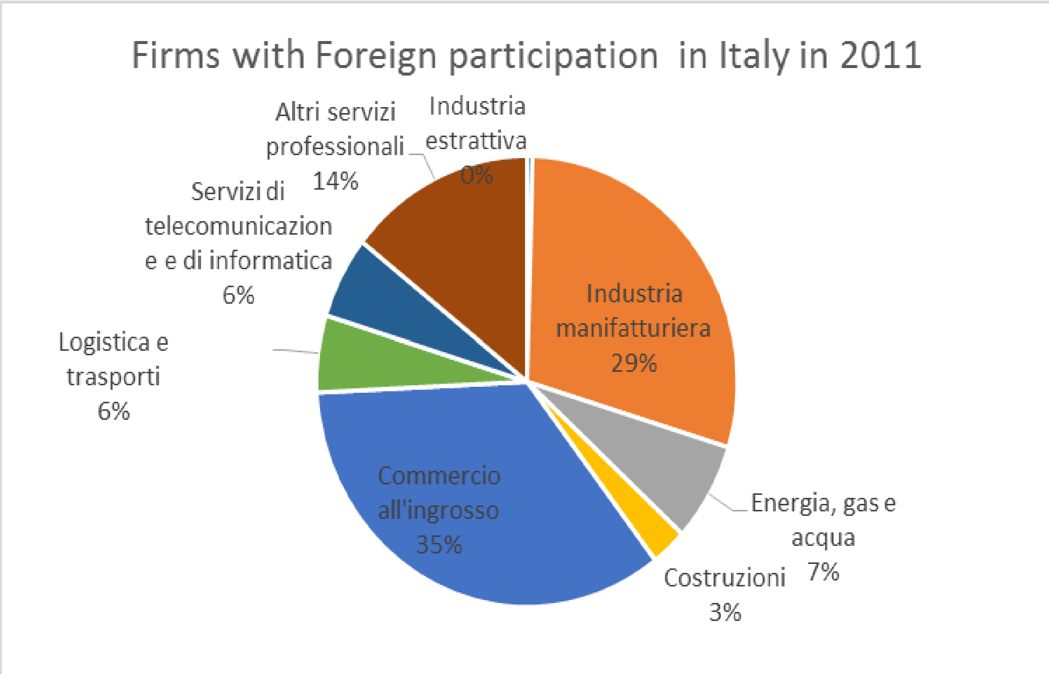


Graph realized with data from UNCTAD

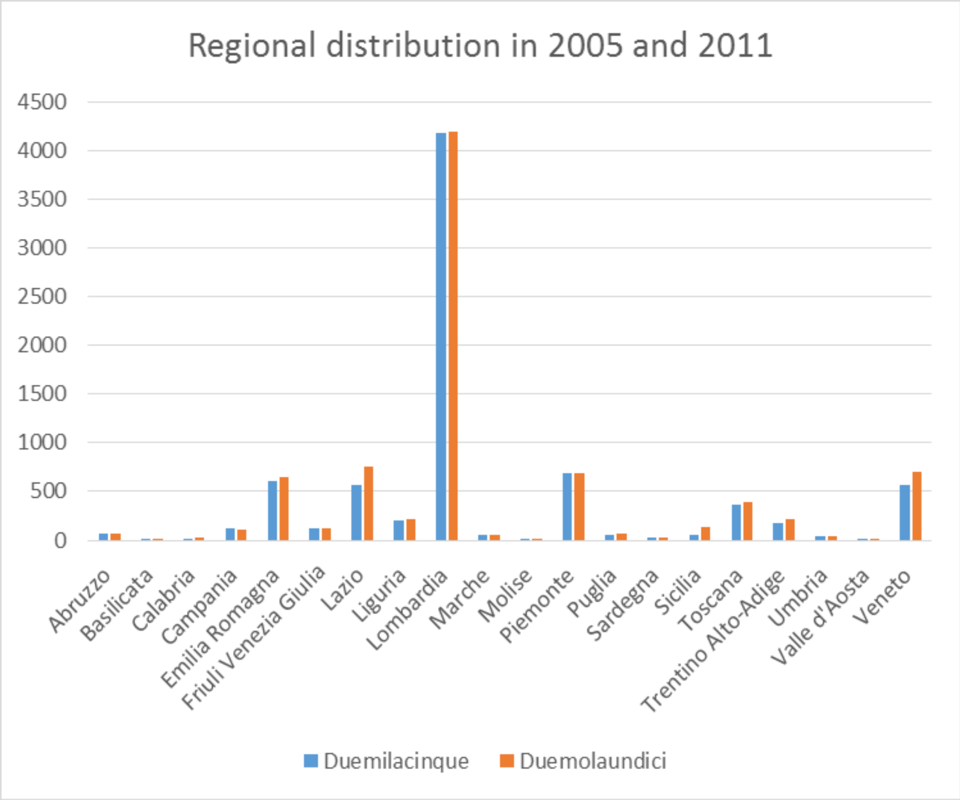
If we consider which industries in the country have been the most attractive, analysing data provided by ICE about the number of foreign firms operating in Italy, we find that both in 2005 and 2011 the most favourite sectors were manufacturing and wholesale. Within manufactory, the most interesting sectors have been metallurgy and chemical in any period considered, before and after the crisis.





Graph realized with data from ICE

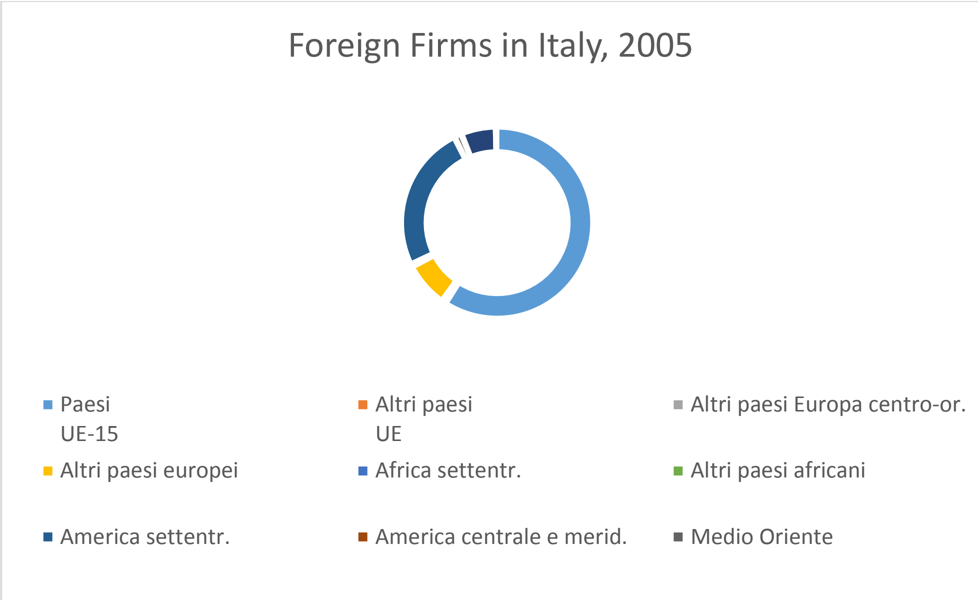
If we analyse the regional distribution of foreign direct investments in Italy, considering the number of firms partially owned by foreign investors, Lombardia, Piemonte e Veneto result in being the most popular locations both in 2005 and 2011, representing together 68% in 2005 and 66% in 2011 of foreign firms' presence in Italy. From another point of view Sicilia and Molise were the regions where the increment in the number of foreign firms operating between 2005 and 2011 were more noticeable (166% in Molise and 123% in Sicilia).

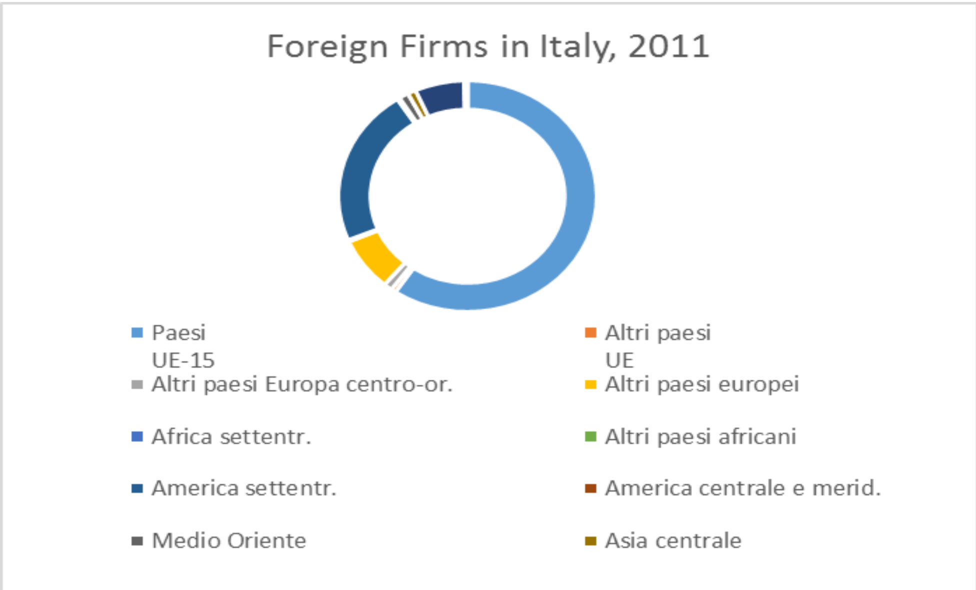


Graph made with data from ICE

b) *Sources of FDI in Italy and the increasing importance of developing countries*

If we focus on these sources, we can observe that the bulk of foreign subsidiaries in Italy are owned by investors within the European Union, which both in 2005 and 2011 represented almost 60% of such firms' ownership, while the North America region turned out to be the second largest source, detaining about 25% of foreign firms in Italy in 2005, a share that dropped to 22% in 2011.





Graph made with data from ICE

Although developed countries have maintained a dominant role in FDI inflows to Italy, recently emerging economies' corporations have increased their presence in our country. It is difficult to report direct data about sources of foreign direct investments, but we can analyse the number of firms totally or partially owned by investors from such countries and their level of revenues as indicators of their presence in our country.

According to a report by Mariotti and Mutinelli (2008) at the beginning of 2008 5,5% of foreign investors came from developing countries, and their participation to local firms with foreign shares accounted for 5%, 4,4% of the employees in such companies and 7,3% of their total sales value. The same authors refer to the fact that between 2001 and 2007 the number of these kinds of investors had increased by 35%. Focusing attention on BRICs, according to these authors, the principal country interested in Italian corporations in 2008 was India, which in that year accounted for 40 firms, against 28 partially owned by China and 23 by Russia. If we look at the value of sales, on the other side, we find that Kuwait played a central role for that year (with a total value of €6854 million), given the presence in Italy of Kuwait Petroleum Corporation (known in Italy as Q8), a huge oil company. Despite the low number of firms located in our country (none, in 2011), Egypt showed a high level of revenues (in 2005 an Egyptian group purchased a big share of Wind Telecomunicazioni from ENEL), especially when compared to other developing countries which should have been more interested because of their growing presence in Italy.

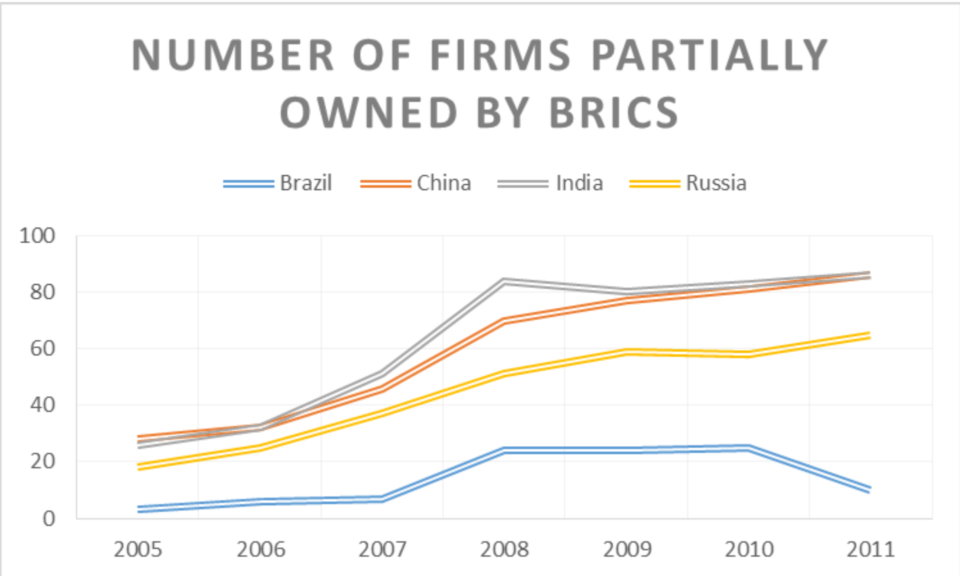
Considering separately the dynamics followed by single BRICs countries in investing in our country, we find in data from ICE that Brazil doubled the number of firms partially owned in Italy between 2005 and 2006, and the positive trend was maintained in 2007, with an increment by 16%; between 2008 and 2010 the growth was impressive, passing from 7 to 24 Italian companies owned by Brazilian investors, but the trend declined in 2011, when the number of such companies dropped by 60%; this is supported by the data found about foreign direct investments flows from Brazil, which dropped from €99million recorded in 2010 to €42 million. This downturn can be easily justified analysing the weak trend followed between 2009 and 2010 by Brazilian companies operating in our country, which reported negative or no variation in revenues (-20% and +3%), and in general by the poor perspective of our country, which had started to show signs of structural weakness. In general, despite the high cultural connections, investments from Brazil are not particularly interesting and only a small part of these companies are actually subsidiaries, also because the south-American country has no significant investments abroad yet.

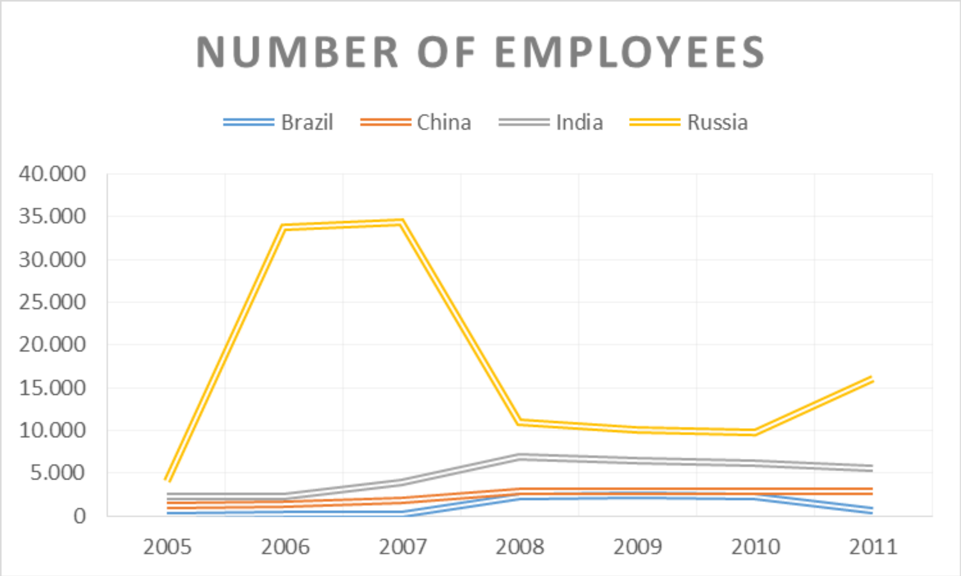
On the contrary, in spite of the crisis China has progressively increased its presence in our country and this fact has generated high interest in specialist literature too. In 2005 it accounted for only 28 firms participating in our country, but in 2006 this number increased by 14%, and one year later by 44%; in 2008 the increment was of about 53%. From 2009 this pace slowed down, and an increment of 10% were recorded in 2009, by another 5% in 2010 and by 6% in 2011, so that at the beginning of 2012 86 firms where Chinese investors took part were accounted; among these, 77 were subsidiaries.

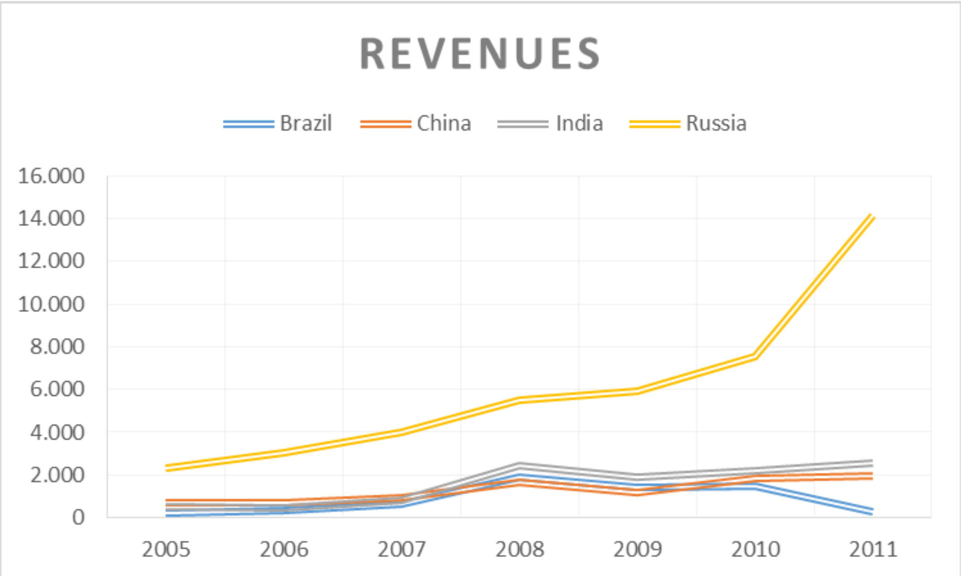
With the Go global policy aimed at encouraging national firms to internationalize, China has exhibited not only an increasing interest in Italian companies, especially through greenfield investments, but also with acquisitions finalized to brand appropriation. The country was a protagonist during the 2000s of an impressive growth and it has accumulated, in order to keep the exchange rate fixed, huge reserves of foreign currency that it has decided to invest abroad to reduce the high values of the balance of payments, which put pressure on the appreciation of Renminbi. According to data elaborated by Spigarelli (2009) the value of Chinese direct investments to Italy, in 2001 these amounted to €2,354 million, representing a very small share of total FDI inflows; in 2007 the total value of Chinese capital flows into Italy were €14,638 million, still a small share, but showing a huge increment. According to an Infomercati Esteri report about China, investments inflows to our country in 2010 and 2011 they accounted respectively for €5.211 and €7.199 million. The numbers considered are not impressive when evaluated in absolute terms, but the growth year by year is quite important; although Europe is not yet the most attractive pole for Chinese firms, Italy in 2007 ranked as the fifth favourite destination in the European Union. These investments are located to several regions, such as Lazio, Toscana and Lombardia, but Veneto stands out as the most attractive, attracting in 2007 24% of such resources. Even if Chinese FDI in Italy is a recent phenomenon, it is expected to acquire importance in the coming years; the evolution followed by Chinese firms is similar in all European countries, and generally aimed to improve the presence of that country in international markets and technological know-how.

If we take India, we find that this country has also consolidated its presence in Italy, with 26 firms in 2005, 32 in 2006 and 51 in 2007; in 2008, despite the crisis, the number of companies in which Indian investors had share increased by 65%, falling slightly in 2009 (-4%) and recovering, even if at a slower rate, in 2010 and 2011. Like China, India has also shown high rates of subsidiaries among the firms in which it has shares, near, on average, 88%. Looking at the recent trend which has followed, we find that, even if inflows to Italy from India are still positive, the interest in our country has diminished: in 2010 90 million euro of FDI reversed to Italy, number which declined to €66 million in 2011.

Russia also augmented its presence in our country through internally operating firms. In 2005, 18 firms with Russian participation, 15 out of which subsidiaries, were located in Italy, and this number increased by 39% in one year, by 48% between 2006 and 2007 and by another 38% in 2008. After the outbreak of the financial crisis increments were less marked, by 15% in 2009, a slight fall in 2010 (-1%) and +12% reported in 2011. Despite these statistics, the overall flows of inward FDI reported in 2010 and 2011 are negative, -€319 million and -€18 million respectively, signalling the willingness of this country to move investments elsewhere, despite the huge increment showed by the revenues of these firms: between 2009 and 2010 the value of good/services sold grew by 28%, and in 2011 it almost doubled.







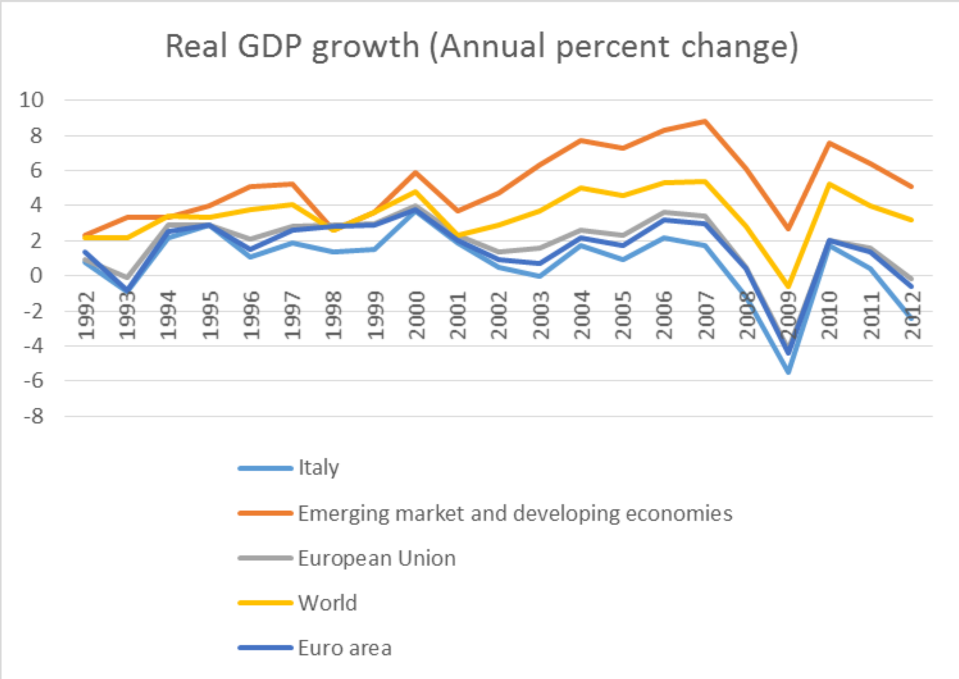
Graphs made with data from ICE

c) *The macroeconomic environment*

Recently the situation in the country has not been the most encouraging. Even if Italy did not suffer economic crisis immediately, the turmoil in financial markets has exacerbated structural weakness of an economy that basically stopped its growth in the 90s. In particular, with the crisis economic forces have begun to recognize differences in the European Monetary Union countries that were ignored before.

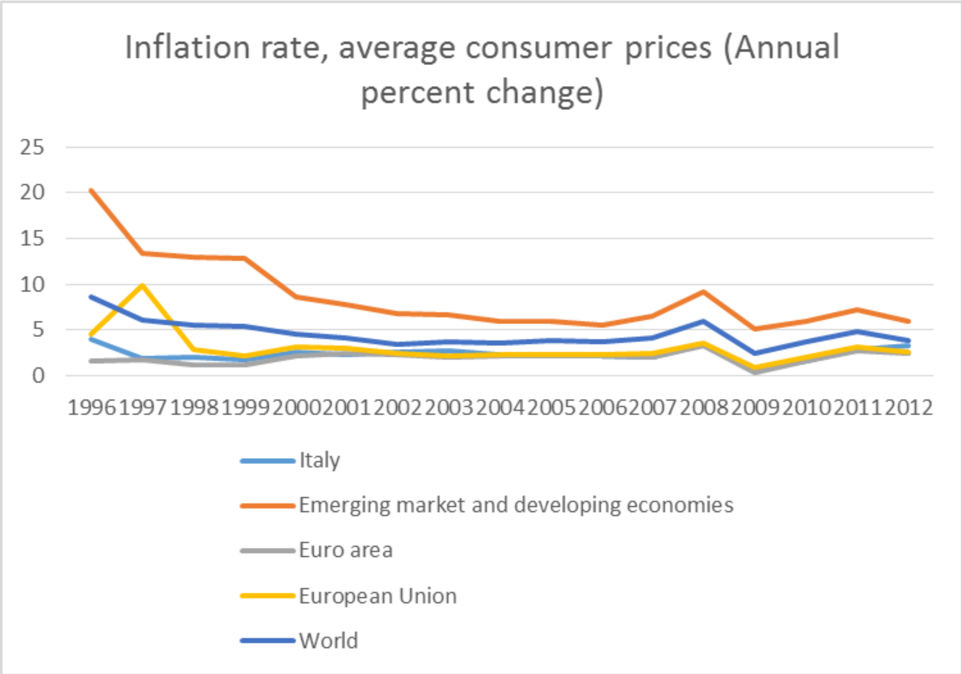
Focusing attention on the growth factor, we find that from 1992 Italy has shown a lower growth rate than the average of the European Union and, consequentially, of developing countries. The fact that the country rates of growth has been low can be justified by the law of diminishing marginal returns: a country with a high endowment of capital can increase its production with other investments, but the result will be less marked than the one showed by a country with low endowment for the same upsurge in investments. In this sense, Italy is an advanced economy and its slower rate of growth is in line with the trend followed by all developed countries with respect to developing economies and new countries (NM10) accounted in the European Union. Even when we consider the country growth rates in comparison to the ones exhibited by the most advanced economies in European Union (thus considering only the Eurozone), we find that our country has shown lower numbers every year. In the period immediately before the crisis growth was weak but positive: in 2005 Italy's gross domestic product increased by 0,9%, against 1,7% exhibited by the Eurozone and 2,3% by the whole European Union. During the same year, developing economies grew by 7,3%. In 2006 the growth of Italian GDP were more marked, 2,2%, but still below the numbers showed by other economies: +3,2% for the partners of EU-15 and an even stronger +3,6% for EU-25. In 2007 the increment for Italy was about 1,7%, against 3,4% and 3% shown respectively by the European Union and the European Monetary Union, and a world average growth of 5,4%, mainly driven by emerging economies, which reported for that year the record value of 8,8% of increment. When in 2008 the crisis was evident and began to affect real economy, while Europe and the developing world continued showing positive, even if weak, results, in Italy GDP fell by 1,2%, and the result was even worse in 2009, when the loss was about 5,5% with respect to the previous year, also in this case a result which was worse than the one exhibited by the other advanced economies in Europe, although other countries did not record brilliant results either. In 2010 it seemed that the country started to recover, in line with the global trend, exhibiting a modest +1,7% of increment in its gross domestic production, slightly below the 2% reported by Europe.

This evident stagnation in productivity is discouraging for foreign investors and may explain why Italy is behind other advanced economies, showing a lower level of international integration from the point of view of direct investments, and is not able to deal with the competition of developing countries, which present better future scenarios for investors.



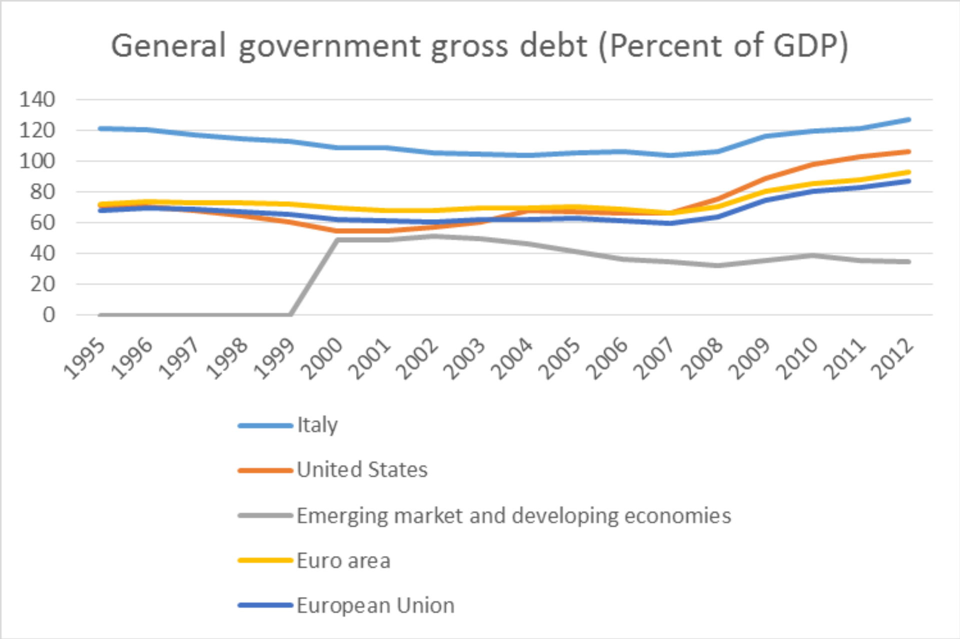
Graph made with data from IMF

Driven by a common monetary policy, mainly aimed to control the movement of prices, inflation in Italy and in the Eurozone more or less coincide, although country-specific factors can lead to no identical results, and the increment of prices in the common currency area are controlled and lower than the one reported by the whole European Union, where the presence of developing economies makes these statistics more volatile and higher. For this reason, inflation has not been a relevant issue for Italy in the last fifteen years, especially when compared with the results showed by emerging countries and the world in general. In the period preceding the crisis, Italy exhibited in 2005 and 2006 the same inflation rate of European Monetary Union (+2,2%), slightly below the increment recorded on average in the 25 countries of European Union (2,3%) and definitely below 5,9% and 5,6%, the results reported by developing countries for 2005 and 2006. In 2007 inflation was even lower, 2%, below the result of common currency area (2,1%) and EU (2,4%). The crisis did not generate turmoil in the level of prices despite the expansionary monetary policies exerted, and inflation for 2008 was just 3,5%, higher than the one shown on average by countries of Eurozone (3,3%), but more controlled then in emerging economies, where it reached 9,2%. In 2009, when the effects of crisis on demand started to strengthening, inflation recorded very slow values both in Italy (0,8%) and in EMU (0,3%), while the average world inflation was 2,4%. In 2010 price growth touched 1,6% both in Italy and the Eurozone, while in the European Union it reached 2%.



Graph made with data from IMF

Despite this kind of stability emerging from data, market perception of the risk associated to Italian economy has increased since the outbreak of the crisis. In particular, the most adverted fear is the possibility that the government will not be able to repay the quantity of debts contracted in the last decades and that, from the 90s, has constantly overcome the gross domestic product.



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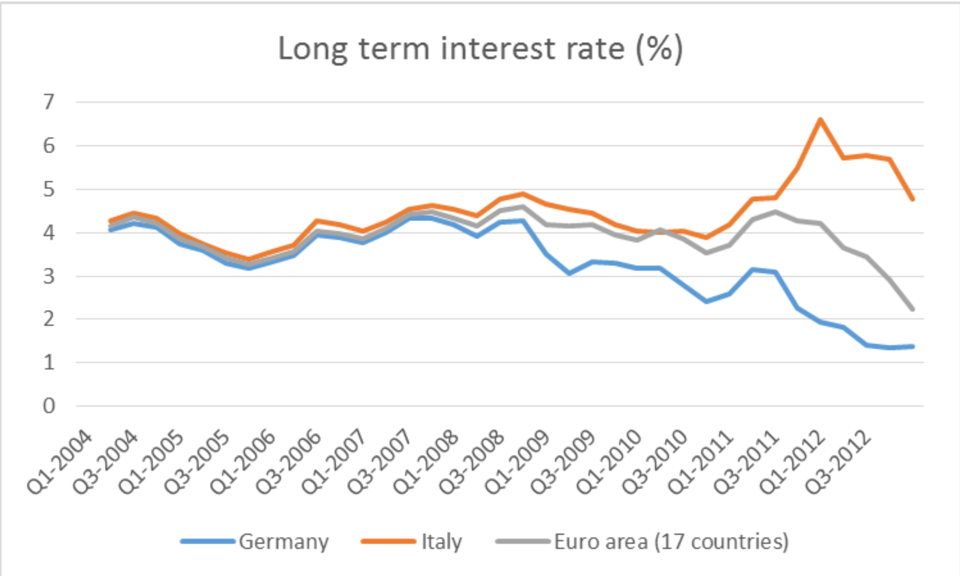
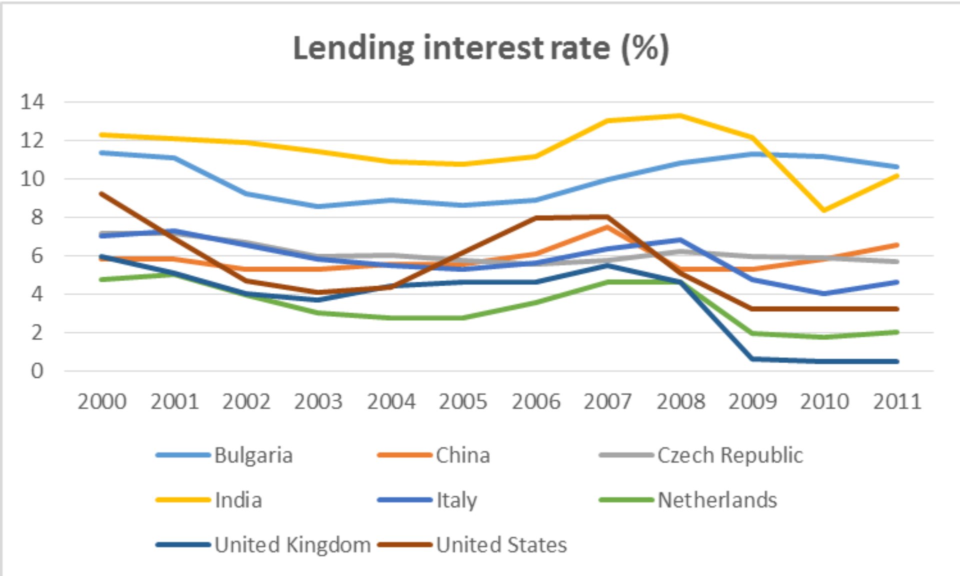
This fear has led markets to value Italian bonds less and the government to offer higher yields when it issues new debt; this factor is commonly measured by the spread between the interest offered by German (considered risk-free) and Italian long-term bonds.



Graph made with data from OECD

This has led to higher interest rates in Italy when we compare it to other countries in Europe. In particular, focusing on the interest rate that concerns international corporations in evaluating the opportunity to start projects in our country more closely, we find discouraging result. Recently lending rates, following the trend of monetary policy rate, which has reached its minimum level, has seemed to decline. Nevertheless, Italy has shown higher values with respect to other advanced economies, both in Eurozone (the Netherlands) and outside (the United Kingdom and the United States). However, emerging countries as some new members of the European Union or India have shown higher values.[16] Lending interest rate in Italy reached its higher value in 2008 (6,83%) and then, in line with the trend of rates in the European Monetary Union, fell to 4,75% in 2009 and to 4,03% in 2010.

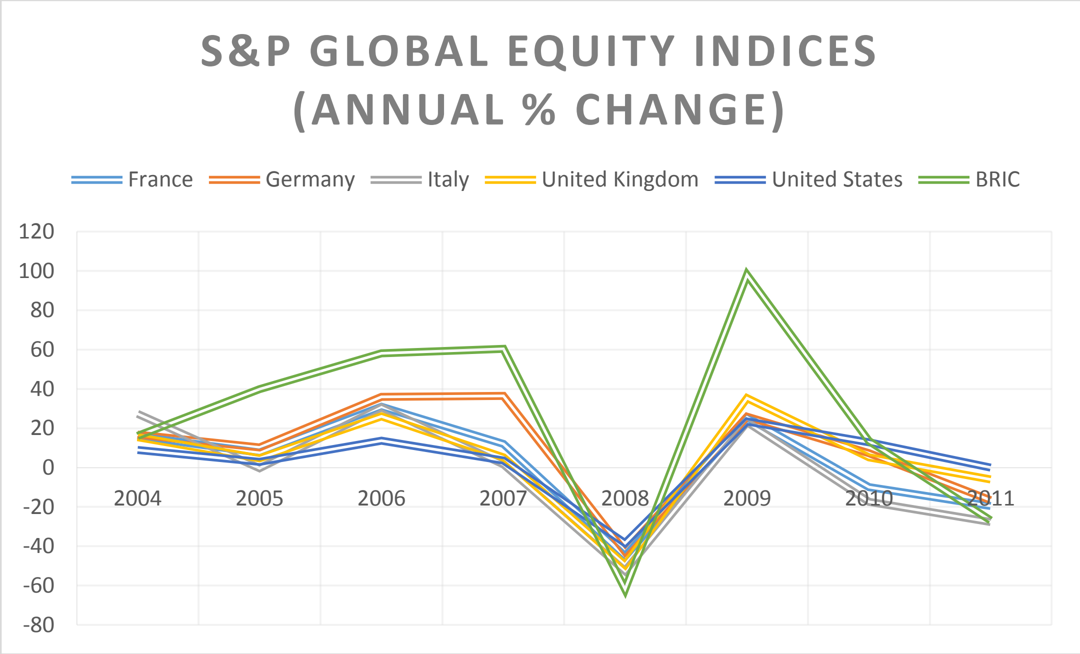


Graph made with data from World Bank

Considering the general level of profitability of Italian firms, we note that with crisis these lost a huge part of their value, observable when we look at financial markets. When we compare the annual variations of S&P Global Equity Indices of Italy and other developed countries, we note that Italian stock markets have fallen more markedly recently, and in the years just before the crisis its growth was less marked. In 2005 Italy exhibited a little fall in its stock market (-0,23%), in a year

[16] As stated by the World Bank, lending rate reported here is the bank rate that usually meets the short- and medium-term financing needs of the private sector.

during which Germany (+10%) and other European countries showed a good trend (on average, +14%), even better than the United States (+3%); in 2006 an important recovery was reported: the index examined showed an increment of 30%, in line with the ones exhibited by developed European countries (Germany recorded +35%) and higher than the United States (+13,6%) and the United Kingdom (+26%). In 2007 the stock market began to advert the downturn of global economy; results are still positive in most countries, but Italy showed a weak 1,6% of increment, sharply below the result of other European Union countries (on average, +24%). When in 2008 global economy was in the middle of the crisis, stock markets worldwide reported bad results; in Italy, the index lost almost 53% of its value, more then what German (-43%) or French (-45%) markets lost, but also the United States and the United Kingdom, whose markets fell respectively by 49,5% and 38,5%. In 2009 stock markets partially recovered, and Italy showed a slightly lower increment than Germany and France, 23% against 25%, but significantly lower than the average computed for the European Union or the United Kingdom, both of which exhibited +35%. In 2010 some countries suffered a downturn in financial markets and their stock values fell; Italy was one of these, and, against a positive +3% reported on average by the European Union, it lost 17% of its stock market value. In the same period, other advanced economies reported good results: in the United Kingdom stock market grew by 5% and in the United States by about 13%.



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Again, these results were not the best way to attract foreign investments, either before or after the crisis.

Conclusion

From data, we can see that foreign direct investments flow into Europe and Italy decreased after the crisis of 2008.

Analysing the worldwide trend followed by FDI flows after the breakdown of financial markets, we have observed a shift in inflows toward developing countries, which now represent a significant share in FDI global distribution. As the crisis has been absorbed differently in developed economies, where it arose, in developing and transition countries, the behaviour of FDI inflows also has had different connotations, since international production and consumption shifted to developing and transition economies.

In particular, in 2008 the global amount of flows declined after four consecutive years of growth, falling from the record value of $1,975 billion reached in 2007 to $1,790 billion in 2008, a decline of 10%. In that year investments to the European Union represented only 30% of total FDI flows, against 43% of pre-crisis period.

A drastic decline in FDI flows worldwide was observed also in 2009: global FDI inflows fell a further 33% to $1,198 billion. FDI inflows to developing and transition economies also declined by 23% to $591 billion in 2009, after six years of continuous growth, but this decline was still lower than the one faced by developing countries (-41%), so that these gained share in global distribution, while EU-25 kept the same contribute of 2008. In 2010 the trend changed, and global foreign direct investment flows rose moderately to about $1.31 trillion in 2010, showing about a 9% increase over a year, but given the decline of flows to Europe (-11%), the Union continued to lose share, receiving only 23% of total inward FDI in 2010.

Even if other developed regions suffered such a deterioration, in Europe the decline was more marked than elsewhere. Looking at the macroeconomic fundamentals of the area in the period immediately after the crisis, we found not only that the growth of gross domestic product was weaker and that the euro depreciated against dollar, but also that some economic indicators started to diverge in several countries within the Eurozone, indicating that the decline in FDI can also be attributed to the poor performance of such countries. The crisis of 2008 has exacerbated some structural differences between the most advanced economies of the area and the so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain), in particular because of the huge public debt contracted by these countries' governments in past decades and its sustainability. When after the crisis the markets started to pay attention to this factor, investors asked higher returns for their investments to be compensated for the higher risk perceived and, given that the weakness is thought to affect PIIGS in the long run, also foreign direct investments suffered a decrease.

Focusing on Italy, we notice that it had always have a low level of internazionalization in terms of inward and outward foreign direct investment flows with respect to GDP. This situation has been worsened since 2008, as we can see from the fact that it has suffered a reduction in inward foreign direct investments, achieving the second worst result in European Union in 2008 behind Ireland, a partial recovery in 2009 and, in contrast with global trend, another decline in 2010.

What is more interesting to note about our country is the increasing presence of direct investments from emerging countries, with India and China in particular showing higher and higher numbers of subsidiaries in Italy even after the crisis.

Even if data are not particularly impressive yet, since it is a trend that concerns many advanced countries in Europe, especially when we consider investments from China, it would be interesting to investigate this phenomenon in the coming years.

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