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FOREIGN DIRECT INVESTMENTS IN EUROPE AFTER THE CRISIS OF 2008

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Sommario

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 crisis and economic slowdown 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.

The situation before the crisis in Europe

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.

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 EU 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 and growing in a year by 62% to $553 billion.

Several elements made Europe an attractive pole for investments. According to neoclassical theory, capital should flow from advanced to emerging economies to exploit the higher return of capital in theory offered by developing countries. Data do not confirm this fact, as we have seen that Europe was, in the period immediately before the crisis, the largest recipient area, with most inflows deriving from exchanges of capital between countries within the European Union. Beyond the facilities 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 explaining 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.

Furthermore, the richer the host and source countries the greater the volume of exchanges, implying, according to what has been found by Hattari and Rajan, that FDI increase relatively more than portfolio investments. Given that EU countries 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. Analysing 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%). However, if we look at the growth between 2005 and 2006, we can observe an increment of 3,6%, lower than the one experienced by developing countries but higher than the 3% on average exhibited 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 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 attractive for investors.

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 prices. 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.

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[1], 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 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

[1] 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

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.

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[2]. Moreover, this statistic is important to evaluate risk sentiments toward a country. We note that, from 2005 to 2007, the 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; however, 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.

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 appreciation. If in 2005 one euro was able to buy 1,18 dollars, in one year the exchange rate rose to 1,31, showing an appreciation of the European currency by 11%, while in 2007 the exchange rate rose to 1,47, an increase of 12% in just a year.

The crisis

When the financial crisis broke out resulting in a huge impact on investments, Europe lost part of its appeal. The crisis broke out between 2007 and 2008, starting from financial markets, with the increasing default cases caused by subprime mortgages, 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. For all these

[2] 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.

reasons, the year 2008 marked the end of the positive trend for Foreign Direct Investments, which had increased worldwide 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 and the economic and financial system facing liquidity problems, to which we add the stronger sentiments of risk aversion, not only 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.
In particular, The European Union started to reveal signals 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.

Even if no striking cases such as Lehman Brothers failure are recorded in the Eurozone, the climate of instability has hit this huge market too, forcing governments to set up safety plans leading to an increase in public deficits and to offer guarantees to banks, which increase the risk perceived. Furthermore, when, because 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 standard 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 that 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.

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.

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 shown 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.

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 common currency area. However, 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 analysing the figures, 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 growth, shortening the gap with advanced economies not only in terms of investments but also in terms of domestic production.

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.

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 prices (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 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.

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 (represented in our analysis by BRICs) showed more volatile results.

Foreign Direct Investments in Italy before and after the crisis

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.

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.

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.

In particular from this point of view the most interesting investors where India and China. 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 share were accounted; among these, 77 were subsidiaries.

According to an Infomercati Esteri report on China, investments inflows to our country in 2010 and 2011 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 and this phenomenon is expected to acquire importance in the coming years.

If we consider 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, 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 that declined to €66 million in 2011.

With respect to the macroeconomic conditions of Italy, we note that 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. 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.

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, so the increment of prices in the common currency area are controlled. 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.

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 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. 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.

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, we found 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.[3]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.

Conclusion

From data, 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 represented 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

[3] 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.

of FDI inflows also had different connotations, since international production and consumption shifted to developing and transition economies.

Even if other developed regions suffered such 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 internalization 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. 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 and, since it is a trend that concerns many advanced countries in Europe, especially when we consider investments from China, we think that it would be interesting to investigate this phenomenon in the coming years.

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