International investment collapsed during the financial crisis that started in 2008. Today, global flows of foreign direct investment (FDI) remain 40% below the peak levels reached in 2007. At the start of the crisis, global FDI stocks actually declined, an extraordinary example of de-globalisation. While declines in FDI stocks are not uncommon at the level of individual countries, a decline at the global level is rare and shows how broadly the financial crisis affected FDI.¹

Nonetheless, it remains that there have been significant differences between countries and regions. Generally OECD countries were the sources of the biggest declines while many emerging economies experienced increases in FDI flows.

One of the worst affected regions has been Europe. Since the beginning of the crisis EU inflows are down 75% and outflows are down 80% from their pre-crisis levels. This paper considers whether these declines simply reflect a particularly severe FDI cycle or whether there might also be structural factors involved.²

Foreign direct investment is sensitive to structural factors. Outward investment performance can be interpreted as a gauge of competitiveness since it is based on the ability of firms from a region to compete in international markets. Similarly, inward FDI performance can be interpreted as an indicator of a market’s long-term economic outlook since FDI decisions by multinational enterprises (MNEs) generally reflect long-term strategic planning.

One of the main conclusions of this paper is that structural factors are part of the explanation for Europe’s poor inward and outward FDI performance, which started before the crisis in 2008. This has important implications for formulating appropriate policy responses for getting Europe back onto a healthy investment path.

¹ www.oecd.org/daf/investment
International investment trends in Europe

Figures 1 and 2 depict inward and outward FDI flows for the EU and the rest of the world.\(^3\) With respect to inflows into the EU, these are currently around $200 billion, down from $800 billion at the peak of the global FDI cycle in 2007. Outflows are also currently around $200 billion, down from $1.2 trillion in 2007. For the rest of the world, we see that a global economy without the EU is doing quite well. In this global economy, inflows recovered strongly starting in 2010 and reached new record heights in 2011, at just over $1.2 trillion. With respect to outflows, the FDI crisis was limited to a one-year decline of 20% in 2009. Although world-minus-EU outflows have not grown over the past three years, they have been at record levels.

Part of the strong performance of the world-minus-EU can be explained by the growing importance of the emerging markets, in particular China, as sources and recipients of FDI. In 2012, emerging markets received over 50% of global FDI flows for the first time, and China is now consistently among the world’s top three sources of FDI.\(^4\)
What about the EU’s ‘peers’, the rest of the industrialised world – how does the EU compare to this group?

Figures 3 and 4 address this question by comparing inward and outward FDI flows for OECD countries that are not part of the EU with flows to and from the rest of the world.\(^5\) With respect to both inflows and outflows, the crisis initially gave rise to a significant gap between the non-EU OECD countries and the rest of world group, just as it did for the EU. A big difference, however, is that for the non-EU OECD countries the gap closed after only two years. While the EU and the world-minus-EU group have been going in different directions ever since the start of the crisis (figures 1 and 2), the non-EU OECD group and its rest-of-world counterpart appear to have returned to a similar cycle after parting ways for a much shorter period during 2008-9.

Looking at the trends presented in figures 1-4 from a slightly different angle, figures 5 and 6 compare the EU and non-EU-OECD shares of world inflows and outflows. This highlights the extent to which the positions of these two groups have reversed in recent years. At the turn of the century the EU accounted for over 50% of global inflows and 70% of global outflows. By 2013 both shares were down to 20%. Conversely, the non-EU-OECD countries have seen their shares of global FDI inflows and outflows recover to pre-crisis levels. This group surpassed the EU since 2010 in terms of its share of both inflows and outflows, thus reversing the historical relationship.
Insights

What is the source of this collapse?

Figure 7 provides a partial answer. The greatest declines in inward FDI in the EU have been from within Europe itself. Before the crisis around 70-80% of the region’s inward FDI consisted of intra-EU investment. Today only 30% of inward FDI is intra-EU. This sharp decline in the share of FDI EU countries receive from their EU neighbours also helps to explain the decline in outward EU FDI depicted in figure 2.

The decline in the share of intra-EU in total EU inward FDI would seem to suggest a lack of confidence on the part of EU investors in their own regional market. One tempting explanation for this is that these declines have been concentrated in a sub-set of EU countries that have experienced particularly difficult economic conditions (such as Greece, Ireland, Portugal, and Spain) during the crisis.

This has not been the case. The FDI crisis in Europe has been broad based, with the bulk of the declines in FDI flows concentrated in the largest economies. France, Germany, and the UK accounted for 50% of the $600 billion decline in FDI inflows between 2007 and 2013. Over the same period, Greece, Ireland, Portugal, and Spain accounted for only $14 billion, or 2%, of the inflow decline. With respect to outflows, France, Germany, and the UK accounted for 59% of the $1 trillion decline between 2007 and 2013. Over the same period, Greece, Ireland, Portugal, and Spain accounted for 12% of this decline.

Source: OECD International direct investment statistics database.
Have certain sectors been harder hit than others?

Figure 8 provides a firm-level view of international investment flows into Europe using data on international mergers and acquisitions (M&A). Mergers and acquisitions constitute a major component of FDI flows. Mergers and acquisitions can underpin declines in investment flows in two ways. First, firms can collectively reduce the value of their M&A transactions. Second, in more serious cases, firms can divest themselves of international assets.

Figure 8 suggests that part of the explanation for the decline in investment in Europe is linked to an increasing share of international divestment relative to international M&A (right hand axis). While pre-crisis levels averaged around 35%, they reached almost 60% in 2010-11 and now stand at around 50%. In other words, for every dollar invested, 50 cents is divested. Consequently, net international M&A investment in Europe is currently at its lowest levels in a decade, at around $100 billion.

Table 1 provides an industry-level breakdown for the divestment/investment ratio presented in figure 8, taking the average divestment/investment ratio for the period 2009-2014 (through Q3). The clear ‘leader’ in this regard is the consumer products segment, with a divestment/investment ratio of 148%. This means that for every dollar (or Euro) invested in consumer products over the past six years, around one and a half dollars was divested. This is an example of investment de-globalisation. Forestry and paper and oil and gas were close to break even, with every dollar invested accompanied by over 90 cents of international divestment.

Source: OECD International direct investment statistics database.
Insights

Has domestic investment fared better than international investment in Europe?

Figure 9 provides a comparison, again using data on M&A investment, showing that domestic and international M&A in Europe have generally followed the same pattern. International and domestic M&A are both on track (based on data through Q3) to reach their lowest levels in a decade. Conditions that are holding back international investment in Europe would seem to be discouraging domestic investment as well.

Conclusions

Viewed through an international investment lens, it is difficult not to conclude that what is happening in Europe has a structural component to it, that this is not just a question of being in the trough of a tough international investment cycle (although this is clearly also a factor). The decline in Europe’s international investment performance started well before the crisis and continued to decline as international investment in the rest of the world began to recover. In an imaginary world without the EU, global investment flows had fully recovered and were setting new records already in 2010.

From a policy perspective, the challenges of breaking out of this regional investment slump are daunting but urgent. A useful starting point is the recognition that a supportive environment for productive international investment needs to reflect the evolving needs of international investors. Such a supportive environment has three dimensions.
First, investors generally favour predictable, open, transparent, rules-based regulatory environments, much along the lines put forward by the OECD’s Policy Framework for Investment. Where impediments to investment have not been addressed by governments this often has more to do with implementation challenges rather than disagreement over principles. For example, it is widely accepted that excessive ‘red tape’ is an obstacle to investment but in many countries this is still often cited by business as being one of the most important impediments to doing business. Europe is no exception in terms of having these sorts of impediments to international investment that remain in place despite widespread recognition that they are discouraging investment. Many such impediments represent low-hanging policy fruit -- relatively easy opportunities for improving the regional investment climate.

The second dimension concerns important changes in the structures and patterns of global investment flows as well as in the way MNEs are organising their international operations. This is reflected in new phenomena such as instances of investment de-globalisation and the phenomenon of “vertical disintegration” which has seen MNEs become more focused on their core lines of business over time and more reliant upon international contractual relationships for organizing their global value chains.7

Such structural changes in the global economy will require more innovative policy responses that go beyond the fundamentals of a healthy policy environment for investment. For example, in a world in which international production continues to be broken down into more and more specialized activities, involving heightened levels of communication and logistics throughout global value chains, are countries investing enough in infrastructure and, perhaps more importantly, in the right kinds of infrastructure?

Finally, Europe would seem to be confronting a competitiveness puzzle in which declining competitiveness is discouraging investment, and declining investment is in turn undermining competitiveness. A few years ago, OECD Secretary General Angel Gurría outlined six policy recommendations8 for getting Europe back on a sustainable growth path, and these recommendations are worth repeating here since they also hold the key to getting back onto a sustainable investment path.
They include:

- Further developing the Single Market, one of the EU’s “most powerful tools to stimulate growth and competitiveness”;  
- The introduction of policies to ease excessive product market regulation;  
- Investing more in R&D and stepping up innovation to boost Europe’s competitiveness, especially in the Southern European countries;  
- Improving education and training institutions to make sure that these deliver highly sought after skills in an increasingly competitive global economy;  
- Increasing the number of participating workers in labour markets and making them more inclusive with a view to addressing social inequalities; and  
- Reforming the tax system, including by reducing the high average and marginal tax wedges on labour.

In sum, one thing is clear: the collapse in international investment flows in Europe, both outward and inward, is more than just a passing cyclical phenomenon. The appropriate policy responses to restore investor confidence and revive investment flows must take this into account. The canary has stopped singing and it’s time to sound the alarm.

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1 Global inward FDI stocks declined by $1 trillion, or 6%, between 2007 and 2008. The only other time global stocks have recorded a decline was in 1992 during the recession of the early 1990s and in the lead-up to Black Wednesday when the UK withdrew pound sterling from the European Exchange Rate Mechanism (ERM). On that occasion global FDI stocks declined by $16 billion, less than 1%. Much of this was due to the devaluation of the pound, resulting in a $40 billion (18%) decline in the USD value of FDI stocks in the UK.


3 Here inward and outward EU FDI includes intra-EU flows. Later in the paper we consider differences between intra- and extra-EU flows.

4 For a survey of FDI trends in emerging economies, see OECD (2014), Development Co-operation Report 2014: Mobilising Resources for Sustainable Development, chapter 5, “Putting foreign direct investment to work for development”.

5 The non-EU OECD countries comprise Australia, Canada, Chile, Iceland, Israel, Japan, Korea, Mexico, Norway, Switzerland, Turkey, and the United States.

6 International M&A investments less international divestments.


8 Speech delivered by OECD Secretary-General Angel Gurría on “The Challenge of Competitiveness in Europe: an OECD Perspective”, Bratislava, 6 December 2012.