



The Fallout from the Financial Crisis (4): Implications for FDI to Developing Countries

by Andrew Mold

- ◆ Although Foreign Direct Investment (FDI) is considered by many to be a major source of financing for a number of developing countries, it can sometimes compound problems during times of financial crisis.
- ◆ Multinational enterprises can shift financial resources easily from one country to another, adding to macroeconomic instability in developing countries.
- ◆ FDI is no substitute for enlarging tax bases and promoting better mobilisation of domestic resources.

Foreign direct investment (FDI) has been one of the principal beneficiaries of the liberalisation of capital flows over recent decades, and now constitutes the major form of capital inflow for many developing countries, including low-income ones like Chad, Mauritania, Sudan and Zambia. But while there are reasons to celebrate this success, the current financial turmoil does not bode well for the sustainability these flows in 2009.

It is often argued that countries are less vulnerable to external financing difficulties when current account deficits are financed largely by FDI inflows, rather than debt-creating capital flows. True, FDI inflows generally provide a more stable source of external financing than private debt and portfolio equity flows. And there is no gainsaying the importance of FDI inflows for its contribution to sustaining current account imbalances in countries such as Pakistan, South Africa and Turkey, where the value of FDI inflows is estimated to have covered their entire current account deficit in 2007.

But this is only part of the story. There are a number of reasons for adopting a more cautious approach to FDI finance:

1) Approximately 30-35 per cent of current flows are accounted for by mergers and acquisitions (M&As), and much of this activity is likely to dry up, as corporations have increasing difficulty in getting access to credit (though there may be isolated examples of "opportunistic" FDI, as multinationals with stronger cash balances take advantage of low "fire sale" prices to buy up assets). Some M&As in developing countries are already being cancelled. For

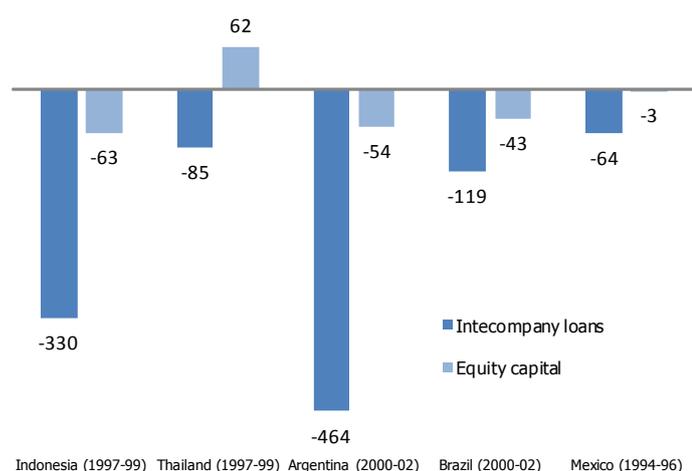
example, the recent proposed takeover of a South African mining conglomerate by Xstrata was abandoned due to financing difficulties.

2) If profit remittances are taken as a proxy for its "price", FDI can be an extremely "expensive" form of financing, especially for low-income countries. In 2005, profit remittances actually surpassed new inflows of FDI for low-income countries. The scale of the remittances can be enormous. In Chile, for instance, remittances in 2007 amounted to \$21.7 billion, or about 13.3 per cent of the GDP. Such outflows need to be financed and add to pressure on the exchange rate.

3) The ease with which multinational enterprises can shift financial resources from one country to another may add to the current instability. For instance, FDI investors often use derivative products such as currency forwards and options, which may put the local currency under pressure and increase instability. Similarly, some components of FDI are more pro-cyclical than others. In particular, reinvested earnings and intra-company loans are likely to be curtailed sharply during the current crisis, as companies repatriate financial resources towards the parent companies. This was very much the case during previous crisis, such as the Thai crisis (1997) and the Argentinian crisis (2001) (See Figure 1).

4) Finally, and perhaps more importantly, FDI itself is pro-cyclical (though perhaps not to the same extent as other private capital flows). In recent years, outflows of FDI from OECD countries – still the major source of investment flows – have been quite clearly correlated with

Figure 1. Decline of intercompany loans versus equity component of FDI during financial crises (per cent)



Source: World Bank (2004), *Global Development Finance*, page 87.

economic growth. This was particularly evident during the downturn in 2000-01, when global FDI outflows fell by almost 50 per cent. The implications are clear: as the credit crunch starts to bite and capital becomes scarcer and more expensive, so multinational corporations will scale back their investment plans. FDI inflows are also highly contingent on local growth as a "pull factor" which entices foreign investors. In so far as the prospects for growth in the developing countries deteriorate, so too will FDI inflows. This is particularly important to the extent that much FDI in the developing world is directed towards local markets.

Once the crisis is over, FDI might actually be one of the forms of cross-border flows that will be privileged (as it has been in the aftermath to previous crises). Indeed, in a deleveraged world, FDI may become one of the few ways in which low and middle-income countries can access capital for development. But in the meanwhile policy makers in developing countries need to monitor trends carefully and adapt policy accordingly. FDI is in itself no panacea, and can sometimes compound problems during times of financial crisis. It is certainly no substitute for enlarging tax bases and promoting better mobilisation of domestic resources.