

# Impact of financial crisis and foreign direct investment in the united states rep...

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Foreign direct investment (FDI) has come up as a highly important and one of the fundamental features of the globalized economy in the past two decades. The Global FDI inflow statistics show big rising figures from 1990 to 2009, rising to \$1. 1 trillion from \$208 billion which resulted in a cumulative stock of approximately \$18 trillion by the end of year 2009. The positive trend of International investment has gained as double the importance as of trade of goods and services across borders. FDI has grown faster than the world GDP and is a result of comparatively relaxed policies of the home and host countries and liberalization of investment policies at notional and sub national levels. The global financial and economic crisis has had a drastic impact on FDI flows. Declining from US\$ 2. 09 trillion in 2007 to US\$ 1. 73 trillion in 2008 the FDI inflows dropped to 17%. The impact of the crisis has however varied by country and region. Developed economies were hit first and the hardest, but the impact has been spreading to transition and developing countries. The United Nations Conference on Trade and Development (UNCTAD)—the organization dealing with trade, development and investment and issues for the United Nations—notes that “ for developing and transition economies, the worst is yet to come.” 1

## **Foreign Direct Investment**

When a foreigner company or a person invests in a business in which the investor has significant interest in the United States. This contract requires the investor to have ownership rights of at least 10% of the voting stock. The investment of the foreign companies in the United States businesses provides comparatively high paying job opportunities. This encourages more foreign direct investment, expanding the number of investors willing to

invest in the United States. As a consequence more job opportunities and more economic growth can be attained. A survey shows that employees working at FDI supported companies earn up to 30 percent more than those working with non FDI supported companies.

### **FDI in the US: over view**

U. S. FDI was \$194 billion in year 2010, and was \$1. 7 trillion over the past ten years. FDI inflows and outflows have greatly varied from year-to-year and have generally followed the U. S. business cycle: FDI gained a historical boom of \$328 billion in 2008 after hitting a low of \$64 billion in year 2003. The US was then hit by the financial crisis of 2008-09 among other countries that caused major downfalls in the countries financials. In 2008, global FDI flows declined by 15% from 2007 and this figure were even bigger in the year 2009.

At present, comparatively fewer countries invest in the US. 84% of the FDI inflow in the U. S. in the year 2010 came through or from eight countries: The United Kingdom, Switzerland, Japan, Germany, France, Luxembourg, Canada and the Netherlands.

### **Figure 1 below shows the FDI into the US by country**

FDI into the US by country

Foreign Direct Investment inflow of the United States has been a key factor in the growth of the U. S. economy for a substantial number of years, with FDI of \$1. 7 trillion over the past ten years. Figure 2 shows that FDI has fluctuated along the business cycle of the U. S. The FDI surged to a historical

boom of \$328 billion in 2008 and attained a similarly peak level in 2000, though it touched the lowest depression of \$64 billion in 2003. Foreign Direct Investment rebounded to \$194 billion in Year 2010 and is expected to flourish more in the coming years.

## **The Financial crisis 2008-2009**

The world economy has faced many financial crises since the birth of proper economic systems. Bordo et al. (2001) find that the frequency of these crises has been doubled in the recent decades. The Gold Standard Era (1880-1993) and the Bretton Woods Period (1945-1971) recession periods were only comparable to the Great Depression Era. But, the financial crisis that began in the middle of 2007 came as a big surprise to most of the people. What initially observed was difficulties in the U. S economy subprime mortgage market, escalated rapidly and spilled over initially to the financial markets and later to the real economy. In the following months and the first quarter of year 2009, the economic activity declined significantly in the United States and many other countries. Unemployment rose drastically as a consequence. The generally accepted opinion is that the crisis of 2008-09 was the worst after the Great Depression. The crisis has completely changed the financial landscape of the economic world and its complete cost is yet to be calculated.

## **Impact of the Financial Crisis on United states**

October 2008, flow of the credit froze the confidence of the lender dropped and different economies around the world declined to recession one after another. For the U. S. the financial turmoil directly impacts the fundamental

national interest of ensuring the economic security of its natives. It also has affected the U. S. in achieving its national goals, like maintaining the cooperative relations, and supporting such financial infrastructure that paves the way for the smooth running of the international economy.

Reverberations are not only being felt on the main street and the Wall Street but are obvious in world flows of imports and exports, rates of unemployment and growth, and government expenditures and revenues. The pace with which the growth is declining in countries indicates that this global downturn is not a mere phase in a usual business cycle.

## **Aftermaths**

The financial crisis of 2008, has led to a massive deterioration of the investment sector. Economic indicators already suggested a downfall in the world economic growth and in the investors' confidence as well. This deteriorating climate started off leaving its initial negative impacts in investment projects, including Foreign Direct Investment, in early 2008. According to UNCTAD's 2008-2010 World Investment Prospects Survey, ' 40% of the respondent firms already declared at that time that this financial instability had a " negative" or " very negative" impact on their investment'. Statistics available during last quarter of 2008 showed a ' downward trend for 2008, both for Greenfield Investments and cross- border Mergers and Acquisitions (M&As), as compared to the same period of the previous year [1]'. This setback in FDI has specifically affected the cross-border mergers and acquisitions (M&As), the impact could be judged by the comparison of the values with the previous financial year's record high. It also has turned in

to a rising wave of restructurings and divestments. International greenfield investments however have been less affected to this point, yet a large number of programs have been postponed or cancelled.

## **FDI Outflows**

Typically FDI is considered to as a lagging indicator of the investment atmosphere in which once a project is finalized on paper, the funds are delivered a little later. Therefore, analyzing the data on FDI outflows in a certain year does not portray the complete picture on the investor sentiment in that specific year. However, known the magnitude of the economic crisis emerged in 2007, the impact on the Foreign Direct Investment outflows was already reflected in the financial data of year 2008. The reasons for the reduced desire and capacity of companies to make investments were a. reduced access to financial resources, b. declining corporate profits, c. perceptions of low or negative returns and d. heightened risk.

## **FDI Inflows**

Empirical studies have shown that the multinational firms continue investing in their host country and in some cases even increase the investments after a financial crisis. This inflow of capital from multinational companies to the host country is called FDI inflow. In 2007 FDI inflow among financial and nonfinancial industries was around \$207 billion or 2. 7% of United States nonresidential fixed investment; this represented around 10. 7 % of capital flows in the U. S. in the same year.

## **Impacts of Financial Crisis on U. S. FDI; Facts and Figures**

These cross-border Foreign Direct Investment flows do not essentially match parallel with the expenditures of the affiliates on structures, capital and research & development as the expenditures could be financed partially by raising funds in the parent or the host economy. In this scenario, only a percentage of the expenses for investment are inculcated by the BOP notion of FDI. Investment via U. S. affiliates of multinational companies in the nonfinancial industries was about 8% of gross fixed capital in year 2007.

These two measures of FDI in United States affiliates of foreign multinational companies have been focused in this report —the BOP notion of FDI and the capital expenditure (CE) notion of FDI for the recent economic crisis to examine the changes in FDI during the financial crisis.

Silvio Contessi found that; “ FDI flows from overseas parent companies contracted, but intracompany debt and reinvested earnings were affected much more than equity FDI”.

The figure shows the evolution of inward FDI in manufacturing industries in year 2006 and 2007 (averaged) and the available most recent year 2010 as a sum and by 3 major components.

As can be deduced from the figure that all the constituents squeezed following a ‘ V’-shaped pattern which is common in many economic series e. g. imports and exports. Reinvested earnings and intracompany debt dropped earlier (in 2008) and quite sharply as compared to the equity component. The driving force for these differences was that at the peak of the crisis the cost of financing the source economy A possible explanation for these

differences is that the cost of financing in the source economy was increased, whereas equity investment may have been financed as per plan prior to the crisis and was carried out according to the plan once the crisis has hit (Contessi and De Pace, 2011). When compared with the 2001 depression, these series portray similar patterns with more contractions, specifically in intracompany debt.

The Bureau of Economic Analysis also provides statistics on the expenditures on plant, property, and equipment by the U. S. affiliates of foreign multinationals.

Li Li writes in his synopses. (FDI in US in the economic crisis) “ Similar to the capital flows measure, expenditures by U. S. affiliates in manufacturing industries contracted markedly during the 2008-09 recession (–26 percent), which was about the same as the change in investment in the U. S. economy overall (–24 percent)”.

The information in the above table shows the changes in investment for certain industry. The classifications and past findings show that between years 2008 and 2009 the sectors producing durable goods suffered relatively more than the producers of the nondurable goods. As the future expectation of the economy was more uncertain, consumers curtailed their consumption of the durable goods like computers and cars which as a consequence affected the investment.

‘ Investments by foreign-owned affiliates in industries with higher external finance dependence contracted relatively less than domestic investment



overall and less than affiliates in industries characterized by less external finance dependence'(Federal Reserve Bank of St. Louis Economic Synopses, 2012-06-01 2012, No. 14)

The reason behind this trend was that in an industry where the funding is mostly dependent on external finance, the affiliates could rely on their own multinational system of internal capital markets in order to raise funds for financing rather than looking at other firms that already are dealing with issues with financing. There could be other reasons and dimensions to this which the data could not capture.

Another angle to examine the framework of the foreign direct investment is by viewing the differences in the transactions in which the foreigners established new companies and the acquisition of the existing U. S. companies. New investments are mostly preferred locally as they are considered to contribute to local employment, whereas an acquisition itself might add comparatively less.

According to Federal Reserve Bank of St. Louis Economic Synopses, 2012-06-01 2012, No. 14, “ In 2008, outlays for new investments, which include investments made directly by foreign investors and those made by existing U. S. affiliates, were \$260 billion, a 3. 0% increase over the \$252 billion invested in 2007”.

A release from the Department of Commerce says that ‘ the increase in new investments reflected several large transactions’. These include the acquisition of Alcon Inc., by Novartis AG for \$10. 8 billion, acquisition of

Anheuser-Busch Cos. Inc., by Stichting Interbrew SA for \$52 billion; and huge investments in New Jersey, Commerce Bancorp, Citigroup and Morgan Stanley. Acquisitions of existing United States companies accounted for 93percent of the new investments by value. Investments made by existing United States affiliates of foreign companies accounted for 82percent of the net transactions by the investor, whereas other foreign direct investors accounted for the rest of the 18percent of transactions.

FDI in the United States has started to rebound gradually after falling from the \$310 billion in 2008, a record crossed only by the \$320 billion that was invested in 2000 in the U. S. businesses and real estate. In 2011 however, as per Department of Commerce data, the foreign investors invested \$234 billion in the U. S. real estate and businesses. Many struggling local and state governments look for FDIs in order to create more employment opportunities. However some politicians in Congress also encourage such investment so as to offset the perceived contradictory economic impacts of U. S. firms investing across border, while others have concerns regarding foreign acquisitions of the U. S. companies that are considered a necessity to the U. S. economic and national security.

The figure shows a comparison of the foreign direct investment in the United States and the U. S. direct investment annual flow from year 1990 to 2011.

Foreign investors invested \$234 billion in U. S. real estate and businesses in 2011, according to information provided by the Department of Commerce, this represents a 14percent increase in comparison to the \$155 b, invested

in 2010. Investments by U. S. parent firms into the foreign companies escalated by 28 percent in 2011 to \$419 b, higher from the \$328b, invested abroad in 2010. This increase in FDI flows depicts a rebound in worldwide flows followed by the sheer drop in direct investment inflows and outflows in 2009 and 2010.

## **Conclusions**

Three facts can be concluded from the above discussion (a) Foreign Direct Investment flows from foreign parent companies contracted, but reinvested earnings and intracompany debt were affected much badly than the equity FDI. (b) Expenditures of the affiliates as well as in the U. S. overall economy dropped by similar ratios. And (c) affiliates in the industries, more dependent on external funding may have more confidence on internal capital markets, which can provide cushion to the retracted investment.

As long as the rate of growth of the U. S. economy keeps on improving in relation to the other advanced economies, the interest rates will remain low, and the price inflation rate could be monitored, the FDI in the United States will continue to escalate. The particular importance will be of public concerns on the (FDI) foreign direct investment in the national economy as well as the investments made worldwide, as it directly impacts the rate of employment in the economy, a fluctuation in the function of which leads to a chain reaction taking the economy towards a boom or a recession as it happened in 2008.

The World Investment Report [2011] forecasts that, ' FDI will recover to pre-crisis levels over the next two years. Unlocking the full potential of the new developments will depend on wise policymaking and institution building by governments and international organizations. Global FDI has not gained back the previous to levels, yet some economies have shown comparatively better recovery than the rest. The reason is risk factor, in post-crisis business environment, such as the unpredictability of global economic governance, a possible widespread debt crisis and fiscal and financial sector imbalances in the global economy'.

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