

## Will FDI be Resilient in this Crisis?

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*Although FDI flows have tended to remain resilient during previous crises, they may not behave in a similar fashion during the current crisis. Why? In past crises, the stability of FDI flows was significantly associated with an increase in mergers and acquisitions (M&A), reflecting "fire-sale FDI". In the present crisis, by contrast, M&A activity decreased significantly in the last quarter of 2008, and this trend may continue as long as the global crisis constrain the purchasing ability of foreign (acquiring) firms. These developments further illustrate that the nature of the current crisis differs considerably from previous ones, suggesting that certain key lessons from past crisis lessons might not apply in the current context.*

### 1. Introduction

The outlook for private capital flows to emerging market economies, and especially to Latin America, has deteriorated substantially in recent months. Net flows to the region are expected to decline to US\$ 43 billion in 2009, down from US\$ 89 billion in 2008. This implies a decline of approximately 75% from the record net flows in 2007 —US\$ 183.6 billion (IIF, 2009). While all components of net capital flows are projected to decline, the largest drop is expected on net private debt flows —an estimated decline of US\$ 40 billion in 2009.<sup>1</sup>

Recent studies have shown that the various types of financial flows have different dynamics along business cycles and in particular during crises.<sup>2</sup> For example, using a panel dataset of 66 countries during 1970-2003, Levchenko and Mauro (2007) find that net equity flows, FDI flows, are not only less volatile than net debt flows (i.e., portfolio debt flows, bank lending, and trade credit) but also more resilient during episodes of sudden stops. In fact, the authors find that net debt flows explain almost entirely the reversal in the financial account that characterizes a sudden stop.

The resilience of FDI flows during crises episodes have been attributed to an increase in *fire-sale foreign direct investment*. The tightening of liquidity constraints for domestically owned firms during these episodes has been associated with an increase in foreign acquisitions, usually at significantly low prices. This foreign ownership may

<sup>1</sup> The decline in net private debt flows is even larger, more than US\$ 100 billion, if we compare the net private debt flows in 2009 relative to its record level in 2007.

<sup>2</sup> See, for example, Sarno and Taylor (1999) and Levchenko and Mauro (2007).

facilitate the access of financially-constrained domestic firms to world capital markets by bringing transparency, better management, and improved technology.

In this note, we argue that, although FDI flows remained resilient during previous crises, they may not behave in a similar fashion during the current financial crisis. Why? Recent crises, including the Asian crisis for example, were circumscribed to the emerging market world. Firms buying out Asian firms were not affected by the liquidity crisis and had ample access to financial resources. In contrast, the current crisis has imposed severe liquidity constraints not only on the owners of (financially-constrained) firms in emerging markets but also on the potential foreign buyers of these firms.

We analyze the SDC mergers and acquisition database, which contains high frequency data on all cross-border mergers and acquisitions since 1985. The dataset includes all corporate transactions (public and private ones) involving at least 5% of the ownership of a company, with a total of 607 thousands of transactions until November of 2008. Merger and acquisition deals usually take a long time to be completed. Thus, in order to capture the right incentives behind these transactions, we consider the announcement date as the date of a merger and acquisition. Lastly, all announced deals that have not been withdrawn are considered.

## **2. Evidence from previous crises**

Although East Asian countries experienced a sharp reversal in net portfolio equity and debt flows during the 1997-98 financial crises, they witnessed a significant increase in FDI inflows. Krugman (2000) and Aguiar and Gopinath (2005) provide evidence that this increase in FDI inflows was driven by an increase in foreign acquisitions.<sup>3</sup> This finding is confirmed by the data shown in Figure 1, which plots the number of cross-border merger and acquisition (M&A) deals during this period for East Asian countries.

The 1997-98 crises also affected other emerging market countries, namely countries in LAC and Eastern Europe. Cross-border merger and acquisition activity for these two regions are also plotted in Figure 1. The graph shows a clear upward trend in the number of cross-border M&A deals over this period. For example, LAC-7 countries had on average around 40 deals per quarter before the crises, whereas during the second half of 1998, this number increased around 50% to 60 deals per quarter. A similar pattern is observed in Eastern European countries after the Russian crisis in the third quarter of 1998. These countries went from an average of 26 deals per quarter before the crisis, to 52 deals per quarter six month after the onset of the crisis.

In line with the existing evidence, Figure 1 suggests that during a crisis affecting only emerging economies, foreign investors from developed countries still have access to financial resources. They are thus able to take advantage of cheaper investment

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<sup>3</sup> The evidence is explained not only by the elimination of policies unfavorable to foreign ownership in East Asia but also by the perception of multinational firms that they can buy Asian companies at significantly lower prices.

opportunities in crisis-affected countries. Consequently, there is a significant increase in foreign ownership of domestic firms in financially-constrained countries.

### **3. The current financial crisis**

In contrast with the Asian/Russian crises, the current financial meltdown was originated in the United States and has then spread to both developed and emerging countries. Consequently, severe liquidity constraints are affecting not only the owners of (financially-constrained) firms in emerging markets but also the potential foreign buyers of these firms. In other words, cross-border mergers and acquisitions in emerging economies should not increase as it has during previous crises.

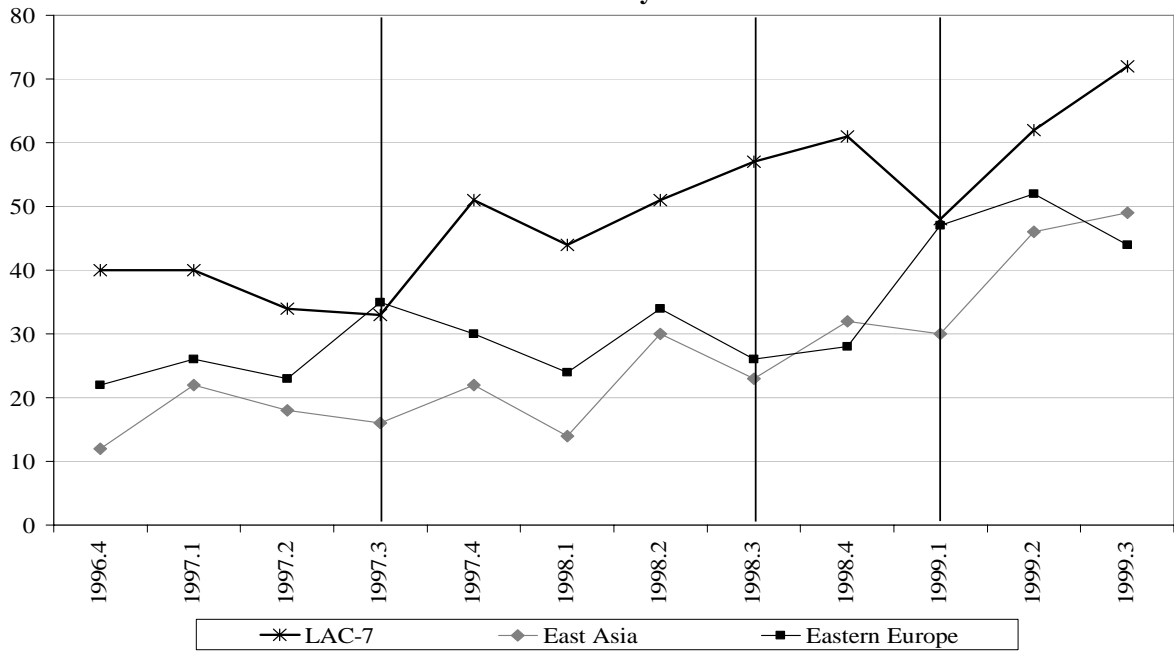
The data shown in Figure 2 confirms this hypothesis. If LAC-7 countries are considered, the number of announced deals has fallen almost 60%, from around 105 deals per quarter in the second quarter of 2007 to only 44 in the last quarter of 2008. There is a similar decrease in the value of the cross-border mergers and acquisitions. Foreign acquisitions amounted to about US\$ 11.6 billions in the second quarter of 2007 and have declined to only US\$4.6 billions in the last quarter of 2008. It should be noted that the decrease in M&A activity is not an issue only for Latin American countries. Similar patterns can be observed in other regions. For example, the number of cross-border M&A deals has decreased 25% in East Asia and almost 70% in Eastern Europe between the second quarter of 2007 and the last quarter of 2008.

Furthermore, the main argument discussed in this note also implies a similar dynamics for the evolution of mergers and acquisitions in the United States. As the crisis has spread to the rest of the world, we should also observe a decrease in cross-border M&A in the United States, which is confirmed in Figure 2. The number of cross-border M&A deals starts to fall in the first quarter of 2008 and has followed a downward trend since then, decreasing almost 70% in the last quarter of 2008 vis-à-vis the second quarter of 2007.

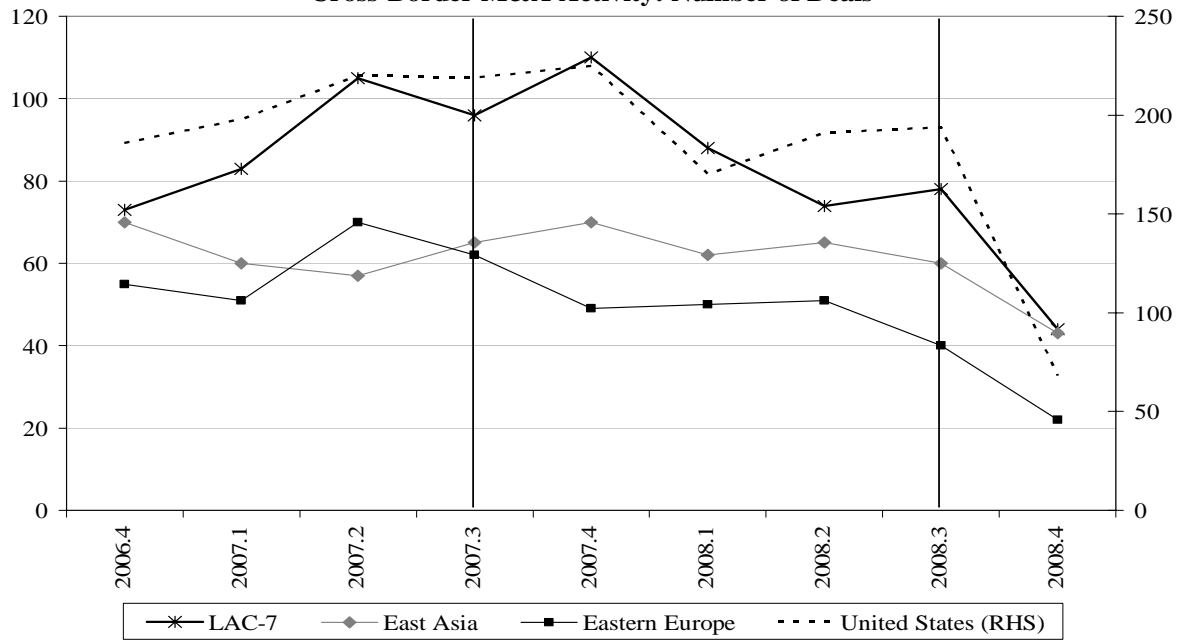
### **4. Conclusion**

In sum, the evidence presented in this note suggests that FDI flows might not remain as resilient as they have been during previous financial crisis. A larger decrease in foreign direct investments should be expected. These developments further illustrate that the nature of the current crisis differs considerably from previous ones, suggesting that certain key lessons from past crisis lessons might not apply in the current context.

**Figure 1**  
**Cross-Border M&A Activity: Number of Deals**



**Figure 2**  
**Cross-Border M&A Activity: Number of Deals**



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