FDI Trajectory in Pre and Post Global Financial and Eurozone Crisis and Policy Response:

focusing on the MEFMI region from 2000 - 2011

Abstract: FDI Trajectory in Pre and Post Global Financial and Eurozone Crisis and Policy Response: Focusing on the MEFMI Region from 2000 to 2011

The study was written by MEFMI Programme Officers - Mr. Evarist A. Mgangaluma and Mr. Amos Cheptoo, MEFMI Graduate Fellows - Mr. Farai Masendu and Mr. Wilson Phiri. It was supervised by: Mr. Sydney Mabika – Director Macroeconomic Management Programme and reviewed by Dr. Satwinder Singh- Senior Lecturer, Brunel University, UK, Dr. George Kararach- AfDB, Mr. James Wakiaga – UNDP and Mr Tinashe Bvirindi, Reserve Bank of Zimbabwe.

This study analyses the impact of the global financial and economic crisis (GFC) on foreign direct investment (FDI) inflows in the MEFMI region for the period 2000 to 2011. Using Vector Error Correction Model (VECM) the study traces long run post- GFC FDI recovery trajectory in selected MEFMI countries. Impulse Response Functions (IRF) has also been generated to explain the response to shocks on FDI and macroeconomic variables with strong bearing on foreign private capital flows. The likely effects and initial experiences on the impact of the Eurozone debt crisis have also been extensively explored. The study analyses the measures and policy responses undertaken by Governments, institutions and multilateral enterprises to minimise the adverse effects of the global financial crisis and the Eurozone sovereign debt crisis on the performance of the domestic economy, with specific focus on stimulating FDI.

The analysis is based on both quantitative and qualitative data. Macroeconomic variables and FDI quantitative data were mainly sourced from Central Banks. The findings from quantitative model have been verified and enriched with inputs from policy makers, institutions, multinational corporations and other stakeholders in the MEFMI region through a perceptions survey.

Quantitative econometric findings suggest that the Global Financial Crisis (GFC) exerted downturn effect on FDI trajectory in the MEFMI region. The adverse effect was indirect and through other key macroeconomic variables notably; collapse in external demand, decrease in world commodity prices, decline in Governments' official reserves and slowdown in real GDP. In the short run, GFC effects are temporary as FDI inflows are gradually converging to their pre-crisis path in the post crisis period. However, grave adverse effects on FDI are evident if GFC persists in the long run.

The quantitative empirical results largely corroborate the findings from the perceptions survey. Survey results suggest that 60% of the survey respondents rated the effects of the twin crises negative. The study establishes that turnover, profits and retained earnings were the most adversely affected variables. However the impact was asymmetric across the selected countries.

The perception results further revealed that Eurozone debt crisis disturbs recoveries in FDI inflows in the post GFC period especially in countries with strong links to the Euro Area. In the outlook period, its influence is projected to be significant if the ailing economies in the Euro Area continue to worsen.

Governments and companies were cautious of the emergence and potential devastating impact of the crises. Monetary and fiscal incentives, including tax waivers and rescue packages, were implemented by most countries in the region as interim measures. Some companies insulated themselves by exploring new markets for their products, exploring cheap sources of finances to reduce costs and reinvesting profits.

Downsizing of labour force was also adopted, mainly among manufacturing enterprises. Closure and suspension of operations were minimal and most enterprises viewed these as measures of last resort.

Although short term crisis mitigation measures proved successful, going forward, the authors recommend long lasting pre-crisis solutions which hinge on the following:

i. Exploring new source markets for FDI and destination markets for goods and services. The reduction in North-South FDI flows could be offset by a surge in South-South flows, with countries like China, India, South Africa, Russia and Brazil taking the lead. FDI flows from these new players, however, remain small relative to total FDI. Nevertheless, South-South FDI is expected to be more resilient when compared to flows from advanced countries, owing to the significant role of state-owned enterprises, limited

reliance on international debt markets for financing, and continued efforts to gain access to energy and minerals assets from the MEFMI region,

ii. Enhancing competitiveness and reducing cost of production. Enterprises should focus on production efficiency and Governments should buttress these efforts through investment in infrastructure such as power generation and roads, which are critical in facilitating current and future growth. Conducive domestic policy solutions could thus ease the painful adjustment related to the fall in FDI by increasing the growth benefits of each unit of the remaining FDI,

iii. Economic diversifications. Efforts should be tailored towards diversifying the economies away from the overreliance on raw natural resources and commodities to minimise vulnerability to external shocks. Such policies include prudent fiscal management and consistent monetary policy supported by appropriate incentives to channel FDIs into export oriented manufacturing, services sectors and import substitution production activities,

iv. Building adequate buffers. Governments should aim at building adequate buffers to cushion the likely effects of the Eurozone sovereign debt crisis. These include taking every opportunity to build foreign exchange reserves, strengthening stabilisation funds and social safety nets. Monetary policy response needs to strike an appropriate balance between fighting inflation and stimulating FDI inflows.

v. Investment policies that attract FDI in form of equity capital which is more resilient to shocks compared to loans. The findings in this study indicate that during recessions in advanced countries, investors tend to reduce their FDI exposure in developing countries by calling back intercompany loans and increasing repatriated earnings, but the equity component generally remains more resilient. Pro-equity capital policies include tax waiver on capital goods and easing regulations on repatriation of shareholder's dividend.

In addition, well-developed financial markets and strong banking systems can enhance foreign investors' confidence and motivate them to hold equity capital in FDI recipient countries.

To order a copy contact MEFMI, 9 Earls Rd, Alex Park, P O Box A1419, Avondale, Harare, Zimbabwe. Email: capacity@mefmi.org / gladys.siwela@mefmi.org