International investment in Europe: A canary in the coal mine?

by Michael Gestrin, OECD Directorate for Financial and Enterprise Affairs
At the start of the 2007 crisis, global foreign direct investment (FDI) stocks actually declined, and even today, global flows of FDI are still 40% below their pre-crisis peak. Generally, OECD countries were the sources of the biggest declines while many emerging economies experienced increases in FDI flows. Europe has been one of the worst affected regions. EU inflows are down 75% and outflows are down 80% from their pre-crisis levels.

Inflows into the EU are currently around USD 200 billion, down from USD 800 billion at the peak of the global FDI cycle in 2007. Outflows are also currently around USD 200 billion, down from USD 1.2 trillion in 2007. For the rest of the world, 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 USD 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.

The crisis initially gave rise to a significant gap between the non-EU-OECD countries and the rest of world with respect to both inflows and outflows, 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, 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.

Comparing the EU and non-EU-OECD shares of world inflows and outflows highlights the extent to which the positions of these two groups have reversed in recent years. At the turn of this 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-EUOECD countries have seen their shares of global FDI inflows and outflows recover to pre-crisis levels. This group overtook the EU in 2010 in terms of its share of both inflows and outflows, thus reversing the historical relationship.

Why? 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 that EU countries receive from their EU neighbours also helps to explain the decline in outward EU FDI.

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 USD 600 billion decline in FDI inflows between 2007 and 2013. Over the same period, Greece, Ireland, Portugal, and Spain accounted for only USD 14 billion, or 2%, of the inflow decline. With respect to outflows, France, Germany, and the UK accounted for 59% of the USD 1 trillion decline between 2007 and 2013. Over the same period, Greece, Ireland, Portugal, and Spain accounted for 12% of this decline.

Part of the explanation for the decline in investment in Europe is linked to an increasing share of international divestment relative to international mergers and acquisitions (M&A). 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 USD 100 billion.
The clear “leader” in this regard is the consumer products segment, with a divestment/investment ratio of 148%. This means that for every dollar 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. Domestic and international M&A in Europe have generally followed the same pattern: both are on track 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.

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. In Europe, many such impediments represent 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 investment de-globalisation and “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 organising their global value chains.

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 recommendations for getting Europe back on a sustainable growth path that also hold for investment:

1. Further develop the Single Market.
2. Ease excessive product market regulation.
3. Invest more in R&D and step up innovation.
4. Make sure that education and training institutions deliver highly sought after skills.
5. Increase the number of workers participating in labour markets and make markets more inclusive to address social inequalities.
6. Reform the tax system, including by reducing the tax wedges on labour.

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