The Impact of Economic Crisis on the International Investment Position and Foreign Direct Investments of European Union

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Abstract: In 2007/2008 world economy faced the deepest economic crisis since World War 2. Economic crisis originated from US but soon adopted a global shape and effect many developed and developing countries. 2007/2008 economic crisis significantly increases public debt of many developing and developed countries. The crisis turned into serious debt problem particularly in Europe. Financial crises of 2007/2008 seriously influence the investment opportunities in European Union region. The crisis hit hard both inward FDI and outward FDI on a higher level. Crisis in EU restrict inward FDI coming in European Union, while high debt limit the outward FDI. Restriction of both inward and outward FDI severely hit the job sector and foreign companies in EU. NIIP of overall Europe Union fall significantly during the crisis. In 2008 EU faced current account deficit and net financial transaction created a negative impact on NIIP.

Keywords: European Union, Foreign Direct Investments, International Investment Position

General terms: EU, FDI, IIP

1. Cause, Responses and Consequences to Economic Crisis in Europe in 2007/08

1.1 Causes of Economic Crisis in Europe in 2007/08

The 2007-2009 financial crises affected the European Union’s (EU) economies mainly because large European financial institutions adopted essentially the same business model as those operating in the United States before the crisis. The financial crisis began in the United States during the second half of 2006 with a sharp increase in U.S. bank losses due to subprime mortgage foreclosures. Because the U.S. and EU large banks were using a similar business model, the EU experienced similar distress financial conditions that U.S. banks faced: Large banks on both sides of the Atlantic found themselves severely undercapitalized and holding insufficient liquidity. EU financial regulations are enforced at the European level as well as the member country level. One of the consequences of this bifurcation of financial services regulations is that finding and implementing effective remedies for the causes of the financial crisis have been slower and different from the U.S. experience. Almost immediately after the decline in profits began in the United States, the EU’s bank profits were similarly negatively affected. Six months later, in July 2007, the German government and financial regulators asked for and were granted approval by the EU Commission to bailout a German bank, IKB, with a 9 billion Euros ($11.7 billion) recapitalization due to losses suffered for investing in U.S.-subprime mortgage securities. Other EU member countries’ governments’ injected capital in their financial institutions such as the UK’s Northern Rock bank soon after the subprime crisis hit the United States. The speed of the financial effects on the EU was not surprising because much of the U.S.-securitized debt was originated to be distributed to European institutions and investors. This report assesses the response of the EU to the 2007-2009 financial crises in terms of the financial regulatory changes it has made or is planning to make.

Financial crisis - the economic situation that is related to the banking panic, which includes significant production and financial sector losses, causes chaos on international markets, creates the stock market’s downfall, financial bubbles, currency crises, and foreign loans, leads a sharp decline in economic activity and has a potential to cause an economic recession. The most common financial (economic) crisis occurs when certain financial institutions or funds invested in financial assets lose most of their value.

Although the types of economic crisis, the reasons and circumstances in different countries in different periods are different, there can be found crises common denominators and learnt from past mistakes. Monitoring of relevant macroeconomic variables, comparing them with the theory of the trends can provide early warning of impending crisis. [2]

1.2 Responses to Economic Crisis in Europe in 2007/08

1.2.1 Five key responses combined to steer Europe out of the crisis

1. Crisis-hit countries like Ireland and Spain pushed through badly needed reforms, improving public and increasing competitiveness.
2. EU economic governance was strengthened. The European Commission received new powers to enforce the Stability and Growth Pact, issue country-specific recommendations and underline obstacles that need to be removed to foster growth. Euro stat, Europe’s statistical agency, became more powerful in cross-
checking and challenging the data received from each country.
3. Euro area countries created the European Stability Mechanism and its predecessor the European Financial Stability Facility. These institutions were a great success: no country was forced to leave the euro area, the cash-for-reform approach worked and growth accelerated in countries that implemented reforms. Importantly, no European taxpayer money was spent on the rescue programs.
4. The European Central Bank’s unconventional measures helped. The ECB expanded its balance sheet like the FED. Bank of Japan and Bank of England, provided unlimited liquidity for banks, started a bond purchasing program to avoid low inflation, which also made it easier for banks to lend and boost investor sentiment. The euro weakened which helped to increase exports.
5. The Banking Union was established: new institutions were created to monitor macro-prudential risks and supervise banks, securities markets and insurance companies. The Single Supervisory Mechanism is the centerpiece of this initiative; it oversees the 139 largest euro area banks. During the crisis, EU banks also padded out their capital, increasing their capital base by € 600 billion since 2008.

1.2.2 The Borrowing Responses

In the years before 2007/2008, Ireland and Spain appeared to have the healthiest fiscal positions. They had run overall budget surpluses for at least the preceding three years. But, with the onset of the crisis, it quickly became clear that this position was propped up by unsustainable revenues, from the property market in particular. Although suffering a little less severely, France, Italy and the UK also saw their underlying public finances weaken, each by just over 5% of GDP. In other words, they had taken no policy action at all. They would have ended up borrowing over 5% of GDP more every year and forever.

The only exception was Germany, whose public finances were in the long term unaffected by the Great Recession. Germany was the only one of the six countries for whom this looked like a “text book” recession; a temporary increase in borrowing followed by a quick return to normal times.

1.3 Consequences of Economic Crisis in Europe in 2007/08

Europe not only endured the last crisis, it capitalized upon it. Europe’s five key policy responses meant the continent emerged stronger. The results, such as in Ireland or Spain, are impressive. Completing the Banking Union, deepening the Capital Markets Union and strengthening Economic and Monetary Union will make Europe’s economy more competitive, diverse and robust. It is crucial that Europe not deviate from this path and that it continues to turn headwinds, like immigration into opportunities.

Europe has put together the building blocks for a bright future. Its citizens can justly be proud of these achievements. Realizing this ambitious agenda will make Europe stronger, more influential and ensure it maintains its position as an economic powerhouse.

2. Four Member Countries Regulatory Structures and Responses

EU member countries have not delegated all financial regulatory authority to the European Union to enable the EU (Brussels) to fully manage the EU response to the 2007-2009 financial crises. With some EU oversight, each of the 27 member countries had the responsibility to respond. The Congressional Research Service (CRS) selected Four Euro zone countries to illustrate the regulatory changes that have occurred or are planned to occur since the beginning of the 2007-2009 crisis. The countries are Germany, the United Kingdom, the Netherlands, and Spain. These countries provide a variety of financial services regulatory structures through which their national regulatory policies as well as the EU’s policies are being implemented. Germany and the United Kingdom have single financial service regulators [7].

2.1 Germany’s Financial Regulatory Structure

The single regulator of financial services in Germany is the German Federal Financial Supervisory Authority (BaFin), which was established in 2002 to improve the functioning, stability and integrity of the German financial system. BaFin is an independent agency governed by public law, run by an administrative Council, and chaired by the Federal Ministry of Finance. It does not receive any funding from the German government’s budget. In the area of financial regulatory enforcement, BaFin has wide ranging authority to conduct investigations and the power to immediately call for the cessation and closure of
unauthorized activities. It can take appropriate and necessary action to prevent undesirable developments that might harm or threaten the interest of policy holders.

BaFin’s supervisory responsibilities of the securities industry involve enforcing standards of professional conduct aimed at preserving investor trust in the securities markets. Even though securities exchange supervision is shared with the local governments where they are located, BaFin’s investor protection responsibilities of securities exchanges include solvency and disclosure requirements. If an institution finds itself in a liquidity crisis, the law gives BaFin the power to prohibit that company from making payments to its foreign parent company. The law gives the regulator the power to increase capital requirements and require equity capital buffers in times of economic slump or under special business circumstances. Under financial institutions governance, the new law mandates that the number of supervisory board members should be limited to no more than two former executive managers. BaFin may prohibit an institution from distributing their profit to shareholders if such distribution could hinder the institution’s ability to fulfill its liquidity requirements. The new law also increases professional competence requirements of financial institutions.

2.1.2 Germany’s 2007-2009 Financial Crises

Despite BaFin’s enhanced authority, BaFin, like U.S. and other EU financial services regulators, failed to anticipate the 2007-2009 financial crisis. As the crisis unfolded several of BaFin supervised institutions were found to be severely undercapitalized because they had adopted the originate-to-distribute business model, which was not directly addressed in the act for the Strengthening of the Financial Market and Insurance Supervision. Instead, government bailout policy in the form of bank recapitalization was implemented because these troubled institutions’ balance sheets were heavily burdened with nonperforming securitized assets. The German government allowed these institutions to create a so-called “bad bank” to which banks transferred their securitized non-performing assets. In return the banks received government bonds and debt guarantees as well as lines of credit valued as high as 90% of the securitized debt (toxic assets). The bailout is funded by Germany’s Financial Market Stabilization Fund (SoFFin). Although the German government took this action in the crisis, the European Commission’s approval was also necessary. The EU commission approved all financial assistance programs extended by the German government. Germany’s Financial Market Stability Fund provided a guarantee of 152.9 billion euros ($186 billion) to Hypo Real Estate Holding (HRE): HRE immediately received 103.5 billion euros ($127 billion). In addition, the German government provided financial support to: Aareal Bank AG: 0.5 billion euros ($614 million), Commerzbank AG: 18.2 billion euros ($22 billion), and West LB AG: 3.0 billion euros ($3.6 billion).

2.2.1 The United Kingdom’s Financial Regulatory Structure

The United Kingdom’s regulatory response to the 2007-2009 financial crisis was executed through the Financial Services Authority of the United Kingdom (FSA). In 1997, the United Kingdom’s government consolidated financial services regulation in the UK by combining nine regulatory bodies into one new agency. FSA was given the responsibility to regulate virtually every aspect of financial services. To compare with the United States, FSA has the roles played by the federal and state banking agencies, the Securities Exchange Commission, the Commodity, Futures Trade Commission, state insurance and securities commissions, as well as the Self Regulatory Organizations. Over the years, it was given expanded independent enforcement powers enabling it to bring action against violators and impose sanctions. FSA has a single ombudsman to handle complaints by consumers in all financial services. This is in contrast to the numerous hotlines to the various federal and state agencies in the United States. Another provision of the FSA is that it assigns one office to develop policies on capital requirements for all financial sectors. By comparison, in the United States, the assessment of risks and capital requirements are developed separately for insurance, banks, broker-dealers, and futures commission merchants. FSA is organized as a private corporation with a chairman and a chief executive officer and 16-person board of directors. Eleven members of the board are independent. FSA’s organizational strategy is to focus on the most damaging potential risks to the financial system. Consequently, it generally targets larger financial firms. It is required to furnish cost-benefit analyses for its proposals and report annually on its costs relative to the cost of regulations in other nations. Most financial firms under the FSA and the International Monetary Fund (IMF) have reported that FSA has been successful in regulating the financial services industry in the United Kingdom.

The Conservative Party had made its plan known to abolish the FSA during the election campaign. The Conservatives blamed FSA, which was established by former Labor Prime Minister Brown, for failing to prevent the 2007-2009 financial crisis that caused economic activities to decline into the worst recession since World War II and taxpayers having to bailout a number of large financial institutions. In the next two years, the Chancellor’s plan is to create a prudential regulatory authority as a subsidiary of the Bank of England that will work with the UK Treasury. At the Bank of England, there will also be a financial policy committee and a consumer protection and market agency.

2.2.2 UK’s 2007-2009 Financial Crises

In February 2008, the UK government had to nationalize Northern Rock Bank plc, which was the first UK bank failure of the 2007-2009 financial crises. This originate-to-distribute lender was near collapse in 2007, which caused it to seek emergency funding from the Bank of England after which there was a run on the bank on September 14, 2007 causing it to lose deposits rapidly in...
the beginning of the liquidity crisis. After FSA and the Bank of England placed a significant amount of taxpayers’ money in Northern Rock, these regulators entered an auction process to find a private buyer, but no suitable bids were made. Consequently the government nationalized the bank in order to protect the taxpayers’ investment in the bank. The Bank of England plans to attempt selling the bank in the future in more favorable financial conditions. The United Kingdom responded to the financial crisis similarly to the United States. The Bank of England and FSA tried to slow the financial turmoil and avert the threat of a deep economic recession by injecting 500 billion pounds ($750 billion) in the country’s eight largest banks and building societies.

2.3.1 The Netherlands’ Financial Regulatory Structure

The twin peaks financial services regulatory structure for all financial institutions in the Netherlands was established in 2004. It is called twin peaks structure because it divides the supervision of financial services providers into two parts: prudential supervision and market conduct supervision. The prudential supervisory agency writes and enforces the prudential requirements on financial services providers. These requirements include licensing, reserve levels, and capital requirements. Providers found not in compliance with these requirements could be ordered to cease operations in the Netherlands. The market conduct supervisory agency regulates the financial market with regard to consumer protection, financial audits, disclosures and the overall integrity of markets. The prudential supervisory agency was placed under the Netherlands national bank, which is the Netherlands’ central bank and is a member of the European System of Central Banks. The market conduct supervisor was placed under the newly established Netherlands Authority for Financial Markets (AFM). Both prudential and the market conduct supervisors were placed under the Ministry of Finance57 that does no supervision of financial services providers, except mergers and takeovers of any of the five major banks in the Netherlands.

2.3.2 The Netherlands’ 2007-2009 Financial Crisis

The Netherlands’ financial structure was severely exposed to the 2007-2009 financial crises and immediately concentrated on recapitalizing its major banks. When the financial crisis began affecting bank profits in the United States in the summer of 2006, the Netherlands had very low unemployment, a large and stable current account surplus, low government debt and a budget surplus. However, at that time, the Netherlands had the largest foreign claims in the Euro-zone. Foreign claims on Dutch financial institutions amounted to 300% of the country’s GDP. More importantly, its exposure to the American financial market was also the highest in Europe with an exposure of 66% of GDP compared with the UK’s exposure of 40% of GDP.

The crisis really took hold in Netherlands with the bankruptcy of Lehman Brothers in September 2008. Several Dutch banks had counterparty financial relations with Lehman Brothers. By early October 2008, the Belgian-Dutch bank, Fortis asked for government help because of liquidity problems caused by declining stock value and the acquisition of the Dutch Bank ABN Amro, which depleted Fortis’s capital. The finance ministry’s response was to fully nationalize the Dutch bank and insurance division in a 16.8 billion euros ($21.8 billion) agreement. The Belgian government took a minority interest (49%) in Fortis and the majority interest (51%) was sold to the French Bank BNP Paribas. The Dutch government also guaranteed all bank savings up to 20,000 euros ($26,000) and drew up plans to guarantee all savings up to 100,000 Euros ($130,000) because there was a run on savings accounts at Fortis.

2.4.1 Spain’s Financial Regulatory Structure

Like the United States, the Spanish financial regulatory structure is a modified functional regulatory framework where the functions of banking, insurance, and securities trade are supervised by separate prudential supervisory agencies. The Bank of Spain (BDE), Spain’s central bank, writes and enforces Spain’s banking laws and regulations. For the securities trade, the National Securities and Exchange Commission (CNMV) is the primary regulator. For insurance, the Ministry of Finance is the insurance industry primary regulator. However, the General Directorate of Insurance and Pension Fund (DGFP), which is under the auspices of the Ministry of Finance, has no regulatory powers but influences insurance supervision through its influence on the Ministry of Finance. As a member of the European Union since 1986, Spain’s financial services regulatory structure is governed by a policy of taking preventive rather than corrective actions in compliance with the EU’s harmonizing legislation and international standards. As a member of the European System of Central Banks, Spain’s financial markets have become increasingly integrated into the European Markets.

2.4.2 Spain’s 2007-2009 Financial Crises

Spanish banks are very retail-orientation. Consequently, Spanish banks were not directly affected by the U.S. subprime crisis and ramifications. Even though Spanish commercial banks have had less exposure to mortgage-backed securities and derivatives because of more conservative underwriting regulatory enforcement, the credit crunch of the financial crisis brought the Spanish decade-long real estate and construction boom to an end in 2009 when Spain’s GDP fell by 3.9%. Moreover, Spanish banks were less leveraged than their European peers and also more profitable. However, since customer deposits have not kept pace with domestic credit expansion, banks have increasingly tapped international capital markets. Because Spain introduced economic austerity before Greece, Spain’s unemployment rate was higher. The expectation was that Spain would be better able to keep its debt payments current, which they have done so far despite paying higher interest rate on its debt.
3. Impact of Crisis on FDI in EU Countries

3.1 The situation before the crisis in Europe

In the period before the crisis, Europe had kept the lion’s share of Foreign Direct Investment flows, especially because of large interchanges of capital between the countries of the European Union, given the high level of economic integration of the area and the participation to this agreement of ten new members, all developing countries with good perspectives of growth.

Considering figures, in 2005 the 25-member European Union was the favorite destination of FDI across the world, with inflows of $499 billion (almost half of the world’s total); in 2006 the predominant role was still played by the European Union, where inward FDI grew by 9%, to reach $585 billion (41% of total global amount). In 2007, the EU attracted two thirds of the total flows to developed countries, receiving $854 billion, about 44% of the total FDI reported for that year, and confirming to be the most important pole with the European Monetary Union (or Euro zone), at that time including 13 countries, playing a central role and growing in a year by 62% to $553 billion. The richer the host and source countries the greater the volume of exchanges, implying, according to what has been found by Hattari and Rajan, that FDI increase relatively more than portfolio investments. Given that EU countries are among the most advanced economies in terms of gross domestic product, also this fact is confirmed by our data.

In 2007, the European Union presented an increment of 2, 4% of the level of prices, a little higher than the one faced on average by other advanced economies (2, 2%), while the euro region showed a 2, 1% increase. Investments are inversely correlated with the cost of capital. In this case, to check these data, we use the long-time interest rate, observed by the Organization for Economic Cooperation and Development, as a benchmark for the general level of the cost of capital. Moreover, this statistic is important to evaluate risk sentiments toward a country. We note that, from 2005 to 2007, the Euro zone showed low rates when compared with the United States and the United Kingdom data, while the statistics from the other countries of the European Union (like Denmark, Czech Republic, Slovak Republic, Slovenia) were quite close to the Euro zone ones; however, Japan is the only country displaying inferior levels, below 2% for each period considered.

If in 2005 one euro was able to buy 1, 18 dollars, in one year the exchange rate rose to 1, 31, showing an appreciation of the European currency by 11%, while in 2007 the exchange rate rose to 1, 47, an increase of 12% in just a year. [3]

3.2 The situation during the crisis in Europe

When the financial crisis broke out resulting in a huge impact on investments, Europe lost part of its appeal. The crisis broke out between 2007 and 2008, starting from financial markets, with the increasing default cases caused by subprime mortgages, rapidly affecting real economy.

The European Union started to reveal signals of weakness: not only the growth of GDP in the years after the crisis was lower than in other advanced economies, but States with structural problems and high stock of public debt accumulated (such as Italy) exhibited statistics, especially regarding the interest rate, diverging from other economies of the Union, discouraging investments from international corporation. In the majority of EU-27 countries Foreign Direct Investments fell, with a reported decline of 37%, to a total of $542 billion considering the whole region. The trend continued in 2009, when FDI flows into the 27 European Union countries dropped by 34% (to $357 billion).

![Chart 3: FDI Inflow/Outflow](image)

It is worth knowing that, for the considered period, developing countries exhibited high growth, shortening the gap with advanced economies not only in terms of investments but also in terms of domestic production. [3]

4. Data and Descriptive Statistics

Based on the GDP growth rate evolution, we consider the year 2009 to be the first year of the economic crisis, because all CEE countries recorded a decrease in both GDP and FDI level. The exception is Poland which in 2009 recorded an increase in both GDP (1.6%) and FDI level (7.1%).
Table-1: The table presents the total value of FDI invested by the main 20 investors in EU countries for the period 2005-2012 expressed in billion EURO. The column Share denotes the percentage of each country FDI in the total value of FDI in EU countries for the same period. At the same time, the table presents descriptive statistics for two important sub periods: 2005-2008 and 2009-2012, as well as the percentage evolution between these two sub periods. Data were obtained from each national bank of EU countries, being collected from July until August 2015.

Table-2: The table presents the total value of FDI for EU countries split by economic activities expressed in billion EURO. The column Share denotes the percentage of FDI value for each economic activity in the total value of FDI in EU countries for the same period. At the same time the table presents the average FDI per economic activity for two important sub periods: 2005-2008 and 2009-2012, as well as the percentage evolution between these two sub periods. Data were obtained from each national bank of EU countries, being collected during July to August of 2015.

5. The Structure of International Investment Position (IIP) and The Stability of External Financing of The Economy

In 2008 a global crisis broke out that triggered a deep recession in the real sphere and led to disturbances in the financial markets of the European Union. One of its causes was a growing external imbalance, demonstrated through lasting current account deficits and a mounting foreign debt of certain member states (Alessandri, Hallett, Presbitero, Fratianni, 2012). Considering the negative consequences of the crisis, at the end of 2011 the European Union implemented solutions that were to detect and remedy the disturbances of macroeconomic balance, not only in external terms, but also internal ones. One such solution is the so-called Macroeconomic Imbalance Procedure, the objective of which is, interalia, to facilitate an early diagnosis and monitoring of macroeconomic balance disturbances in all of the EU member states. Within the scope of the procedure the European Commission each year prepares a report in which it evaluates the economic and financial situation of member states based on the analysis of a number of indicators. One of such basic indicators regarding an internal balance is

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the relation of net international investment position (net IIP) to GDP, for which a threshold value of ~35%GDP was adopted. The use of international investment position for the evaluation of an economy’s external balance results from the fact that it reflects a wide scope of a country’s financial ties abroad. The IIP value can impact on an economy’s capacity to serve its liabilities towards non-residents, to contract new liabilities and it further influences the balance of payments.

A negative Net IIP value means that there is an excess of foreign liabilities over assets and it reflects the scale of the demand for an economy’s net foreign financing. From the research it follows that a high negative IIP value increases the probability of an economy’s financial destabilization as a result of a sudden foreign capital departure. A crisis typically causes a decrease in economic activity and a growth of the risk of debtors’ insolvency on account of their deteriorating financial situation (Fidora, Schmitz, Tcheng, 2017, p. 4). Apart from the value and balance of foreign assets and liabilities, their structure plays a significant role in evaluating the risk resulting from excessive negative IIP (Knap, 2016). The structure divided into functional categories, i.e. a division into direct, portfolio investments, other investments and derivative instruments are, among other things, of significant importance. In the literature of the subject the dominant view is that direct investments are the most stable element of foreign liabilities (Loungani, Razin, 2001). It results from the long-term nature of those investments as well as their generation of profit from the conducted business activities; hence the probability of a sudden capital departure is relatively lower than in the case of other foreign investments. It applies in particular to the part of direct investments that were made in the form of a contribution of participating interest. It is particularly important at the age of growing attacks from speculative capital. Differently than in the case of bank loans, or the issue of debt securities, the above-specified type of foreign financing allows for a division of risk between an investor and a borrower, since the investor gains profits from a financial enterprise only when it generates profits. [9]

6. Conclusions

The 2007-2009 financial crises affected the European Union’s (EU) economies mainly because large European financial institutions adopted essentially the same business model as those operating in the United States before the crisis. The financial crisis began in the United States during the second half of 2006 with a sharp increase in U.S. bank losses due to subprime mortgage foreclosures.

When the financial crisis broke out resulting in a huge impact on investments, Europe lost part of its appeal. The crisis broke out between 2007 and 2008, starting from financial markets, with the increasing default cases caused by subprime mortgages, rapidly affecting real economy.

In 2008 a global crisis broke out that triggered a deep recession in the real sphere and led to disturbances in the financial markets of the European Union. One of its causes was a growing external imbalance, demonstrated through lasting current account deficits and a mounting foreign debt of certain member states. However, Europe’s five key policy responses meant the continent emerged stronger. Europe has put together the building blocks for a bright future. Its citizens can justly be proud of these achievements.

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