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THE EFFECT OF COVID-19 PANDEMIC ON FOREIGN DIRECT INVESTMENT

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Abstract:

The COVID pandemic is a game-changer that affected almost every aspect of our lives, both economically and socially. The emergence and spread of the COVID virus forced countries worldwide to impose various restriction policies at different times. Growing economic ties between countries are accelerating the transfer of goods and information and the effect triggering economic crises. Multinational corporations' foreign direct investments (FDI) have been greatly affected, as they represent a significant global aspect of economic development in the last decades. The Foreign Direct Investments (FDI) are sensitive to economic and other shocks. Nevertheless, only by a few because FDI is often considered long-term and less sensitive to global shocks, as they involve large amounts of capital investment that are costly to reverse. This paper examines whether the COVID-19 pandemic impact FDI flows. If they do, we analyze the possible channels through which the COVID-19 pandemic influences FDI flows. Our findings show that during the COVID-19 pandemic, investment flows had different impacts on various sectors and were also influenced by the modes of entry. In the manufacturing sector, pandemic damage in host countries has a significant negative impact on both Greenfield FDI and cross-border mergers and acquisitions. In-home countries, it does not significantly impact both types of FDI.

Key words: Foreign direct investment; Covid-19, pandemic; host country; home country.

JEL classification: F20, F21, G01.

1. INTRODUCTION

The COVID pandemic is a game-changer that affected almost every aspect of our lives, both economically and socially.

The emergence and spread of the COVID virus forced countries worldwide to impose various restriction policies at different times. Some governments introduced stringent measures and then relaxed them due to the decrease in outbreaks. Instead, other governments imposed fewer and more gradual restrictions as infection outbreaks emerged. (Hale et al., 2021).

Cross-border economic activities were severely affected by the movement of capital, trade flow and human movement. In this context, multinational corporations' foreign direct investments (FDI) have been greatly affected, as they represent a significant global aspect of economic development in the last decades.

According to the International Monetary Fund (2021), in 2020, “the global economy decreased by 3.2% and global trade by 8.3%; foreign direct investments were the most affected”. According to the United Nations Conference on Trade and Development (2021), “*global FDI flows fell by 35%, from $1.5 trillion in 2019 to $1 trillion in 2020. Globally, in 2020 FDI decreased more than the global gross domestic product, or trade decreased*”.

In general, FDI is affected by economic shocks. Financial crises have been observed to negatively influence the FDI flows (Dornean, Işan, and Oanea, 2012; Poulsen and Hufbauer, 2011; Dornean and Oanea, 2015; Stoddard and Noy, 2015). Financial crises cause less liquidity for investors.

The restriction policies, such as lockdowns and social distancing, have determined a reluctance to develop new investments, considering the state of uncertainty regarding the subsequent evolution of the economies. FDI operating costs have also increased. The COVID-19 pandemic has again illustrated the vulnerability of global trade and value chains to external shocks.

The entire supply chain was automatically affected when a country had to close its factories due to pandemic measures. To reduce this risk as much as possible, many companies have been tempted to reduce their dependence on concentrated production in foreign countries (Lee and Park 2020). This aspect influences the direction of FDI flows (Hanson, Mataloni și Slaughter, 2005; Aizenman și Noy, 2006, Carril-Caccia și Pavlova, 2018; Kazunobu Hayakawa et al., 2022).

2. FOREIGN DIRECT INVESTMENT DURING THE PANDEMIC

During the pandemic, lockdowns worldwide have slowed down existing investment projects and caused potential future investments to be re-evaluated. In developed economies, FDI fell by 58%, the leading cause being corporate restructuring and intra-firm financial flows. In developing economies, FDI fell by 8%, the leading cause being strong flows from Asia. Thus, "developing economies accounted for two-thirds of global FDI, up from just under half in 2019" (World Investment Report, 2021).

All components of FDI decreased. Capital investments fell by more than 50%, due to the reduced implementation of new projects and the slowdown in cross-border mergers and acquisitions (World Investment Report, 2021).

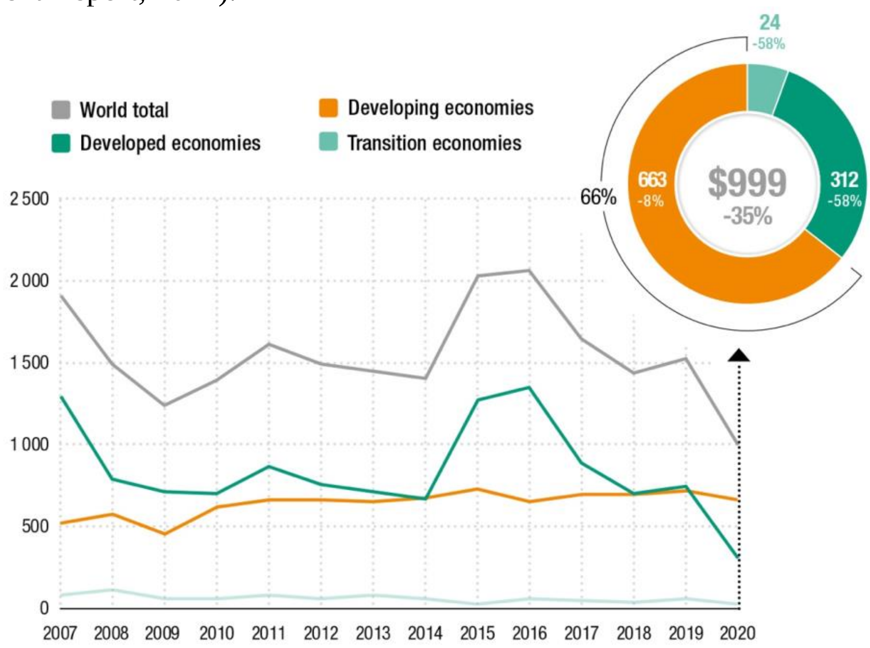

Figure no. 1. FDI inflows (billions of dollars and percent)
Source: World Investment Report, 2021;

Developed economies were more affected than developing ones. Though, in developing and transition economies, FDI inflows were more affected by the impact of the pandemic on investment in GVC intensive, tourism, and resource-based activities.

In developing countries, FDI flows decreased differently: in Latin America and the Caribbean, there was a 45% drop and in Africa, a 16% drop. Conversely, in Asia, FDI flows increased by 4%, making the region account for half of world FDI in 2020. In transition economies, FDI decreased by 58%. The pandemic further deteriorated FDI in structurally weak and vulnerable economies. Although inflows in the least developed countries (LDCs) remained relatively stable, greenfield investments decreased by half and international project finance deals by one-third. In Europe, FDI inflows dropped by 80 %, while those to North America dropped by -42 %. The largest host country for FDI is the United States, followed by China (figure no. 2). (World Investment Report, 2021).

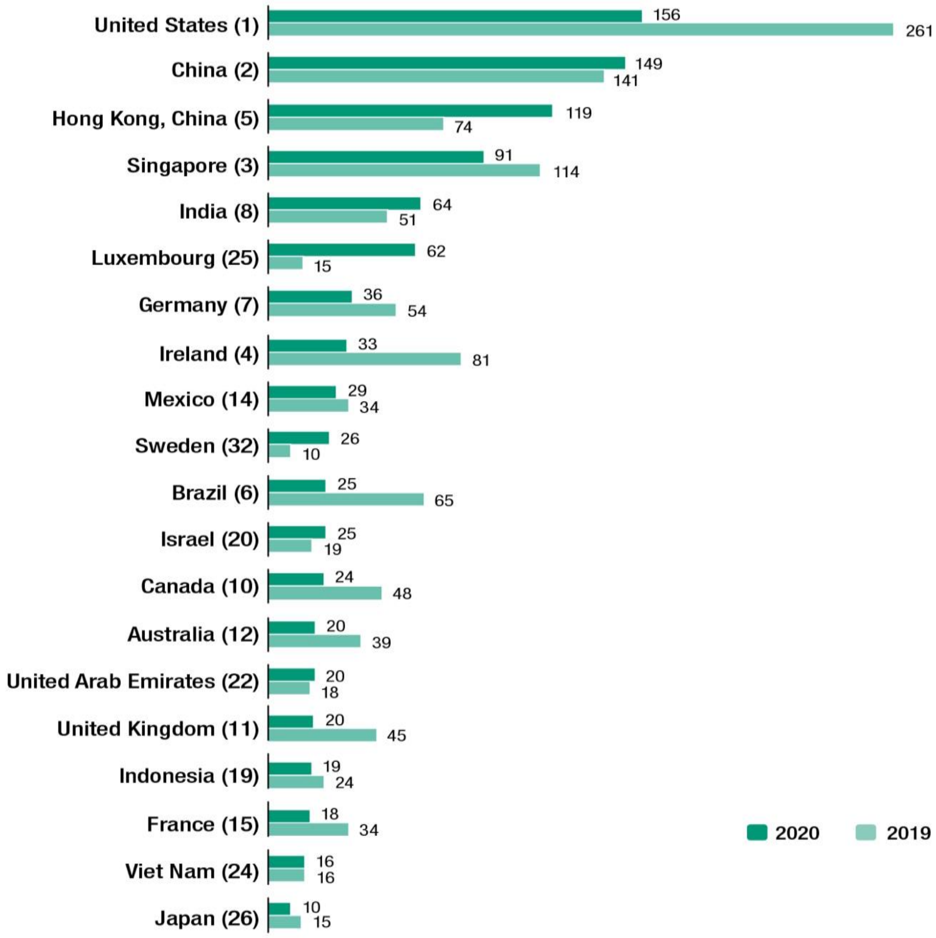

Figure no. 2. FDI inflows, top 20 host economies (billions of dollars)
Source: World Investment Report, 2021;

In 2020, multinational companies from developed countries decreased their investment abroad by 56%, to $347 billion, the lowest value since 1996. As a result, their share of global FDI decreased to a minimum record of 47%. As with inflows, the decline in investment from significant investor economies was exacerbated by high volatility in conduit flows. Total foreign investment by European multinationals decreased by 80%, to $74 billion, and there was a decrease in outflows in the Netherlands, Germany, Ireland, and the United Kingdom. Outflows from the United States were flat at $93 billion. Japan, the most prominent foreign investor in two years, recorded a massive decrease in capital outflows, up to half, reaching $116 billion (World Investment Report, 2021).

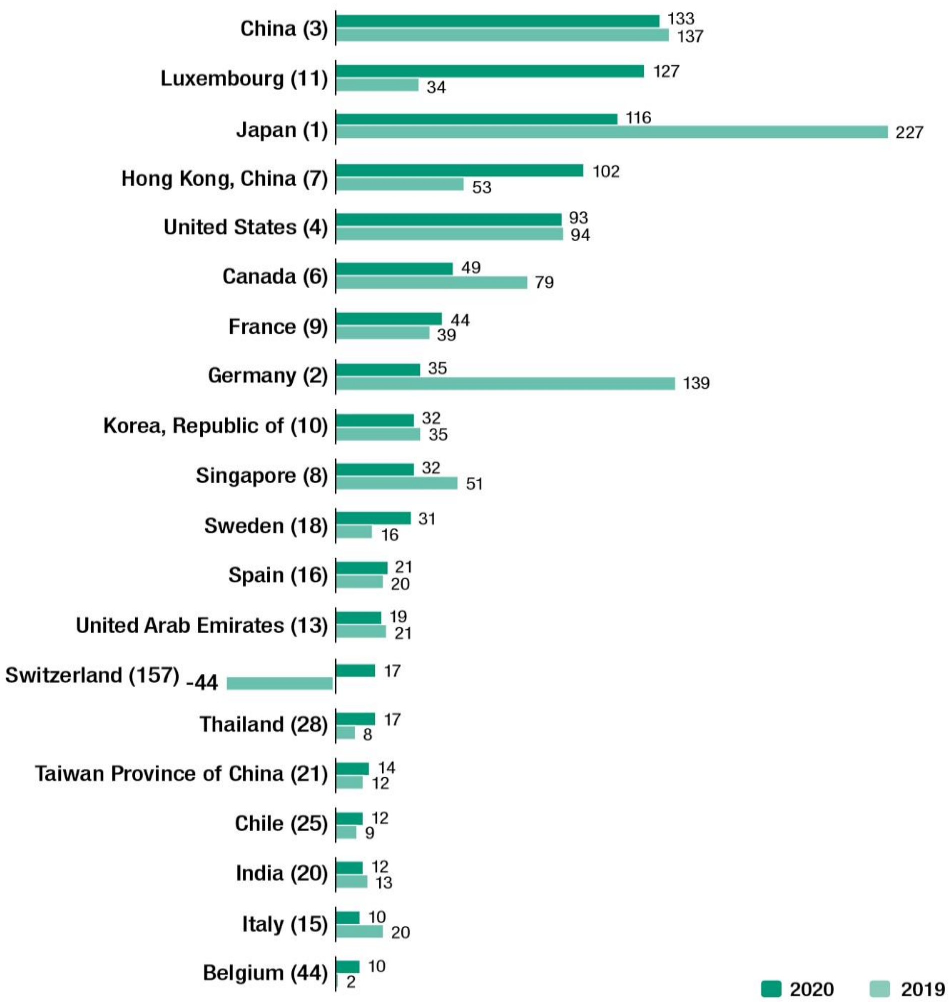

Figure no. 3. FDI outflows, top 20 home economies (billions of dollars)
Source: World Investment Report, 2021;

4. CHANNELS OF INFLUENCE OF FDI FLOWS DURING THE PANDEMIC

Next, we presented the main channels through which FDI flows were affected by the pandemic. A first influencing factor was observed to be the supply capacity of the home country, such as the number of potential investors. It also matters how high is the demand in the host country, what are the costs of production in the host country and what are the costs for implementing FDI (Helpman, Melitz and Yeaple 2004; Kleinert and Toubal, 2010; Kazunobu Hayakawa et al., 2022).

A first analysis ist that of *the damage caused by the pandemic in the host country, compared to the damage in the home country.* The greater the pandemic damage in the host country is, the lower the FDI flows are; there is an inversely proportional relationship. Secondly, when there is a state of uncertainty, investors are more reserved in making new investments. Third, the fixed cost of investment is generally higher in the more affected countries. Also, if the investors encounter difficulties carrying out the activity in their home country, they may partially or totally restrict their activity abroad. On the other hand, if registered damages are very high in the home country, then FDI will go to other less affected countries. However, in this case, handling and transport costs increase. So that companies will tend to move their production abroad and sell in the host country (Kazunobu Hayakawa et al., 2022).

The second aspect analyzed is production versus services, in the context of restrictions on commercial operations imposed during the pandemic. In most situations, working from home was more accessible to implement in the service sector than in the manufacturing sector. Nevertheless, there were also some service sectors in which working from home could not be implemented, such as transport and storage, accommodation sector and food services. Investors can only start a new business abroad if working from home is an option for their business operations. (Kazunobu Hayakawa et al., 2022).

The third aspect analyzed is cross-border mergers and acquisitions (M&A) versus greenfield FDI. In the case of M&A, it involves the acquisition of the assets of a foreign company, including buildings and workers. On the other hand, Greenfield investments assume establishing a new business from scratch. Considering the restrictions due to the pandemic, constructing new factories would be challenging to achieve, so Greenfield investments are more affected. On the other hand, if the host country is severely affected by the effects of the pandemic, then the acquired firms are valued at lower values, named fire-sale FDI. In this case, investors can acquire local firms with better prices (Stoddard and Noy, 2015). From this point of view, M&A tends to increase in countries more affected by the pandemic. Another difference is that M&A can be implemented much more quickly, because they do not involve a time-consuming authorization step (Stoddard and Noy, 2015). Thus, FDI entry modes are affected differently by the pandemic (Kazunobu Hayakawa et al., 2022).

5. CONCLUSIONS

Global foreign direct investment flows have been severely affected by the COVID-19 pandemic. In 2020, they fell by a third to $1 trillion, well below the low level reached after the global financial crisis a decade ago.

It can be seen that the Covid pandemic has had different impacts on various sectors and modes of entry. For example, in the manufacturing sector, pandemic damage in host countries has a significant negative impact on both Greenfield FDI and cross-border M&A. In-home countries, it does not significantly impact both types of FDI. This finding is particularly evident when the number of cases or transactions expresses FDI flows. For example, in the services sector, FDI was affected both in the host and home countries. Cross-border mergers and acquisitions were not significantly affected.

The primary concern is the recovery of FDI flows, as international investment flows are vital for sustainable development. Therefore, increasing investment to support a sustainable and inclusive recovery from the pandemic is now a global policy priority.

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