Euler Hermes Economic Research

Economic Insight

Foreign Direct Investment: The eurozone's transistor

24 April 2013

Ana Boata (Economist)
✉ ana.boata@eulerhermes.com

Mahamoud Islam (Economist)
✉ mahamoud.islam@eulerhermes.com

Clément Bouillet (Intern)
✉ clement.bouillet@eulerhermes.com

Executive Summary:

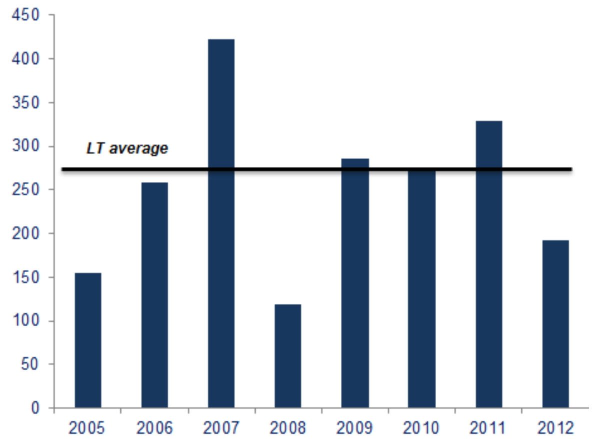
- **In 2012 inflows of foreign direct investment (FDI) to the euro zone slumped -41% (after increasing +20% in 2011) but held above their 2008 low.**
- **This fall was caused by across-the-board investor wariness, in particular on the part of Europeans: FDI from eurozone countries fell -77%.**
- **Medium-term prospects are expected to improve on the back of renewed confidence following the easing of financial tensions, an alleviation of risks overhanging the sustainability of public debts and an improvement in current account balances.**
- **The financial and industrial sectors will remain at the forefront among the major beneficiaries of FDI.**
- **Reciprocally, renewed FDI flows can be expected to aid the return to growth in some eurozone countries.**

2012: Slump in FDI

The eurozone is likely to record a second consecutive year of recession in 2013 (-0.3% according to our forecasts after -0.5% in 2012) and possible short- and medium-term growth drivers are yet to be found. Debilitated by the ongoing fiscal consolidation process, the eurozone countries are relying on the global recovery, driven by emerging countries, and on attracting more foreign investment into their countries.

After recovering strongly in 2011 (+20% compared with 2010), net inflows of foreign direct investment (FDI) in the eurozone fell -41% in 2012 (see Chart 1). This can be explained by the global economic slowdown (+2.4% after +3.0% in 2011), but also by tensions linked to the risk of a eurozone breakup, with the Greek exit risk and no resolution to the institutional crisis.

Chart 1: Foreign direct investment in the eurozone (net, EUR bn)



Sources: Eurostat, Euler Hermes

The grass is always greener: Growing wariness of Europeans towards Europeans?

Although it declined late last year, the level of FDI from non-eurozone countries remains: (i) greater than intra-zone FDI, and (ii) higher than its 2008-2009 low (see Chart 2). Among the main investors, we note the predominance of North America and resilience on the part of large emerging countries (BRIC), in better economic and financial shape.

The medium-term outlook is expected to improve thanks to a return of confidence

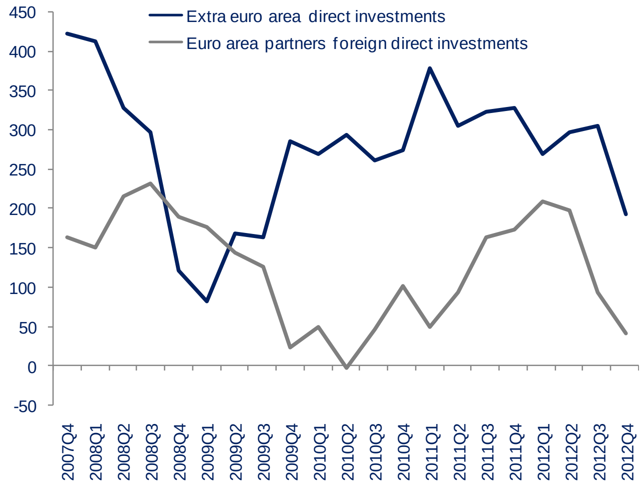
Despite this mixed trend, we remain fairly optimistic about medium-term prospects for a recovery in investment. An upturn in FDI inflows will be contingent upon a recovery in confidence in eurozone countries, which, in turn, will depend on an improvement in the financial health of the member states. Since the fall of 2012, a number of indicators point to an imminent recovery in these flows:

(i) Financial tensions have eased and investor confidence is gradually recovering, despite the recent fears linked to the Cypriot crisis and the political deadlock in Italy (see Chart 3).

(ii) Risks overhanging the sustainability of public debts have receded thanks to institutional progress on European integration: steps towards a banking union, and therefore towards the ECB's role as a common supervisory body over the eurozone banks and a strengthening of the role of the European Commission in terms of budgetary supervision.

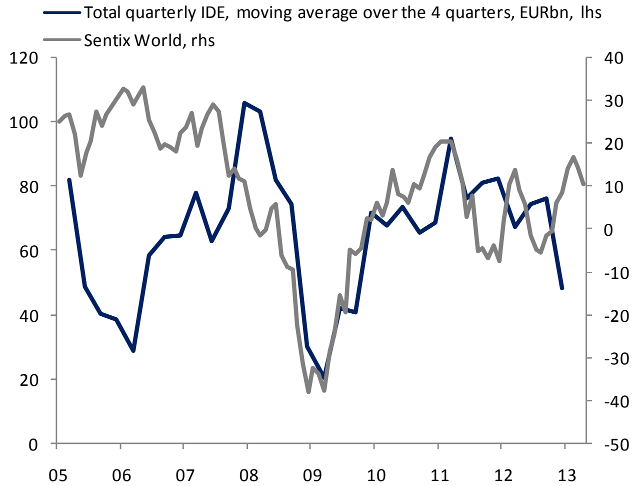
(iii) An improvement in current account balances since mid-2012 points to better financial health in the coming years (see Chart 4). This momentum should be sustained by the ongoing budgetary adjustments – at a more moderate pace and adequate to the economic cycle – and by ongoing structural reforms to improve cost-competitiveness. The latter are expected to lead to improved export performances, in particular to regions where growth – and therefore markets – is significantly more buoyant.

Chart 2 : Net FDI inflows in eurozone countries (Net, EUR millions, 4Q cumulative)



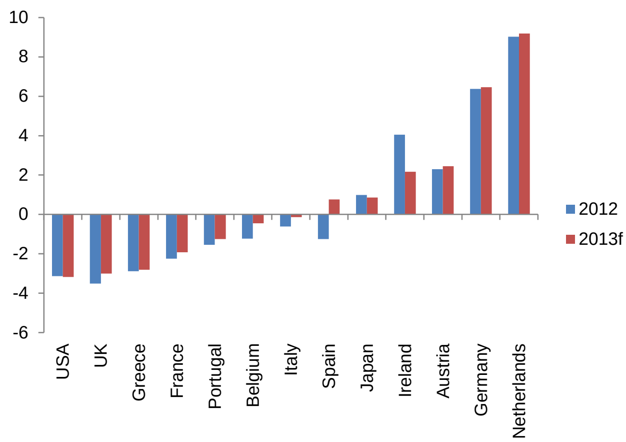
Sources: Eurostat, Euler Hermes

Chart 3: FDI inflows in the eurozone (EUR bn) vs. Global investor confidence



Sources: Eurostat, Euler Hermes

Chart 4: Current account balance, % of GDP



Source: Euler Hermes

Behind the financial sector, manufacturing industry and technologies, ICT, energy and trade are likely to benefit from this new environment

Four key sectors stand out in terms of contribution to the net balance of FDI inflows at the eurozone level: manufacturing industry, financial and insurance activities, electricity and gas production and distribution, and scientific and technical activities. Once again, there are big disparities between European countries (see Chart 5).

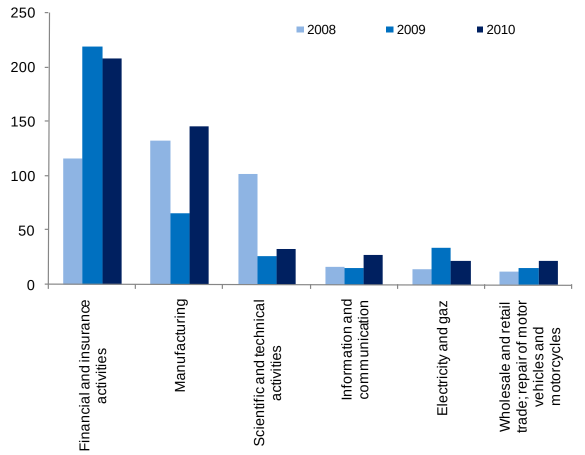
Unsurprisingly, the manufacturing sector received the lion's share of foreign investment in Germany (EUR 5.9 billion), Italy (EUR 10 billion), and Spain (EUR 4.5 billion), whereas it was the financial industry that attracted the most foreign investment (see Chart 6) in France (EUR 15 billion), Luxembourg (EUR 149 billion), and Ireland (EUR 28 billion).

Some eurozone countries are more likely than others to capture these fresh FDI flows

There is a positive link between growth and the share of FDI in gross fixed capital formation. For example, Ireland, where a large portion of investment has been financed from abroad over the past 10 years, has enjoyed the highest growth rate. By contrast, FDI in Italy constitutes a small portion of gross fixed capital formation and the country's growth has been sluggish on average.

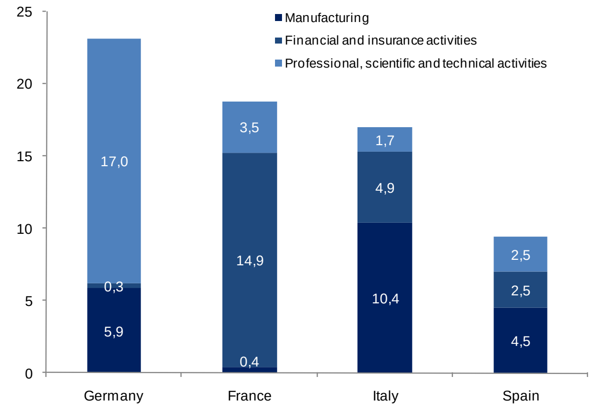
The recovery under way in FDI inflows in some eurozone countries will therefore help fuel the return to economic growth (see Chart 7), but the positive impact will vary greatly from one eurozone country to the next and will probably be more pronounced in the core countries than in the peripheral countries.

Chart 5: FDI inflows by key sector in the eurozone (EUR bn)



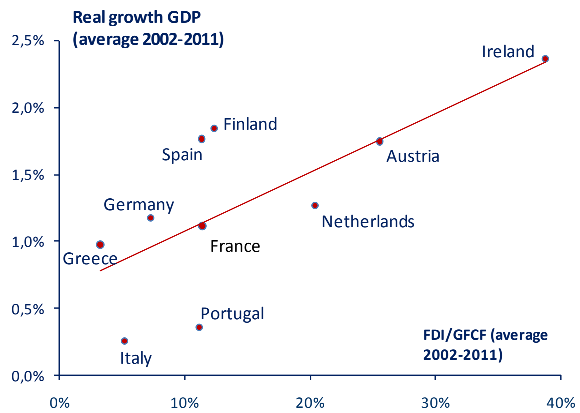
Sources: Eurostat, Euler Hermes

Chart 6: FDI inflows by sector and by country in 2011 (EUR bn)



Sources: Eurostat, Euler Hermes

Chart 7: Real GDP growth vs. share of FDI in GFCF



Sources: Eurostat, Euler Hermes

View all Euler Hermes Economic Research online
http://www.eulerhermes.com/economic-research

Contact Euler Hermes Economic Research Team
✉ research@eulerhermes.com

Publication Director and Chief Economist
Ludovic Subran
✉ ludovic.subran@eulerhermes.com