

KEY MESSAGES

INVESTMENT TRENDS AND PROSPECTS

Global FDI
-13% 2018
\$1.3 trillion

Global foreign direct investment (FDI) flows continued their slide in 2018, falling by 13 per cent to \$1.3 trillion. The decline – the third consecutive year's fall in FDI – was mainly due to large-scale repatriations of accumulated foreign earnings by United States multinational enterprises (MNEs) in the first two quarters of 2018, following tax reforms introduced in that country at the end of 2017.

FDI flows to developed economies reached the lowest point since 2004, declining by 27 per cent. Inflows to Europe halved to less than \$200 billion, due to negative inflows in a few large host countries as a result of funds repatriations and to a sizeable drop in the United Kingdom. Inflows in the United States also declined, by 9 per cent to \$252 billion.

Flows to developing countries remained stable, rising by 2 per cent. As a result of the increase and the anomalous fall in FDI in developed countries, the share of developing countries in global FDI increased to 54 per cent, a record.

- FDI flows to Africa rose by 11 per cent to \$46 billion, despite declines in many of the larger recipient countries. The increase was supported by continued resource-seeking inflows, some diversified investments and a recovery in South Africa after several years of low-level inflows.
- Flows to developing Asia, the largest recipient region, were up 4 per cent. In a sign of continued dynamism, greenfield project announcements in the region doubled in value, recovering from their 2017 pause.
- FDI in Latin America and the Caribbean was 6 per cent lower, failing to maintain momentum after the 2017 increase halted a long slide. FDI in the region is still 27 per cent lower than during the peak of the commodities boom.
- FDI flows to structurally weak and vulnerable economies continued to account for less than 3 per cent of the global total. Flows to the least developed countries recovered from their 2017 fall, back to \$24 billion, the average for the decade.

FDI flows to economies in transition continued their downward trend in 2018, declining by 28 per cent to \$34 billion, driven by a 49 per cent drop in flows to the Russian Federation.

The tax-driven fall in FDI was cushioned by increased transaction activity in the second half of 2018. The value of cross-border merger and acquisitions (M&As) rose by 18 per cent, fueled by United States MNEs using liquidity in their foreign affiliates that was no longer encumbered by tax liabilities.

In 2019, FDI is expected to see a rebound in developed economies as the effect of the tax reforms winds down. Greenfield project announcements – indicating forward spending plans – also point at an increase, as they were up 41 per cent in 2018 from their low 2017 levels. Despite this, projections for global FDI show only a modest recovery of 10 per cent to about \$1.5 trillion, below the average over the past 10 years. The underlying FDI trend remains weak. Trade tensions also pose a downward risk for 2019 and beyond.

FDI downward trend



The underlying FDI trend has shown anemic growth since 2008. FDI net of one-off factors such as tax reforms, megadeals and volatile financial flows has averaged only 1 per cent growth per year for a decade, compared with 8 per cent in 2000–2007, and more than 20 per cent before 2000. Explanations include declining rates of return on FDI, increasingly asset-light forms of investment and a less favourable investment policy climate.

The long-term slide of greenfield investment in manufacturing halted in 2018, with the value of announced projects up 35 per cent from the low value in 2017. Among developing countries – where manufacturing investment is key for industrial development – the growth was mostly concentrated in Asia and pushed up by high-value projects in natural resource processing industries.

The number of State-owned MNEs (SO-MNEs) stabilized, and their acquisitions abroad slowed down. There are close to 1,500 SO-MNEs, similar to 2017. Their presence in the top 100 global MNEs increased by one to 16. The value of their M&A activity shrank to 4 per cent of total M&As in 2018, following a gradual decline from more than 10 per cent on average in 2008–2013.

Much of the continued expansion of international production is driven by intangibles. Non-equity modes of international production are growing faster than FDI, visible in the relative growth rates of royalties, licensing fees and services trade. The top 100 MNE ranking for 2018 confirms that industrial MNEs are sliding down the list, with some dropping out.

MNEs in the global top 100 account for more than one third of business-funded R&D worldwide. Technology, pharmaceutical and automotive MNEs are the biggest spenders. The R&D intensity (relative to sales) of the developing-country top 100 is significantly lower. International greenfield investment in R&D activities is sizeable and growing.

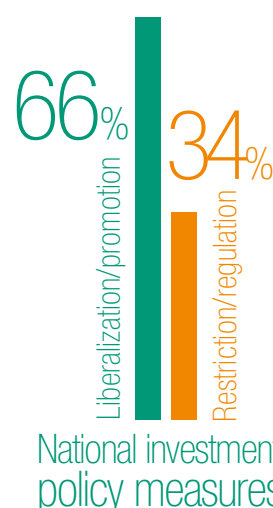
A significant part of investment between developing countries (South–South FDI) is ultimately owned by developed-country MNEs. New data on the global network of direct and indirect bilateral FDI relationships shows the important role of regional investment hubs in intraregional FDI and in South–South FDI. Indirect investment also has implications for the coverage of international investment agreements.



INVESTMENT POLICY DEVELOPMENTS

New national investment policy measures show a more critical stance towards foreign investment. In 2018, some 55 economies introduced at least 112 measures affecting foreign investment. More than one third of these measures introduced new restrictions or regulations – the highest number for two decades. They mainly reflected national security concerns about foreign ownership of critical infrastructure, core technologies and other sensitive business assets. Furthermore, at least 22 large M&A deals were withdrawn or blocked for regulatory or political reasons – twice as many as in 2017.

Screening mechanisms for foreign investment are gaining importance. Since 2011, at least 11 countries have introduced new screening frameworks and at least 41 amendments have been made to existing regimes. Changes included adding sectors or activities subject to screening, lowering the triggering thresholds or broadening the definition of foreign investment. Other new regulations have expanded disclosure obligations of foreign investors, extended statutory timelines of screening procedures or introduced new civil, criminal or administrative penalties for not respecting notification obligations.





Total IIAs in force

2658

71 new
ISDS cases



5 400
zones
across
147
economies

Nevertheless, attracting investment remains a priority. The majority of new investment policy measures still moved in the direction of liberalization, promotion and facilitation. Numerous countries removed or lowered entry restrictions for foreign investors in a variety of industries. The trend towards simplifying or streamlining administrative procedures for foreign investment continued. Also, several countries provided new fiscal incentives for investment in specific industries or regions.

International investment policymaking is in a dynamic phase, with far-reaching implications. In 2018, countries signed 40 international investment agreements (IIAs). For at least 24 existing treaties, terminations entered into effect. The impact on the global IIA regime of novel features in new agreements, including some megaregional treaties with key investor countries, will be significant. Many countries are also developing new model treaties and guiding principles to shape future treaty making.

IIA reform is progressing, but much remains to be done. Almost all new treaties contain numerous elements in line with UNCTAD's Reform Package for the International Investment Regime. UNCTAD's policy tools have also spurred initial action to modernize old-generation treaties. Increasingly, countries interpret, amend, replace or terminate outdated treaties. However, the stock of old-generation treaties is 10 times larger than the number of modern, reform-oriented treaties. Investors continue to resort to old-generation treaties; in 2018, they brought at least 71 new investor-State dispute settlement (ISDS) cases.

IIA reform actions are also creating new challenges. New treaties aim to improve balance and flexibility, but they also make the IIA regime less homogenous. Different approaches to ISDS reform, ranging from traditional ad hoc tribunals to a standing court or to no ISDS, add to broader systemic complexity. Moreover, reform efforts are occurring in parallel and often in isolation. Effectively harnessing international investment relations for the pursuit of sustainable development requires holistic and synchronized reform through an inclusive and transparent process. UNCTAD can play an important facilitating role in this regard.

Sustainable capital market trends

Capital market policies and instruments designed to promote the integration of sustainability into business and investment practices are transitioning from niche to mainstream. A growing number of investors are integrating ESG factors into their investment decision making to enhance performance and mitigate risk. The positive track record of sustainability-themed products is reinforcing the views of asset managers and securities regulators that such factors are material to long-term investment performance. As these sustainable investment trends take root and expand, they can have a stronger influence on the operational policies and practices of MNEs.

SPECIAL ECONOMIC ZONES

Special economic zones (SEZs) are widely used in most developing and many developed economies. Within these geographically delimited areas governments facilitate industrial activity through fiscal and regulatory incentives and infrastructure support. There are nearly 5,400 zones across 147 economies today, up from about 4,000 five years ago, and more than 500 new SEZs are in the pipeline. The SEZ boom is part of a new wave of industrial policies and a response to increasing competition for internationally mobile investment.

SEZs come in many types. Basic free zones focused on facilitating trade logistics are most common in developed countries. Developing economies tend to employ integrated zones aimed at industrial development, which can be multi-industry, specialized or focused on developing innovation capabilities. The degree and type of specialization is closely linked to countries' level of industrialization, following an *SEZ development ladder*.

Many new types of SEZs and innovative zone development programmes are emerging. Some focus on new industries, such as high-tech, financial services or tourism – moving beyond the trade- and labour-intensive manufacturing activities of traditional SEZs. Others focus on environmental performance, science commercialization, regional development or urban regeneration.

International cooperation on zone development is increasingly common. Many zones in developing countries are being built through bilateral partnerships or as part of development cooperation programmes. Regional development zones and cross-border zones spanning two or three countries are becoming a feature of regional economic cooperation.

SEZs can make important contributions to growth and development. They can help attract investment, create jobs and boost exports – both directly and indirectly where they succeed in building linkages with the broader economy. Zones can also support global value chain (GVC) participation, industrial upgrading and diversification. However, none of these benefits are automatic.

In fact, *the performance of many zones remains below expectations.* SEZs are neither a precondition nor a guarantee for higher FDI inflows or GVC participation. Where they lift economic growth, the stimulus tends to be temporary: after the build-up period, most zones grow at the same rate as the national economy. And too many zones operate as enclaves with limited impact beyond their confines.

Only a few countries regularly assess the performance and economic impact of zones. Doing so is critical, because the turnaround of unsuccessful SEZs requires timely diagnosis, especially when there has been a significant level of public investment in zone development. UNCTAD's *SEZ Sustainable Development Profit and Loss Statement (P&L)* can guide policymakers in the design of a comprehensive monitoring and evaluation system.

The decades-long experience with SEZs provides important lessons for modern zone development:

- *Strategic design of the SEZ policy framework and development programme is crucial.* Zone policies should not be formulated in isolation from their broader policy context, including investment, trade and tax policies. The types of zones and their specialization should build on existing competitive advantages and capabilities. And long-term zone development plans should be guided by the SEZ development ladder.
- *Zone development programmes should take a frugal approach.* The Sustainable Development P&L emphasizes the need for financial and fiscal sustainability of zones, as their broader economic growth impact can be uncertain and take time to materialize. High upfront costs due to overspecification, subsidies for zone occupants and transfers to zone regimes of already-operating firms pose the greatest risks to fiscal viability.
- *The success of individual SEZs depends on getting the basics right.* Most failures can be traced back to problems such as poor site locations that require heavy capital

Bilateral
partnerships
building
ZONES in
developing
countries

SEZ Sustainable
Development
Profit and Loss
Statement

expenditures or that are far away from infrastructure hubs or cities with sufficient pools of labour; unreliable power supplies; poor zone design with inadequate facilities or maintenance; or overly cumbersome administrative procedures.

- *Active support to promote clusters and linkages is key to maximizing development impact.* Firms operating in zones have greater scope to collaborate, pool resources and share facilities – more so in specialized zones, but multi-activity zones can extract some of the benefits of co-location. Pro-active identification of opportunities, matching efforts and training programmes, with firms within and outside the zone, significantly boosts the impact.
- *A solid regulatory framework, strong institutions and good governance are critical success factors.* The legal infrastructure of SEZs should ensure consistent, transparent and predictable implementation of SEZ policies. The responsibilities of SEZ governing bodies should be clearly defined. Zones benefit from having public and private sector representatives on their boards.

Looking ahead, SEZs face *new challenges*:

- The sustainable development agenda increasingly drives MNEs' strategic decisions and operations, which should be reflected in the value proposition that SEZs market to investors. *Modern SEZs can make a positive contribution to the ESG performance of countries' industrial bases.* Controls, enforcement and services (e.g. inspectors, health services, waste management and renewable energy installations) can be provided more easily and cheaply in the confined areas of SEZs.

SEZs are traditionally big employers of women, with about 60 per cent female employees on average. Some modern zones are implementing gender equality regulations, such as anti-discrimination rules, and support services, such as child care and schooling facilities, setting new standards for SDG performance.

- The new industrial revolution and the digital economy are changing manufacturing industries – the main clients of SEZs. *SEZs will need to adapt their value propositions to include access to skilled resources, high levels of data connectivity and relevant technology service providers.* SEZs may also have new opportunities to target digital firms.
- The current challenging global policy environment for trade and investment, with rising protectionism, shifting trade preferences and a prevalence of regional economic cooperation, is causing changes in *patterns of international production and GVCs.* These changes can significantly affect the competitiveness of SEZs, which function as central nodes in GVCs. International cooperation on zone development is likely to become increasingly important.

Finally, the 2030 Agenda to achieve the Sustainable Development Goals (SDGs) provides an opportunity for the development of an entirely new type of SEZ: the SDG model zone. Such zones would aim to attract investment in SDG-relevant activities, adopt the highest levels of ESG standards and compliance, and promote inclusive growth through linkages and spillovers.

The recommendations in this report aim to provide guidance for policymakers in their efforts to revitalize and upgrade existing zones, and to build new ones that avoid the pitfalls of the past and are prepared for the challenges ahead. The key objective should be to make SEZs work for the SDGs: *from privileged enclaves to sources of widespread benefits.*



New type of SEZ:
SDG model zone