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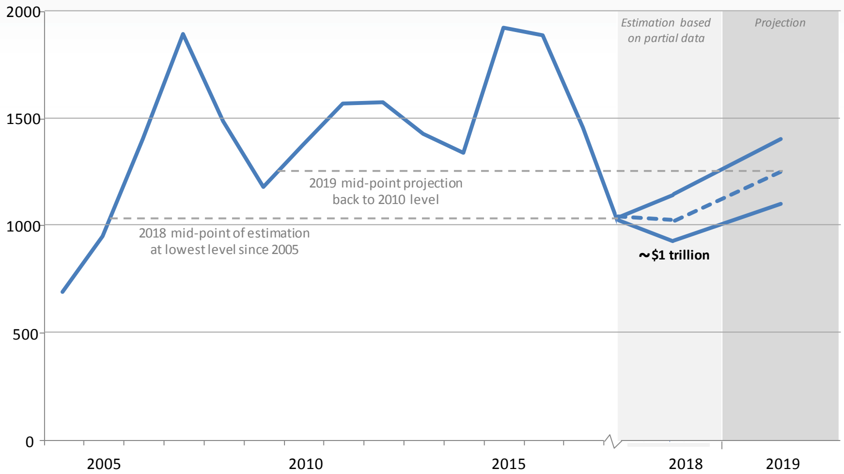
SHORT-TERM PROSPECTS FOR FDI REMAIN GLOOMY

2018 FLOWS EXPECTED TO COME IN AT $1 TRILLION – LOWEST LEVEL SINCE 2005

HIGHLIGHTS

- *Global foreign direct investment (FDI) flows are expected to reach only about US$1 trillion in 2018* – a drop of 30 per cent from 2017 levels, and the lowest value for more than a decade.
- *Prospects for 2019 remain gloomy despite positive impetus from the economic cycle*, due to policy factors – including trade tensions and uncertainty about the global policy environment for investment – and because of structurally lower reinvested earnings by United States multinational enterprises (MNEs).

Figure 1. Global FDI flows, 2002 – 2017, estimation for 2018 and projection for 2019
(Billions of US dollars)



Source: UNCTAD.
Note: FDI flows exclude Caribbean offshore financial centers.

This document summarises the outcome of discussions on prospects at the WIF2018 event on Regional Integration and FDI and is based on available data at the time of the event.

- *At the global level, the 2019 FDI forecast is driven by likely rebounds from anomalously low 2018 levels in developed regions, and by economic fundamentals.* Combined, these factors are expected to take FDI values to US$1.25 - 1.4 trillion in 2019.

- *The bright spot is a significant recovery in announced greenfield investments* in the first half of 2018, from US$320 to US$454 (+42%), which could signal an upswing in FDI in the medium term and might push 2019 FDI to the upper range of projections.

- *Prospects vary significantly across developing regions and transition economies:*

  ✓ FDI flows to Africa are expected to show moderate increases in 2018 and 2019, reflecting higher commodity prices, the rise of intra-African investment flows and the strengthening of regional cooperation.

  ✓ FDI flows to *South, East and South-East Asia* are expected to remain stationary in 2018 and 2019 with diverging trends in sub-regions, but could resume growth in the medium term supported by the region's economic dynamism and economic integration initiatives.

  ✓ Continued elevated country risks due to political and economic instability are still discouraging foreign investors in *West Asia*.

  ✓ FDI inflows in *Latin America and the Caribbean* are expected to decline in 2018, reflecting a slow economic recovery, mainly in the largest economies of the region, affecting market seeking investments. In addition, trade policy uncertainties could affect investments in manufacturing and exporting sectors.

  ✓ FDI inflows to *transition economies* are expected to start a recovery in 2019, following two years of decline, on the back of stronger growth in South-East Europe, and infrastructure spending in other countries in the region.

Full-year estimates for 2018

Full-year 2018 estimates are heavily affected by the repatriation of retained earnings by United States MNEs following the corporate income tax reforms introduced at the end of 2017 (see GITM 30 for half-year 2018 data, and GITM 29, a Special Issue on the investment impact of US Tax Reforms).

The drop in reinvested earnings overseas by United States MNEs amounted to more than US$350 billion in the first six months of 2018 alone, inevitably causing sharp falls in registered inflows in many economies, with the biggest declines recorded in developed countries and offshore financial centres. As a result, global inflows could finish the year at around US$1 trillion, a level not seen since 2005.

Repatriations of accumulated foreign earnings are not the only explanation for the drop in global investment flows in 2018. Inflows to the United States are also expected to end the year significantly lower than in 2017, despite the potential stimulus effect that the tax reforms are expected to have on investments there by foreign MNEs. The decline is expected to be temporary, and due to policy uncertainties related to the detailed implementation of the tax reforms, to developments in global trade relations and the agreement with Canada and Mexico, and to potential tightening of investment screening procedures.

Similar policy uncertainties, in particular those related to tensions in global trade relations, are also affecting other regions: all regions are expected to end the year at or below 2017 levels. However, the stable value of global cross-border M&As and the significant increase in greenfield project announcements suggest that the expected 2018 drop in global FDI flows is mostly due to financial considerations (intra-firm financial flows).

Forecasting Global FDI in 2019

Rebound effects. The anomalously low levels in 2018, and the precipitous declines in developed regions, make forecasts for 2019 exceedingly difficult. A large part of the earnings repatriations of United States MNEs will have taken place in 2018, but this is not a guarantee. Contrary to the 2005 tax amnesty for earnings repatriations, the 2017 reforms do not require MNEs to repatriate in order to fall under the scheme; there is no specified time limit and repatriations could continue for some time. However, assuming that MNEs bring back most funds in 2018, the developed economies that experienced the largest drops in inflows are likely to see a rebound to "average" levels of inflows, which would imply large swings in countries that normally make up a significant part of global FDI flows.

A rebound effect may also occur in the United States itself – 2018 flows there are also anomalously low – for example because the NAFTA break-up has been averted or the implementation of tax reforms starts to attract FDI.

Structurally lower retained earnings. 2019 and future flows will be affected by lower levels of *new* reinvested earnings by United States MNEs which, under the new tax regime, no longer have the same incentive to park funds overseas as retained earnings to defer tax payment. Given that such retained earnings, until 2017, made up the bulk of United States outward FDI of more than US$300 billion annually, this will put a structural dent in global FDI flows going forward.

Lower rates of return. WIR18 notes that the 2017 decline, exacerbated by one-off factors in 2018, is part of a longer-term cycle. One factor behind this appears to be a steady decline in rates of return on FDI. The global rate of return on inward FDI dropped to below 7 per cent, from 8.1 in 2012. Although rates of return remain higher on average in developing and transition economies than in developed countries, most regions have not escaped this erosion. In Africa, for instance, return on investment dropped from 12.1 per cent in 2012 to 5.6 per cent in 2016.

New globalization patterns. Another factor behind tempered future expectations for FDI noted in WIR18 is the importance of increasingly asset-light overseas operations of MNEs, and the shift in international production from tangible cross-border production networks to intangible value chains. This shift is clearly visible in much slower rates of growth of tangible assets of foreign affiliates of MNEs compared to their sales, with implications for expected levels of capital formation associated with FDI.

Macro-economic backdrop. On the positive side, according to the most recent forecasts, global economic growth is projected to continue its steady expansion of 3.7 per cent. Economic activity in developed countries and among commodities exporting emerging and developing economies could bolster investment activity in 2019. However, the IMF warns that forecasts for macroeconomic variables contain important risk factors and downsides, including the prospect of interest rate rises in developed economies with potentially serious implications for emerging market currencies and economic stability.

Project announcements. Pointing to an increase in FDI in 2019 and beyond is the jump in announced greenfield projects in the first half of 2018, from US$320 to US$454 (+42%) – albeit from relatively low levels in 2017. The increase is almost entirely in developing regions, with the most significant rises in East and South-East Asia. Announced expenditures on projects are an imperfect indicator of FDI trends, as projects and associated investments can be drawn out over long periods and announced values do not necessarily materialize, but they signal the intention of investors to spend on real productive assets.

Table 1.FDI inflows by group of economies and region, 2015–2017, estimation 2018 and projections 2019
(Billions of dollars and per cent)

Group of economies/region	2015	2016	2017	Estimation 2018	Projections 2019
World	**1 923**	**1 885**	**1 459**	**950 to 1150**	**1 250 to 1 400**
Developed economies	**1 143**	**1 151**	**739**	**270 to 420**	**550 to 680**
Europe	595	568	362	100	280
North America	513	509	302	190	240
Developing economies	**744**	**670**	**672**	**640 to 670**	**660 to 680**
Africa	57	53	42	45	55
Asia	516	475	476	470	475
Latin America and the Caribbean	169	140	151	140	145
Transition economies	**36**	**64**	**48**	**40 to 50**	**50 to 55**
Memorandum: Annual growth rate (per cent)					
World	**44**	**- 2**	**- 23**	**(- 35 to - 20)**	**(15 to 30)**
Developed economies	**92**	**1**	**- 36**	**(- 65 to - 45)**	**(60 to 100)**
Europe	117	- 5	- 36	~ - 75	~ 180
North America	97	- 1	- 41	~ - 35	~ 25
Developing economies	**9**	**- 10**	**0**	**(-5 to 0)**	**(1 to 3)**
Africa	8	- 6	- 20	~ 5	~20
Asia	12	- 8	0	~ 0	~ 0
Latin America and the Caribbean	- 1	- 17	8	~- 5	~ 5
Transition economies	**- 36**	**78**	**- 26**	**(- 10 to 0)**	**(10 to 20)**

Source: UNCTAD, FDI/MNE database (unctad.org/fdistatistics).
Note: Estimates for 2018 are based on available partial year data. Projections for 2019 are based on UNCTAD's forecasting model (for methodology, see WIR18), projecting forward from the upper and lower-bound 2018 estimates. FDI flows are lumpy and may fluctuate significantly for individual economies based, for example, on large one-off transactions that cannot be captured by the model.

Regional prospects – developing and transition economies

Africa

Investment flows to *Africa* have been weak since the end of the commodity super-cycle. Lower prices of raw materials subdued economic growth; political unrest and security challenges in some countries and sub-regions further weighted on investment inflows in recent years. Investments in Africa have also tended to be concentrated in few recipient countries; Egypt, Ethiopia, Nigeria, Ghana and Morocco jointly accounted for almost half of all FDI flowing to the continent.

The downward trend is expected to halt in 2018, as commodity prices increase, and a further uptick is expected for 2019. More diversified FDI inflows could help African economies diversify their industrial base and strengthen their resilience to swings in the prices of primary products.

The African Continental Free Trade Area (AfCFTA), which is currently in the process of ratification, aims to contribute to this process. Increased openness to trade and investment will stimulate intra-African investment flows. At the same time, liberalisation of trade in goods and services provides pathways for economies of scale and insertion into regional and, by extension, global value chains. The AfCFTA is to be complemented with common regulation on investment, competition and intellectual property rights. A continent-wide alignment across the Phase I and II policy areas should provide a robust, transparent, and predictable regulatory framework conducive to foreign investment. Regional integration efforts are being complemented with further progress at the national level to attract investments, through improvements in the business environment, physical infrastructure and skill base.

Expectations for sub-regions on the continent could vary. For example, COMESA expects higher GDP growth in 2018 and better FDI prospects due to increasing trade and investment ties within the region and the recovery of export markets, particularly in the EU. Increased investment is also expected in strategic sectors such as electricity, construction, technology, and large infrastructure.

South, East and South-East Asia

FDI to *South, East and South-East Asia* will continue to be attracted by the relative economic dynamism of the region and by economic integration initiatives, including the ASEAN Economic Community, the Comprehensive and Progressive Agreement on Trans-Pacific Partnership, China's Belt and Road Initiative, and ongoing negotiations on the Regional Comprehensive Economic Partnership.

Current macro-economic projections (especially GDP growth and trade growth) still suggest FDI flows to the region in 2018 and 2019 to remain at a similar level to 2017. These expectations reflect diverging trends in sub-regions and are in line with relatively low 2017 greenfield investment announcements in the region.

However, in the medium term, given the strong recovery in announced greenfield investment in the first half of 2018 – the number of projects in the first eight months increased 25% year on year and the estimated committed value of these investment more than doubled – the prognosis for a recovery in FDI inflows to Asia is brighter.

Intraregional investment flows, which breached 50% of total inflows flows in the region in 2017, are expected to grow further this year and next. Although FDI outflows from China, one of the major regional investors, decreased in 2017, partly as a result of Government measures to stem capital flight, this is expected to be short-term as China continues to pursue FDI in the region as part of the Belt and Road Initiative. In the current international policy environment closer intraregional trade and investment linkages could strengthen resilience to external shocks.

China itself has increasingly been able to attract FDI in more capital and technology intensive sectors. Ongoing liberalization of trade and investment with trading partners may further promote FDI inflows that are less dependent on exports to the United States. Some FDI in China linked to exports to the United States may exit.

Trade tensions between the United States and China could further result in increasing diversion of investments toward alternate locations. For instance, United States companies in manufacturing supply chains could shift towards production locations in Malaysia, Thailand, and Viet Nam.

Relatively high GDP growth rates and steadily growing purchasing power in most of Asia and the Pacific will further spur market-seeking FDI. In this context, India's high growth is a major attraction for FDI. Some least developed countries, such as Bangladesh, could graduate from LDC status soon as well.

Renewed United States sanctions on the Islamic Republic of Iran and ongoing tensions in Afghanistan and Pakistan will continue to depress investment inflows to these countries, with the exception of Chinese investment in the Pakistan-China Economic Corridor.

West Asia

FDI flows to West Asia have been on a downward slope since the global financial crisis – the last significant increase was in 2008. Inflows are expected to remain sub-potential in 2018 and 2019. High country risks from economic and political instability continue to discourage foreign investors across the region. In addition, several countries in the region lack adequate economic and regulatory frameworks, as well as physical infrastructure, to become more attractive for foreign investors. The relatively unfavorable regional economic outlook and fluctuations in commodity prices coupled with exchange rate volatility further reduce the competitiveness and investment attractiveness of many countries in the region. Finally, the ability of West Asian countries to attract FDI is also undermined by only partial implementation of existing RTAs, a perceived lack of commitment to pursue regional economic integration and the absence of significant progress for the Euro-Mediterranean project and the Pan Arab FTA, which is still limited to trade in goods.

Latin America and the Caribbean

FDI inflows in *Latin America and the Caribbean* are declining in 2018. GDP in the region is set to grow at 1.3% in 2018 and at 1.8% in 2019. This slow recovery, especially in the largest economies of the region, will affect market seeking investments, and trade policy uncertainties could affect investments in manufacturing and exporting sectors. International trade tensions pose a risk to the region's FDI attractiveness, given potential impacts in raw material exports and in manufacturing activities integrated in North America's regional value chains.

Commodity prices are traditionally an important driver of FDI inflows into the region. Most of the drop in FDI inflows after the end of the mineral price boom has taken place in extractive industries. The recent recovery in commodity prices could boost investments; however, the upward sensitivity of investment inflows to commodity prices is expected to be lower than before due to a combination of factors, including high installed capacity from investments made in the past, the gradual shift to a low carbon economy, and economic diversification efforts in the region. Forecasts for FDI in 2019 show only a modest increase.

Transition economies

FDI inflows to *transition economies* are expected to stage a modest recovery in 2019, following declines in 2017 and 2018. Recent announced greenfield investments suggest a reversal of the trend. In the Commonwealth of Independent States (CIS) and Georgia, the pace of economic expansion is expected to pick up in 2019 but remain moderate, with a relatively limited effect on FDI inflows. In the Russian Federation, over the medium-term, a general push to increase investment in the country, combined with planned increases in spending on infrastructure to remove bottlenecks, could have positive implications for FDI. Government plans also include an expanded scope for public-private partnerships. However, geopolitical tensions may continue to have a dampening effect on business confidence in the subregion.

Increased oil prices in 2018 did not translate into positive FDI growth in energy-exporters in the subregion. However, the exploitation of natural resources and related infrastructure development will continue to drive investor interest. In Kazakhstan, the implementation of the 2018-2022 investment strategy, seeking to attract new types of FDI and engage foreign investors in privatization offerings, may contribute to higher and more diversified inflows.

In South-East Europe, the acceleration of economic expansion in 2018, expected to continue at a similar clip in 2019, has created a favourable backdrop for FDI. Countries in the subregion in the past engaged in multiple individual initiatives to attract FDI, but the implementation of the Regional Investment Reform Agenda adopted in 2018 could have a positive impact, both in terms of raising overall inflows and increasing the share allocated to export-oriented sectors. South-East Europe may also benefit from increased FDI inflows to take advantage of untapped workforce potential, building on increased trade relations and regulatory alignment with the EU.

The interest of Chinese investors has started to translate into actual investments in an increasing number of transition economies, with scope for follow-on inflows. Prospects for FDI in transition economies will depend on further progress in improving policy and regulatory environments for investment and in addressing bottlenecks in infrastructure, where despite significant advances in recent years, much still needs to be done.

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