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INVESTMENT TRENDS MONITOR

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2018 FDI FALL PART OF LONGER-TERM DECLINE

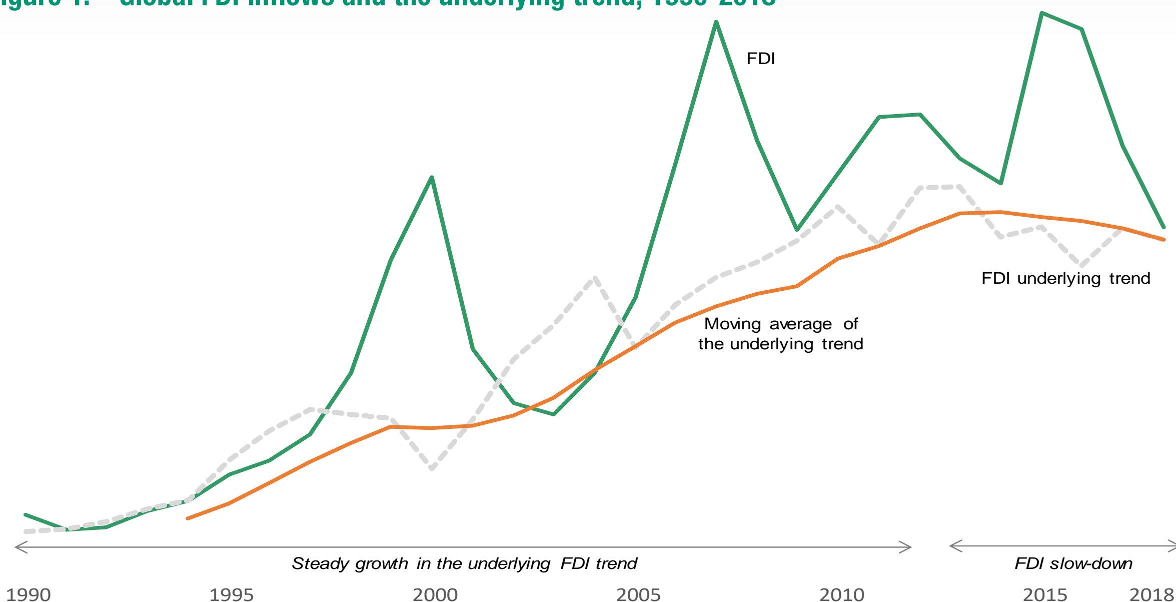
POLICY CONCERN: SLOW-DOWN IN INVESTMENT AND GLOBAL VALUE CHAINS – CRUCIAL FOR DEVELOPMENT PROSPECTS – COULD CONTINUE

HIGHLIGHTS

- *Global Foreign Direct Investment (FDI) fell by 19% in 2018.* This was the third consecutive decline, bringing FDI down to the low-point reached after the global financial crisis.

- The underlying trend index – net of the effect of one-off events, mega mergers and acquisitions (M&As) and the more volatile components of FDI – suggests that the decline started even earlier than is apparent from the headline FDI figure. *The underlying FDI trend has shown anemic growth since the global financial crisis and has been on a downward trajectory since 2013 (figure 1).*

Figure 1. Global FDI inflows and the underlying trend, 1990-2018



Source: UNCTAD.
Note: The FDI underlying trend is a composite index (incorporating balance of payments and other variables), constructed by removing the effect on FDI of fluctuations in M&As, intra-company loans and offshore financial flows, through appropriate smoothing techniques.

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- *The longer-term FDI downturn shows clear parallels with the slow-down of growth in trade in manufactured goods and the slow-down (and possible shift in reverse) of global value chains (GVCs).* FDI is closely linked to GVCs because about 80% of global trade is linked to the international production networks of MNEs and their overseas affiliates.

- *The causes for the FDI downturn include:*

  ✓ *Policy factors:* the return of protectionist tendencies and uncertainty and slow progress in the international policy regimes for trade and investment.

  ✓ *Economic factors:* average rates of return on FDI declined from 8.1% in 2012 to 6.7% in 2017 with, worryingly, significantly steeper falls in developing countries.

  ✓ *Structural changes in the nature of international business:* the digital economy has led to a shift towards intangibles in international production and increasingly asset-light forms of overseas operations.

- *The investment downturn and its causes have important implications for both business and policymakers.* For many firms, the lower profitability of overseas operations is causing a rethink of their multinational modus operandi. For policymakers, attracting investment is key to generate economic growth and jobs. Developing countries are particularly concerned, because FDI and GVCs have provided the development ladder for most of today's emerging markets and they are crucial for industrialization prospects in lower-income countries.

The underlying investment trend shows a longer-term structural decline

The 19% decline in the headline global FDI figure in 2018 is in itself not an immediate policy concern. FDI flows generally fluctuate significantly year-on-year, and the 2018 drop in particular can be explained by the tax reforms in the United States, which caused large repatriations of accumulated overseas retained earnings by United States MNEs, resulting in negative FDI inflows in a number of economies, especially in Europe.

The 2018 fall was the third consecutive decline, from a peak in 2015. That peak again included a number of one-off factors, in particular a series of mega M&A deals and corporate reconfigurations (accounting operations implying large cross-border changes in ownership) which inflated the numbers. The sharp fall in FDI over the last three years is therefore not fully representative of real trends in international investment in productive-assets.

More instructive from a policy perspective is the movement of the underlying investment trend index, which smooths out swings in annual flows caused by one-off events and by the most volatile components of FDI (intra-firm financial transactions and flows through offshore financial centers). The index shows how FDI lost growth momentum already before the global financial crisis, has struggled to recover after the crisis, and has been on a gradual downward trajectory since 2013.

The index also shows a much more gradual and continuous increase through previous decades, without the dramatic drops in FDI after the dotcom bust and during the global financial crisis. On the one hand, this confirms that FDI is relatively stable: investment projects have long gestation periods and investment decisions are not easily reversed based on developments in financial markets. On the other hand, it provides a worrying context for the current downturn, suggesting it is *a secular trend*.

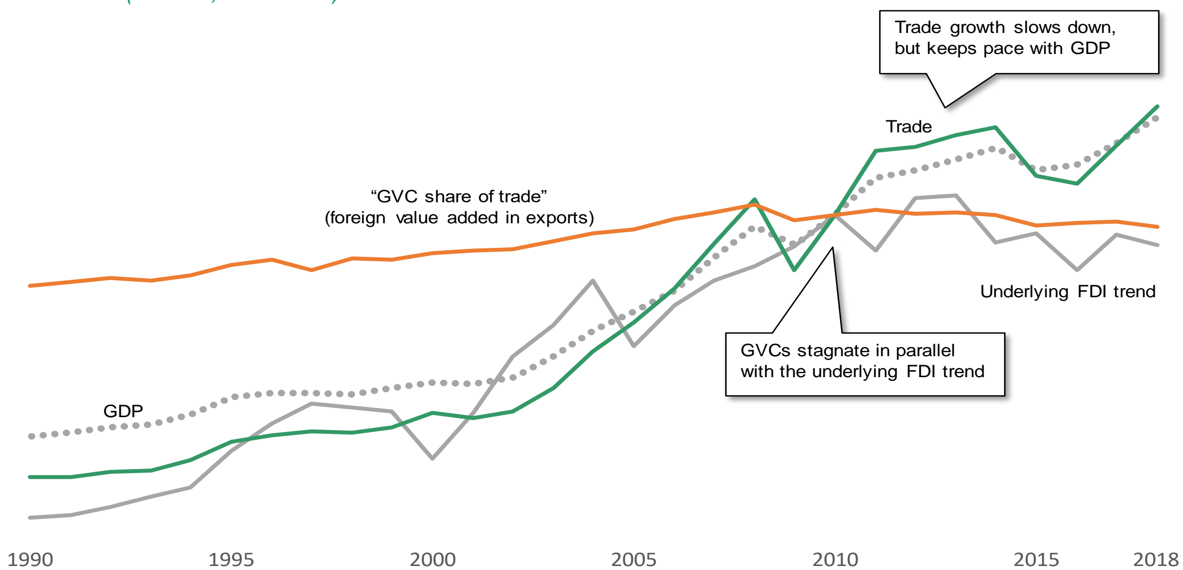
Investment, trade and GVCs: international production slows down

The underlying trend index makes a comparison with global macro indicators, such as trade, much more meaningful than the headline FDI trend. The comparison with trade is telling: while FDI proved relatively more resilient to the financial crisis, in the last five years FDI and trade share the same lackluster trend (negative for FDI, slower growth for trade), evidence of a fundamental change in the dynamics of globalization.

Trade and investment are inextricably linked. Much of global trade is driven by the international production networks of MNEs and their affiliates worldwide, including through intra-firm trade. The rate of expansion of international production, as measured by the economic activity of MNE foreign affiliates, has slowed down with investment. The value added of foreign affiliates grew by 8% per year on average in the 1990s, by 13% in the period from 2000 to 2007, and by slightly more than 2% annually since then.

Foreign value added in trade – the third-country value added (imported raw materials, intermediate goods, components, etc.) incorporated in a country's export – are a standard measure of the importance of global value chains. This measure, "the share of GVCs in trade", has grown slowly but steadily since first measured in 1990 up to 2010, after which it plateaued and slightly declined to 2018 (figure 2). GVCs, which were a major driver of global trade growth, appear to have stagnated.

Figure 2. Trade, GVCs, and the underlying FDI trend, 1990-2018
(Indexed, 2010=100)



Source: UNCTAD.
Note: Trade is global exports of goods and services; GVC share of trade is foreign value added in exports, based on the UNCTAD-EORA GVC database.

Policy, economic and business drivers of the investment slump

The FDI slump is driven by a multitude of factors. On the policy side, in most countries the process of liberalization of national foreign investment frameworks was completed more than a decade ago, with restrictions on foreign ownership lifted in most industries. Thus, while the gradual opening of emerging markets worldwide spurred FDI growth until the mid-2000s, the impetus from further liberalization diminished. In recent years, restrictions on foreign ownership, based on national security considerations or strategic technologies, are again front of mind for policymakers.

Still looking at policy factors, beyond national policies, uncertainty over the development of the international policy frameworks for trade and investment has not helped to build investor confidence. Progress at the multilateral level in strengthening trade and investment policy environments has been scant, regional efforts have swung between promising to substitute for multilateralism and rivalling its inertia, and bilateral efforts, while numerous, are complex and – for the investment regime – in the midst of reform processes.

Economic factors behind the investment slump can be summarized by declining rates of return on FDI (table 1). In 2017, the global rate of return on inward FDI was down to 6.7%, from above 8% in 2012. Rates of return in developed economies have trended downwards over this period but stabilized. Although rates of return remain higher on average in developing and transition economies, most regions have not escaped the erosion. In Africa, for example, return on investment dropped from 12.1% in 2012 to 5.6% in 2016. In developing regions, the decline can be partly explained by the fall in commodity prices during the period. But structural factors, such as reduced fiscal and labour cost arbitrage opportunities in international operations, are also at work.

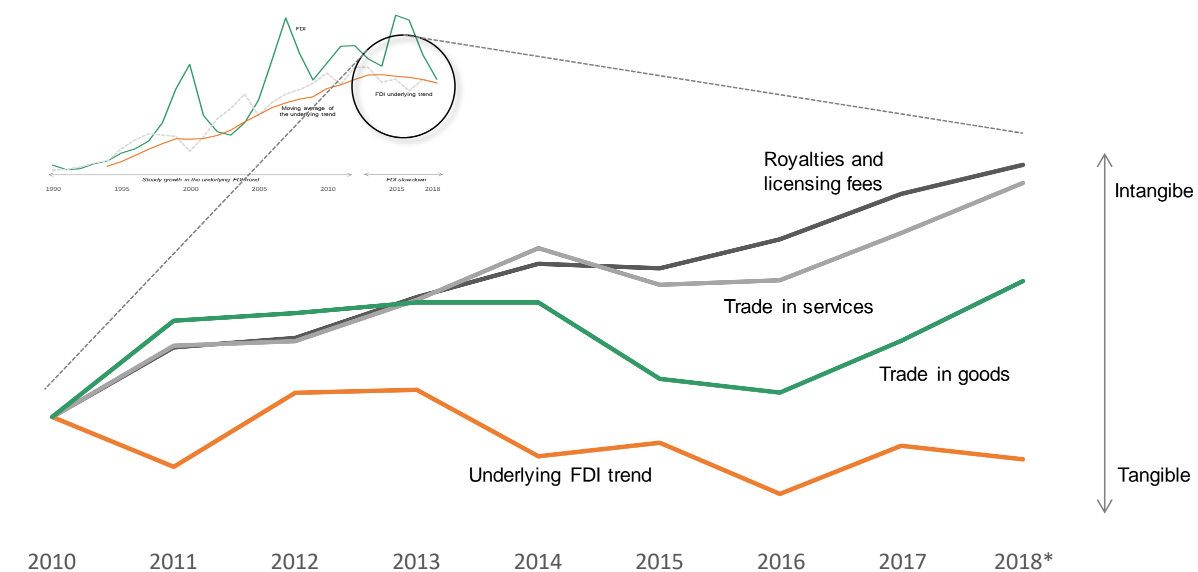
Table 1. Inward FDI rates of return, 2012-2017
(Per cent)

Region	2012	2013	2014	2015	2016	2017
World	**8.1**	**7.8**	**7.9**	**6.8**	**7.0**	**6.7**
Developed economies	**6.7**	**6.3**	**6.6**	**5.7**	**6.2**	**5.7**
Developing economies	**10.0**	**9.8**	**9.5**	**8.5**	**8.1**	**8.0**
Africa	12.3	12.4	10.6	7.1	5.4	6.3
Asia	10.5	10.8	10.6	9.9	9.5	9.1
East and South-East Asia	11.5	11.8	11.7	11.0	10.3	10.1
South Asia	7.2	6.7	6.1	5.5	6.4	5.7
West Asia	5.5	5.4	4.9	4.6	4.6	3.4
Latin America and the Caribbean	7.9	6.7	6.6	5.2	5.3	5.6
Transition economies	**14.4**	**13.9**	**14.6**	**10.2**	**11.1**	**11.8**

Source: UNCTAD, World Investment Report 2018.

Structural changes in the nature of international business are also at work. The digital economy and the adoption of digital technologies in global supply chains across many industries is having profound effects on international production. It is causing a shift to intangibles and increasingly asset-light forms of international production, as reaching global markets and exploiting efficiencies from cross-border operations no longer requires heavy asset footprints. The trend is visible in the divergence of key international production indicators – on a scale from tangible to intangible – with negative growth for FDI, slow growth for trade in goods, faster growth for trade in services, and the fastest growth in international payments for intangibles (royalties and licensing fees) (figure 3).

Figure 3. Indicators of international production, by "tangibility", 2010-2018
(Indexed, 2010=100)



Source: UNCTAD.

Implications for policymakers

The implications of the longer-term FDI downturn are important for policymakers. International investment in productive assets is sought after by almost all countries, developed and developing, to support economic growth and job creation. The presence of investment promotion agencies in most countries, and the proliferation of incentives, special economic zones, and other common tools to attract investment is testimony.

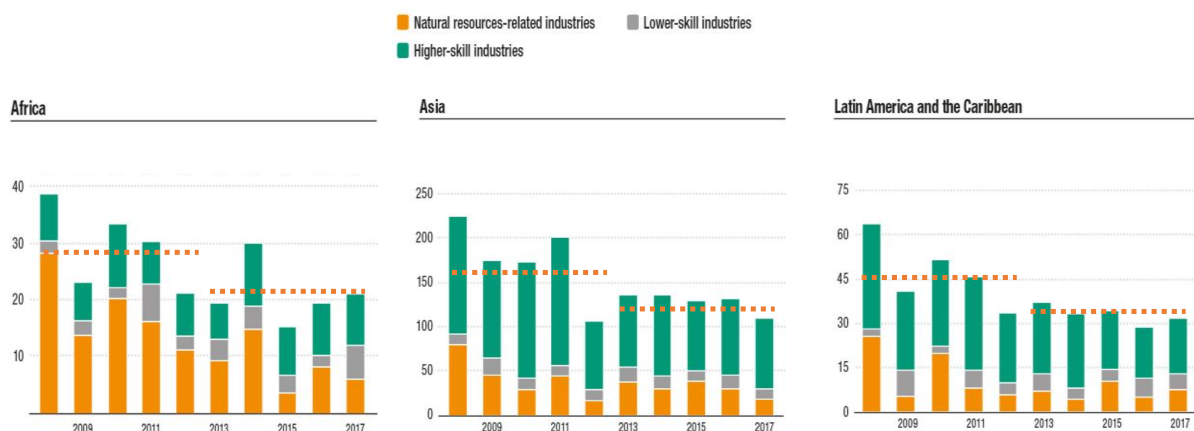
The slow-down in international investment is a concern especially for developing countries. First, because FDI constitutes the largest source of external finance for developing countries – more important than loans, portfolio

investments, remittances and development assistance – and the most resilient to economic and financial shocks. On average, over the last 5 years FDI accounted for more than 40% of external finance for developing countries.

Second, because FDI is more than a source of finance. Investments in productive assets can generate employment, export revenues and fiscal returns, they can have a multiplier effect through links with local suppliers, and they have the potential to create further spillovers in the form of know-how, technology and skill-building. FDI has been a key tool in the development path of most of today's successful emerging markets.

For low-income countries in particular the lack of international investment outside natural resource sectors is a key obstacle to their industrialization. More than 80 countries worldwide have introduced new industrial policies over the last 5 years, almost all of which rely to a substantial degree on attracting international investment. However, over the same period, greenfield investment project announcements in the manufacturing sector – the key target in industrial development strategies – have been structurally lower than in the preceding period, across all developing regions (figure 4).

Figure 4. Value of announced greenfield projects in manufacturing, 2008-2017
(US$ billions)



Source: UNCTAD, World Investment Report 2018.

Questions for business leaders and policymakers

- What are the key cyclical and structural factors causing the slow-down in international investment in productive assets?
- Why does international investment appear to be less profitable for large firms today?
- How are MNEs responding to the new investment playing field? What opportunities do they still see for developing countries, despite the dwindling "global investment pool"?
- How should policymakers respond to increasing competition for international investment? For developing countries, what are the implications for their efforts towards industrial transformation?
- What can policymakers do at the national level, within their own countries, to stimulate international investment in productive capacity? What should they avoid doing?
- What options do policymakers have at the international level to stop and reverse the slide in global FDI?
- What measures or initiatives can promote partnership between business and government to boost investment in sustainable development?

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