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FDI at a tipping point

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International capital flows have significantly decreased since the Great Financial Crisis of 2009. Protectionist tensions, then the Covid-19 crisis, have contributed to this decline. Foreign direct investments (FDIs) are more resilient, but they are also slowing for structural reasons. Even if it is too early to say that we have passed a "peak of globalization", the risk of gradual "disintegration" is very real.

Global activity resumed vigorously in 2021, but the growth potential of economies has undoubtedly declined, due to the scars left by the Covid 19 crisis in the form of losses of human capital, impact on the patterns of consumption and general increase in debt. The low level of interest rates should in principle favour foreign direct investments[1] (FDI), but they are also hampered by structural trends, as well as by the perceived risk of digital, green, regulatory and technological fragmentation.

A slowdown in FDI was becoming clearer before the Covid crisis

Annual cross-border capital flows have declined by more than 60% from the peak reached in 2007. Much of this adjustment resulted from the reduction in cross-border exposures of European banks during the euro area debt crisis. Foreign direct investment flows are less volatile and have generally held up much better. However, starting in 2017, they fell sharply in developed countries. One reason for the decline was the one-off taxation by the Trump administration of income held abroad by US multinationals. This saw a movement of dividend repatriation to the United States, accompanied by a deflation of financial arrangements previously held in the form of SPVs[2], domiciled in countries with low taxation.

The IMF estimated in a 2019 study[3] that Luxembourg was the first recipient of FDI in the world, with a stock of USD 5.1tn, ahead of the US and far ahead of China; 38% of the global stock of FDI in 2018 was thus made up of this "ghost FDI" whose purpose

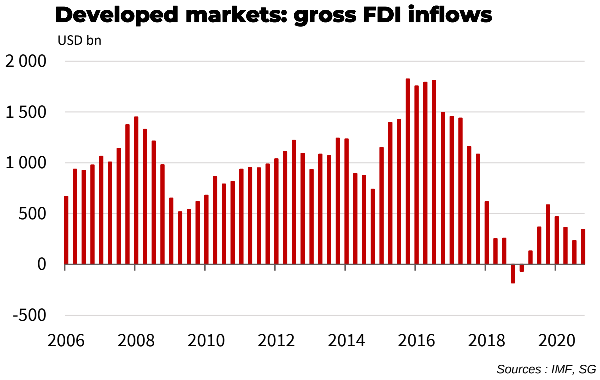
[1] According to the IMF definition, FDI refers to investments made in another economy with the aim of acquiring a lasting interest in a company, which is presumed when the investor owns at least 10% of the shares or voting rights. FDI encompasses all the resources made available to the company, that is to say, capital transactions, loans and reinvested profits.

[2] Special Purpose Vehicle, the purpose being in this case fiscal.

[3] IMF (2019), « The rise of phantom investments", *Finance and Development,* September 2019.

is tax optimization. The IMF estimated in this same study that the partial deflation of these arrangements explained most of the collapse of FDI in developed countries in 2018. The good news is that these accounting movements in the books of multinationals do not directly affect the real economy of recipient countries. However, this amount of “ghost FDI” could nonetheless continue to decline. The consensus reached around the OECD by 130 countries in November 2021 to reduce international tax optimization, by establishing a minimum tax rate of 15% on the income of the largest multinational companies, suggests that this unwinding movement could resume.

Graph 1 & 2: Slowing FDI



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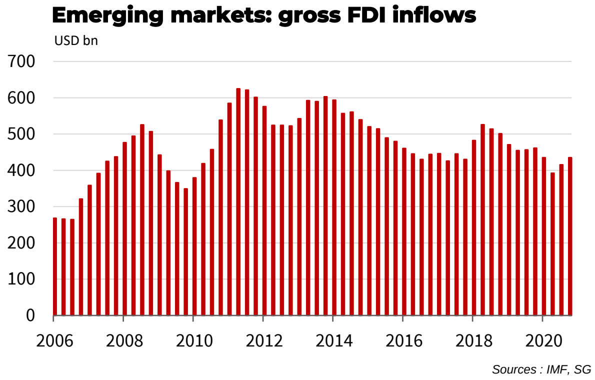

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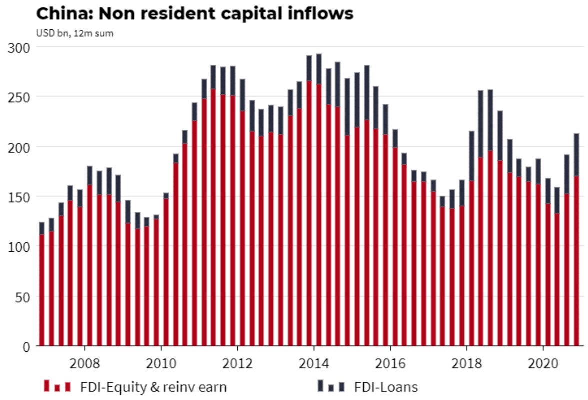
Eroding FDI to emerging countries

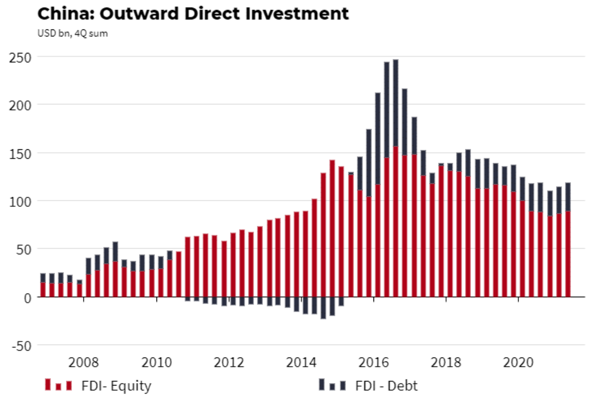
We also note a trend of slower FDI to emerging countries after a peak in 2011. Even if less spectacular than in developed countries, we believe that this trend, which is common to all emerging countries and also concerns China, merits attention.

This erosion is paradoxical because the growth differential in favour of emerging countries increased after the Great Financial Crisis of 2009 and financial performance in developed countries fell, two factors that could have supported flows. In addition, for emerging countries, FDI is a carrier of technological transfers and human capital build up. They also make it possible to finance investment with less recourse to debt. For these reasons, FDI continues to be favoured by most countries, sometimes with tax advantages. However, in recent times, the attitude towards FDI has become less favourable, with an increase in local content requirements and a reduction of tax advantages.

Over the past decade, China has become one of the main foreign investor countries, under the banner of the Belt and Road Initiative. This movement took off in the early part of the decade, but then ran out of steam. Several reasons are put forward: the end of the "super-cycle" of raw materials and the search by China from 2016 for a slower and more balanced growth model. On top of that, the environment for Chinese investments in recipient countries was not always favourable to their performance, especially in the lesser developed countries. From the middle of the decade, anti-corruption campaigns in China also constrained the decision-making process involving capital outflows.

Graph 3 & 4: China FDI & ODI





Source: SG Economics & Sector Studies *Source: SG Economics & Sector Studies*

For emerging countries as a whole, this erosion of FDI is slight in nominal terms, but it is more marked when expressed as a percentage of GDP of the countries concerned. Several factors are contributing to this, such as the decline in growth prospects for the main recipient countries, the slower trends in raw materials compared to the start of the decade and the decline in incentives for the geographical segmentation of value chains. Finally, we note that in several countries, new national investment policies have become slightly more critical with regard to foreign investment.

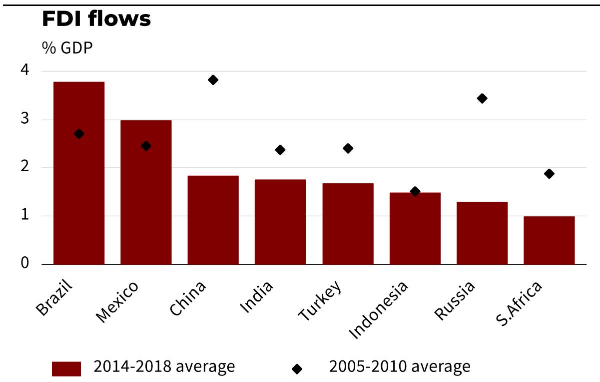
Even before the Covid crisis, in a context of structural slowdown in China, the growth trajectories of some large emerging countries such as Mexico, South Africa and Russia, appeared to be disappointing. In addition, the growth models of countries that are too dependent on oil exports, Chinese demand, or credit will have to be rethought in the future. Beyond the ongoing post-Covid restart, the IMF[4] points to a risk of widening fault lines in the global economy. Fiscal policy support in response to the pandemic was much less pronounced in emerging countries. This support was on average less than 4% of GDP for the years 2020 and 2021, against nearly 18% of GDP in the developed economies.

The most mobile FDIs are those that target global export markets and are primarily in search of operational efficiency. They are affected not only by the slowdown in

[4] https://blogs.imf.org/2021/07/27/drawing-further-apart-widening-gaps-in-the-global-recovery/

international trade and the rise of protectionist policies, but also by the decline in incentives for the segmentation of production processes. The rise in risks associated with this segmentation, whether geopolitical, climatic, or simply logistical, has been singularly illustrated by the recent episode of the pandemic. The adoption of policies that increase the requirements for local content also encourages a refocusing or even a contraction of value chains. Labour costs thus seem to have a little less influence on location decisions. At the same time, there are new incentives to locate in smaller, more flexible production units closer to end markets, also due to the shift towards more sustainable consumption patterns. As a result, multinationals are rethinking their location strategies to adapt to this changing global economy.

Graph 5 & 6: FDI to EM have declined



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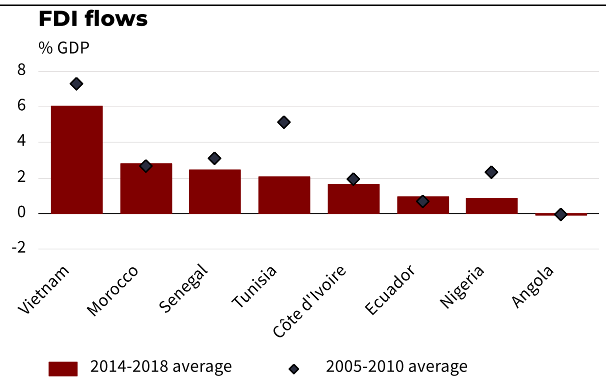

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It is difficult, for lack of statistics, to distinguish between FDI targeting global export markets, which are by nature sensitive to the growth of international trade, local production costs and exposed to protectionist measures, and FDI targeting domestic markets. The latter are more sensitive to the growth of local markets and their profitability may on the contrary benefit from protectionist measures.

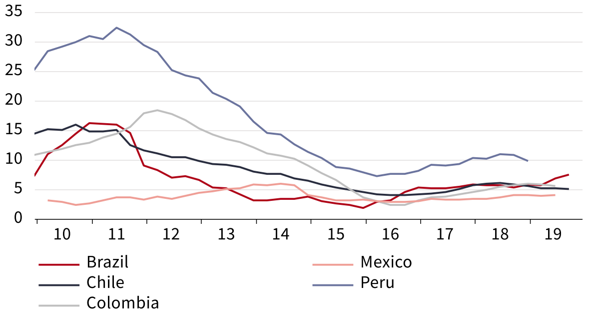
For this second category of FDI targeting domestic markets, the situation has also become more complex. The average growth of large emerging countries has decelerated over the past decade. These countries also have less means to implement counter-cyclical policies, as was illustrated during the pandemic. This is the case in Latin America, for example, but the profitability of FDI seems relatively resilient there (see graph). It is even reasonably high in Brazil despite several years of recession or very weak growth for the past seven years. In proportion to its GDP, Brazil enjoys more FDI than the other large emerging markets. Paradoxically, the high level of entry barriers protects the profitability of FDI in Brazil.

Turning to Central Europe, the environment is also becoming more complex, but this time for opposite reasons: growth is relatively high there but the important place taken by FDI in the economies of these countries at the end of the years of transition encouraged several governments in the region (in particular Hungary and Poland) to indirectly tax them more or to try to reduce their market shares. The willingness to reduce what was perceived to be a form of economic dependence on foreigners affected especially certain sectors, like utilities and financial services.

A mixed picture on FDI profitability

Latin America: return of FDI investments

FDI profit repatriation as % of FDI stock



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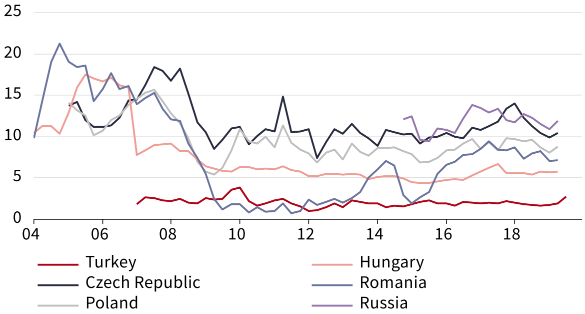
Emerging Europe: return of FDI investments

FDI profit repatriation as % of stock of FDI



Source: SG Economics & Sector Studies

A less integrated global economy is a real risk

Of the recent developments, the rise in tensions in high-tech sectors between the United States and China in 2019, and the supply logistics concerns in the context of the pandemic are the most notable. The issues of digital and technological security, if they are confirmed, are conducive to lasting decoupling in these sectors and undoubtedly beyond. In addition, the adoption of tariff measures and the assertion by several countries of more nationalist policies are giving rise to uncertainties. An increasing number of countries are using national security arguments to filter and sometimes block cross-border transactions. Finally, with the Belt and Road Initiative, China is supporting massive investment projects in infrastructure, the governance of which will remain hybrid, combining the logic of FDI with that of bilateral agreements between States. In this environment, the number of countries that sincerely support trade multilateralism have become fewer, despite the return of the United States in this club.

In addition, investors are taking greater account of ESG (Environment, Social and Governance) issues, which implies more scrutiny and in response greater vigilance on the part of multinational companies. Welcome as efforts to address ESG are, these also pose important challenges. Just zooming in on the climate transitions, we note the battlelines for the adoption of green standards and carbon borders taxes are only just beginning to be drawn up.

In this context, the landscape of trade and investment agreements could continue to fragment, or at least to reshape around large regions. The decoupling of technological standards between large areas could become more pronounced. There is thus a possibility of stagnation and even a slow decline in the production links between economies. The composition of FDI flows would thus be affected by growing doubts about the stability of the benefits of export oriented FDI. These developments may lead to a decline in financial globalization, but we can also hope that they will strengthen its resilience. Indeed, as we saw at COP26, there is a strong call for international co-operation.

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