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Global Future Council on International Trade and Investment

International Investment in the Age of Geopolitical Competition, Technological Change and Trade Confrontation

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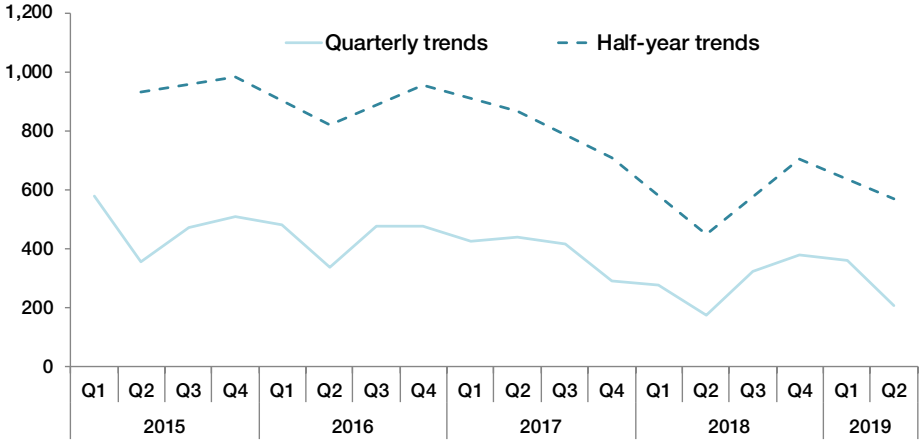
Over the past year, as growing trade tensions and geopolitical uncertainties dampened business confidence, global investment flows have decreased. Total foreign direct investment (FDI) flows decreased by 20% in the first half of 2019 to $572 billion. They dropped by 5% in Q1 2019 and by 42% in Q2 (Figure 1). They were 27% lower in 2018 than the previous year.

This briefing draws attention to the fact that this may be the start of a sustained downward trend. In the absence of policy interventions to counter balance these trends, which we see as unlikely, governments and businesses will need to adjust expectations about FDI. As we discuss in this note, several factors are triggering a broader shake-up in foreign investment flows. These trends are likely to lead to divergent equilibrium outcomes in different industries and regions, which we categorize into three stylized scenarios.

Figure 1: Global FDI flows, Q1 2015-Q2 2019 (US$ billion)



Source: OECD International Direct Investment Statistics database

Developing countries find themselves particularly vulnerable, given recent trends. Private investment in developing countries was already falling prior to this. Between 2016 and 2017, private sector FDI into developing countries declined by 30%, even as overall FDI from G20 countries remained robust. Furthermore, in 2018, project finance for developing countries declined by 30%. A record level of remittances helped to blunt the full impact of this decline, as their importance increased vis-à-vis private sector FDI.

The explanation for why FDI flows have declined is complicated. Part of the FDI downturn is due to domestic policy developments, such as the 2017 US tax reform which created incentives for repatriation of overseas earnings and the growing scrutiny of outbound FDI by Chinese regulators. However, beyond traditional investor motivations, greater systemic forces are also playing a role. These forces include geopolitics, technology, rising populism and even climate change. Some combination of these factors is contributing to deterioration in the policy environment for FDI in multiple countries, while increasing uncertainty over the returns from FDI.

The first part of this briefing note draws attention to five forces that are upending cross-border investment. To be clear, not all of these forces are affecting every industry sector or region in the same way. Government policy-makers, investors and corporate executives will need to consider carefully which of these factors will likely shake up investments in their particular area.

New forces affecting international investment

1. Rising trade tensions

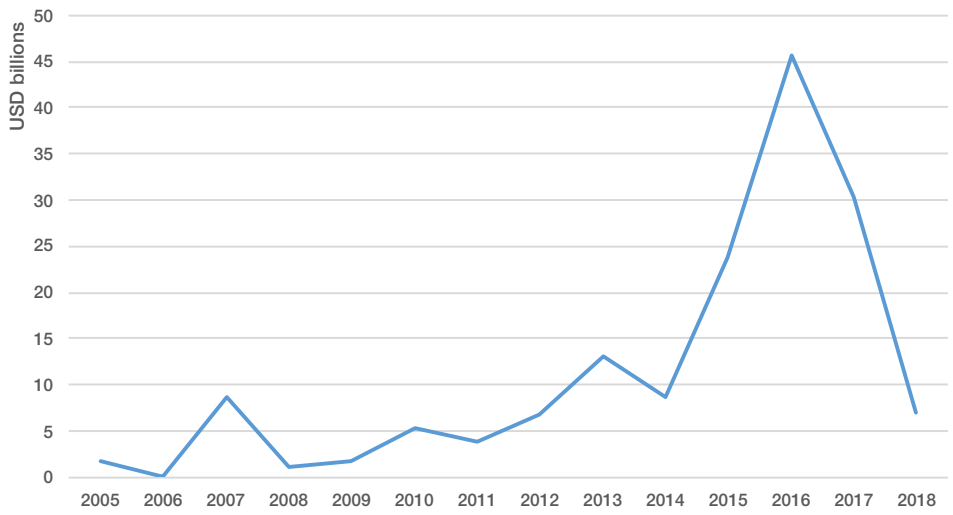
Rising trade tensions, and growing recognition that they portend shifting geopolitics, are chilling FDI, particularly in countries at the front lines of the trade war. Not surprisingly, bilateral investment flows have experienced especially sharp declines between pairs of countries where trade tensions have increased. This is particularly true for the US and China. Investment flows arising out of mergers and acquisitions (M&As) by Chinese firms into the US declined by 77% in 2018 (from $30 billion in 2017 to $7 billion in 2018), as tensions rose. While this figure may seem dramatic, note that current levels of M&A activity are still roughly in line with what they were in the early 2010s, prior to the uptick in 2015 (See Figure 2). Furthermore, other investment flows into the US have increased, particularly those relating to greenfield and multiyear projects.

Trade tensions are also contributing to an overall decline in FDI in China. Cross-border M&As into China were down 15% in 2018. Based on figures available for the first half of 2019, cross-border M&As into China appear to be on course to decline by a further 26% this year. While some of this decline may be driven by structural factors such as rising labour costs, the decline likely also reflects growing concerns over China's attractiveness as an export platform in light of trade uncertainties.

Nonetheless, while trade restrictions have unambiguous negative implications for trade volumes and policy uncertainty has clear negative impacts on investment flows, the impact of trade restrictions on investment is less clear-cut. There may be investment winners from the trade war. In some instances, countries may experience increases in international investment as a result of growing trade restrictions. For example, firms may decide to serve the import-restricting country through a physical presence instead of through trade (i.e. import-substituting investments). Growing bilateral trade restrictions may also lead firms to relocate production to unaffected countries to avoid tariffs and other duties. Certain countries may stand to benefit from supply chain reconfigurations; Viet Nam, for example, attracted a record $18 billion in FDI in 2018.

Notwithstanding these ambiguous investment effects across countries and sectors, it is widely accepted that trade restrictions will ultimately result in a less efficient allocation of capital and reduced international productivity and economic growth. In the near-term, growing trade unpredictability appears to have a chilling effect, as firms adopt a wait-and-see attitude to overseas investments while they wait for the trade war to play itself out.

Figure 2: Declining Chinese M&As into the US



Source: OECD based on Dealogic Cortex SMP database

2. National security safeguards

Concurrent with the trade and emerging geopolitical tensions, countries are also increasing their use of ad hoc policies to screen foreign investment for national security implications. The range of industries now potentially subject in reviews has expanded to include advanced technology sectors, such as robotics, biotechnology and network industries. Countries that already had national security screening mechanisms in place are making significant policy adjustments. Some countries are enacting additional export controls, limiting the possibility for outbound FDI.

The expanded focus on the interplay between FDI and national security is driven by several concerns, some are traditional and some are new, including:

- Restricting access to dual-use technologies
- Reducing risk of sabotage of critical infrastructure
- Increasing diversification of suppliers of certain products or services to prevent a foreign government from using controls over upstream inputs as leverage
- Preventing technology espionage and coercion
- Guarding against inappropriate capture, misuse and manipulation of personal/sensitive data
- Limiting economic interdependency with countries deemed to be strategic rivals

Even if current trade tensions dissipate, these new or reformed national security safeguard mechanisms are likely to remain. The effect on investment is two-sided. Some FDI may be chilled where enhanced national security safeguards increase the uncertainty of regulatory approval or the risk of future divestment. On the other hand, some firms may expand FDI as their downstream purchasers look to diversify supply sources due to national security concerns.

3. Digital Economy

While a key factor impacting geopolitics and FDI flows is the growing US-China technology rivalry, even absent this rivalry, technological change is asserting an independent impact on FDI flows. As the boundaries between digital and more traditional industries have started to blur and as new hybrid business models emerge, FDI decisions are increasingly impacted by technological developments as well as government attempts to regulate the digital domain. The interactions between technology and technology policies are upending firms' calculus over how to structure their production and distribution across countries.

At one level, technological developments threaten to upend industry dynamics. For example, distributed ledgers have the potential to change the way some financial services are organized and delivered. As 5G rolls out, the potential for digital analytics to be embedded within services and industrial goods expands. In addition, many elements of the global value chain could be split with the support of digital technology such as cloud computing, artificial intelligence, 5G and 3D printing. As a result of these technological changes, firms may change their patterns of FDI as new costs and opportunities change their business models.

Digital regulatory policies are also affecting patterns of FDI, even if this may not be their primary goal. Examples include digital taxation, data localization policies, data privacy regulations and e-payment standards. Regulatory measures, barriers and distortions to trade and FDI have spill-over effects, magnifying costs and impeding many firms from pursuing an optimal organization of production networks. Again, the impact is two-sided. In some instances, a firm may decide that the additional costs imposed by digital regulations are too high and not invest in a jurisdiction that it otherwise would have, absent such regulations. In other instances, the new regulations may force a firm to engage in additional FDI to lower its costs or to enable it to service certain markets that it otherwise would not.

4. Developments in bilateral investment treaties and free trade agreements

The global FDI landscape is also affected by changes in the investment treaty framework in G20 countries. As a result of increasing questioning and growing constraints imposed by EU law, European policy is undergoing a major transformation, including the demise of intra-EU investor-state arbitration. The US has scaled back the scope of investor-state dispute settlement (ISDS) in the US-Canada-Mexico Agreement. Meanwhile, G20 net capital importers, such as India, Indonesia and South Africa, are rejecting the terms of first-generation investment treaties, leading to the termination of several bilateral investment treaties. At the same time, treaty changes are not entirely dismissive of ISDS.

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), for example, represents an expansion of a robust North American-style ISDS mechanism to a broader range of economies in the Asia-Pacific.

Because there is no multilateral framework for investment, international cooperation in this area remains fragmented. Treaty-making is done through bilateral/regional arrangement (that could be prone to geopolitical pressure) and through international organizations. In this context, governments are also seeking to undertake reform of investment rules and dispute procedures through various forums, including the UN Commission on International Trade Law (UNCITRAL), UN Conference on Trade and Development (UNCTAD) and Organisation for Economic Cooperation and Development (OECD). In addition, the EU is advancing a proposal for a Multilateral Investment Court. Whether these initiatives gain traction, and if so, whether treaty changes and reform proposals will impact actual FDI flows, remains to be seen.

5. Growing pressures for responsible business conduct

A final set of pressures come from growing expectations that foreign firms engage in responsible business conduct (RBC), even in countries with weak governance. Firms are increasingly expected to respect human rights, meet their fiscal responsibilities, and manage environmental and social risks throughout their operations and supply chains. These expectations have been reflected in the development of broadly recognized international standards such as the OECD Guidelines for Multinational Enterprises, UN Guiding Principles for Business and Human Rights, and ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy.

As an increasingly larger number of governments translate the principles and recommendations of these instruments into domestic legislation and enforce such regulations, firms – in host and home countries – may incur greater material risks to their business operations, including reputational damage, and they are increasingly engaged in developing and implementing RBC standards.

Possible outcome scenarios

Given the disruptive impact of the 2018-2019 global economic tensions, it appears highly unlikely that we will return to a normal state of affairs. Instead, we are experiencing a sustained period of turbulence for investment policies, which will lead ultimately to a changed order. Where then might we be headed?

The answer is likely to be different depending on the given sector, industry or region. Some areas, such as telecommunications and certain internet-related industries, may wind up with increasingly fragmented investment flows, due to technological change and growing geopolitical tensions. On the other hand, cooperation may increase in other areas, such as the mining industry due to RBC developments or South-East Asia as an opportunistic response to supply-chain shifts from the trade war.

To assist business executives and policy-makers to assess possibilities for where they may end up, we have developed three stylized scenarios. Again, we emphasize that we do not believe that the world as a whole will converge against any single scenario necessarily. Instead, each sector or region is to be assessed individually on a case-by-case basis against the larger backdrop of one of these scenarios.

Scenario 1: Disruption leads to enhanced cooperation (eventually)

The first scenario is one where the current tumult lasts for a prolonged period, but all sides ultimately will recognize the benefits of ensuring stable rules for economic cooperation, even amidst growing technological competition and geopolitical rivalry. While certain sectors are “walled off” and technologies withheld for firms operating in countries with different political orientations, there will emerge a set of shared norms among the major economies as to the scope of acceptable safeguards for essential security. This will extend to the digital domain, where greater shared norms and interoperability also will be developed as to the acceptable regulations to safeguard community interests and individual privacy.

To achieve this scenario will require governments to take proactive steps in response to legitimate concerns arising from the populist backlash against foreign investment. A further degree of investment treaty reform will need to materialize to balance better the right to regulate with investment protection and liberalization, beyond that which is already under discussion (as those proposals have largely failed to appease populist demands).

In addition, governments will need to arrive at a new set of investment facilitation rules, whether through a multilateral institution such as the World Trade Organization or through regional/plurilateral arrangements. Such rules would seek to increase transparency and predictability, speed up administrative processing and enhance information sharing for investment-related measures. Furthermore, other related policies will be considered to increase the positive impact of investment in society.

Under this scenario, the new equilibrium that emerges will have a better balance among firms, governments and other stakeholders. Firms will accept this rebalance in exchange for greater stability and predictability. Parties prefer a rules-based system and focus on updating rules to adapt to new technological developments. Foreign investors with strong dependence in technology and digital data will find themselves subject to additional rules and regulations, but these are readily transparent. After some period of disruption, cross-border investment flows will once again increase.

Scenario 2: Limited cooperation led by middle-ground countries

In a second scenario, the US and China will arrive ultimately at a trade truce, but will be unable to reach a common understanding on how to update trade and investment rules. Instead, there will be growing competition between the geopolitical rivals, particularly in technology domains. Most other governments, however, will resist pressures to align squarely with one side. Instead, these middle-ground countries will play an increasingly important role in forging pathways for limited cooperation between the parties. In doing so, they will manage to contain the economic impact of the geopolitical rivalry and enable a state of uneasy coexistence.

Under this scenario, national security concerns will play an increasingly important role in investment policy. A set of advanced economies may seek greater alignment of their investment, security and regulatory rules, but this cohort likely will not include some important emerging economies such as China and India. There may be a limited amount of enhanced investment liberalization and new rules for

investment facilitation, but these will be only among limited groups of countries. Investment rules will continue to be shaped in a piecemeal manner.

A further degree of decoupling in the international investment system takes place extending beyond the US-China relationship, but this phenomenon confined largely to technology-related sectors with possible military applications.

In this scenario, even if there is not a major decoupling, the lack of a new common understanding between the major rivals will cause firms to reorient their capital and supply chains to hedge against possible future escalations in trade tensions. Geopolitics will play a greater role in firms' investment allocations, as parties seek to diversify in order to insulate themselves from future shocks.

Scenario 3: Semi-permanent trade war and technological fragmentation

A final scenario is one in which the trade war and technological rivalry become semi-permanent, leading to greater technological fragmentation across the major economies. National security concerns will become paramount. While decoupling will take place first in technology and infrastructure sectors, the phenomenon eventually will extend to other data-intensive sectors, especially in the knowledge economy underpinning the Fourth Industrial Revolution. Governments will find it increasingly difficult to allow certain forms of foreign investment from firms located in countries with divergent political and social orders, due to their growing distrust over motives.

In this scenario, global attempts to overhaul investment rules and reform the investment regime will grind to a halt. Instead, any updating of rules will arise mainly due to pressure from a trading partner to adopt certain rules as a condition for maintaining market access. The overall investment regime moves away from a predictable, stable, rules-based system towards more of a transaction-specific system where politics plays a bigger role. Middle-ground countries will try, but find it increasingly difficult, to resist pressures from major powers to take sides on particular policies related to the intersection of technology and security.

As the scenario unfolds, the international investment system will realign itself to reflect the geopolitical and technological divides. Firms will allocate their investments to locations where they deem their investments to be relatively secure from the risk of geopolitical entanglement. Unlike the Cold War, some degree of economic interdependence remains, but cross-border investments between rival countries is seriously dampened due to growing uncertainty and higher transaction costs.

Questions to consider

The global investment regime is truly at a crossroads, due to not only the trade war but also technological developments and social pressures. Even if current trade tensions dissipate, it is unlikely that we will return to the state of affairs of the mid-2010s. Rather, the system underlying global investment is likely to undergo some degree of change, but exactly how is unclear. Indeed, the range of possible outcomes is quite large and it will probably include a mix of elements, some of them captured in these scenarios. Against this backdrop, it is worth considering:

- How undesirable is a shift toward fragmentation? Is this a scenario to be avoided at all costs, or is it one to which businesses and investors in a given sector or region can learn to adapt?

- What actions, at the multilateral and national level, are required to de-escalate tensions and preserve cooperation in a given sector or region?

- If cooperation is preserved among only a critical mass of players, with a few major players absent, is that sufficient?

- What steps can business leaders take to preserve cooperation in their industry, independent of governments or international institutions?

- How are small and medium-sized enterprises likely to be affected by these emerging trends? In what ways will they prove to be less adaptable than larger multinational corporations? What can be done to improve their resiliency?

- How will these shifts affect the strategies of countries to achieve the UN Sustainable Development Goals, particularly those that are least developed? What types of additional aid or capacity-building measures are required to help them adjust?

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