ARTICLE FOR THE EDGE

ASIA FACES SHIFTING FOREIGN INVESTMENT TRENDS

The cyclical uplift in the global economy is set to continue, generating ever growing trade flows which will boost Asian economies. That's good news for economic growth in the near term. But, what matters for Asia's long term economic development is foreign direct investment (FDI) which can build the foundations of future growth through skills development, technology transfer, provision of financial capital, integrating a country into global export markets and exposing it to the global competition which spurs continuous upgrading. FDI is important even for the more developed Asian economies such as Singapore.

Recent surveys such as the A.T. Kearney FDI Confidence report gave both good news as well as some warning signs that attracting FDI may not be as easy as it was in the past. If Asian economies are to continue winning the FDI game, they will have to re-think their strategies and address some of their weaknesses.

What are the recent trends that matter to Asia?

The 2018 report of the A.T. Kearney FDI confidence index highlighted some trends with important implications for Asia:

- The good news is that FDI confidence is at its highest level since 2014. About two-thirds of surveyed investors reported that they were increasing their FDI this year compared to just 60% last year. An impressive 79% of surveyed firms plan to step up their FDI in the next three years. Coming after two consecutive years of declines in FDI, it looks like 2018 will see a resurgence of this key driver of Asian economic growth.

- This confidence was particularly evident in the manufacturing and information technology sectors. However, services firms were noticeably more cautious, probably reflecting the slower growth in cross-border services trade in recent years.

- Investors are shifting their capital allocation in favour of developed economies. Europe, in particular, is poised to enjoy a significant pick up in FDI. Of the countries in the top 10 rankings for FDI, nine were developed economies with the United States, Canada, Germany and the United Kingdom leading the pack.

- While there is less interest in emerging economies, this was primarily due to sharply diminished interest in the Middle East and North Africa, probably a consequence of the political upheavals in that region.

    Asia-Pacific economies continue to garner interest but face challenges. According to the United Nations, developing Asian economies secured USD459bn in FDI in 2017, up from USD448bn in 2016 but far short of the USD524bn that flowed into Asia in 2015. However, the countries in the Asia-Pacific that enjoy growing confidence among foreign investors were mainly the more developed ones – Japan, Australia, New Zealand and South Korea. While China was the only developing economy in the top 10 worldwide, it suffered a fall in its rank to 5th, its worst ever showing in the A.T. Kearney rankings. India has fallen out of the top 10 rankings. Singapore was the only ASEAN economy in the top 25 ranks and even it suffered the indignity of a marked fall to 12th rank. Malaysia which had been consistently in the top 25 globally has dropped out since 2015. Thailand re-entered the top 25 in 2017 when it was ranked 19th but it has now fallen out.

What underpins these trends and what do they mean for developing Asia?

On a positive note, there are some powerful drivers of FDI present. Two factors stand out in particular. The synchronous expansion of the global economy has contributed substantially to the high levels of foreign investor confidence: this broad-based growth gives businesses more confidence that continued growth will justify their expectations of a good return on their investment. Companies are also enjoying a cost of capital that remains very low in historic terms. Despite the beginnings of monetary tightening in the United States and higher bond yields, companies are still able to raise debt and equity capital relatively easily. The combination of these two factors – growth promoting the perception of high returns and a low cost of capital - is proving very compelling for foreign investment decisions.

But some of the other driving forces behind FDI may not be so helpful to developing Asian economies.

First, there has been a noticeable increase in investor emphasis on governance and tax issues. Governance and regulation are now rated as the most important factor in determining where FDI goes, up from 5th ranked factor in 2017. Tax-related concerns are now rated 2nd. More specifically, investors are worried about regulatory transparency, corruption, tax differentials and the general security environment. Of all these factors, corruption is a stand-out concern now. Recent scandals such as the infamous capture of state institutions in South Africa by businessmen associated with the previous president, the evidence of widespread corruption in Brazil which has brought two former presidents into disrepute and the 1MDB controversy closer to home have had an impact on the collective psychology of foreign investors. Going forward, large foreign investors are likely to be much more selective about the countries they commit investments to, downgrading those with a poor reputation in terms of corruption.

Second, a range of geo-political risks carry a greater weight in FDI decisions now:

> Investors are worried about protectionism and populism and casting about for ways to protect themselves from their fallout. One response is localisation – moving production to countries with large markets where there is a risk of growing barriers to trade. This would tend to advantage large economies over smaller ones – countries such as China, India and Indonesia may benefit at the expense of long time FDI favourites such as Malaysia, Singapore and Thailand. However, investors are reacting positively to economic integration initiatives such as the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) agreement as they are seen as providing support to trade-dependent economies in a time of growing protectionism. That should help Malaysia, Singapore and Vietnam who are members of the CPTPP.
>
> Investors are also monitoring the general security environment with more watchfulness. Note how the United Arab Emirates (UAE) fell out of the FDI confidence rankings this year. The UAE is an island of stability and sound economic management but it had to pay a price for being in a very difficult region, lying close to countries such as Yemen and Syria which are in the throes of vicious civil wars.

Third, foreign investors are now looking more closely at a country's labour market. Labour-related issues surged from 12th ranked concern last year to 3rd most important one in 2018. Investors will look at the demographic outlook and whether slower labour force growth can be offset by liberal immigration policies.

Fourth, quite surprisingly, infrastructure issues did not feature prominently as drivers of FDI. The quality of transportation and electricity infrastructure was ranked a lowly 19th and 20th in the survey.

But Asia may have other factors in its favour

Of course, the trends reported in the A.T. Kearney report tend to mainly reflect the views of developed economy companies. The views of the newest force in global investing – China – are therefore under-represented. The growing importance of China as a source of FDI should tend to especially benefit Asian economies since China has close trade and strategic ties to its neighbours. Two driving forces will help raise China's investing footprint - the government-inspired Belt & Road Initiative (BRI) and the global ambitions of private Chinese companies.

The BRI is only just getting off the ground and will be a game changer for many countries simply because of the massive scale of the Chinese projects. Such large-scale spending will raise economic growth during the construction phase while the long-term economic potential of the country will also be energised as infrastructure bottlenecks are reduced and connectivity improved. Take Pakistan as an example, where China plans to spend USD63 billion in a country that American and European foreign investment has tended to bypass because of the country's political travails. Clearly, for state-sponsored Chinese investment abroad, strategic considerations may well trump the more conventional ones.

However, that will not necessarily apply to Chinese corporates. Some of them will, of course, feel obliged to show support to their government's strategic ambitions by investing in countries such as Pakistan. However, in the main, Chinese corporate-led FDI will be driven by factors such as the need to open up new markets, relocate labour-intensive production since Chinese labour costs have risen so much, secure access to resources and to acquire technology. As US-China trade tensions mount, Chinese companies exporting goods to the US may also relocate production to other countries which have better trade ties with the US. These considerations largely favour Asian economies.

What are the lessons for Asian economies

Developing countries in Asia have generally done well in luring FDI but they will need to make some adjustments if they are to remain attractive.

First, the increased investor focus on governance and corruption is likely to persist. Even China will have to take note of global pressures on this score. Countries that demonstrate a strong commitment to reducing corruption by empowering anti-corruption agencies will be favoured over others.

Second, economies that offer scale opportunities to investors in the form of large consumer markets will gain. For smaller economies, getting into a large trade pact such as the CPTPP may become essential. It will not surprise us if more countries applied to join the CPTPP. South Korea and Thailand are sure to, in our view.

Third, investment promotion agencies, which have so far focused their efforts on developed countries in the west and Japan, may have to recalibrate their strategies to see how they can persuade Chinese companies to invest in their countries.

Fourth, countries facing demographic issues such as Singapore and Thailand have to think hard about strategies to overcome their disadvantage. So far, some countries in this predicament have taken the easy route of opening up labour markets to large inflows of foreign workers. But this may not be sustainable in the longer run because of political and social consequences and also because such inflows tend to hurt the wages of poorer citizens.

Finally, the larger picture is that there is going to be a lot more competition for FDI. Many countries are focused on attracting FDI and taking vigorous steps to improve their investment environment. Asian economies will have to do a lot more to maintain their competitive positioning in the FDI space.

Prepared by Manu Bhaskaran
CEO, Centennial Asia Advisors