PERSPECTIVES
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Britain as global investor and foreign investment location: second only to the USA

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Introduction

In a recent Perspective we discussed the role of foreign direct investment (FDI) within the financial accounts of Britain's balance of payments.[1] FDI broadly refers to an investment made by foreign companies in another country, including mergers and acquisitions, as well as building up new facilities ("greenfield sites"). Portfolio investment, on the other hand, refers to investments in equity and debt securities issued by registered companies and by governments.[2]

This note looks at another aspect of Britain's FDI and concludes that Britain is not only a major investor in foreign countries (outward direct investment) but is also a highly successful and attractive location for overseas investment (inward direct investment).

International data on FDI

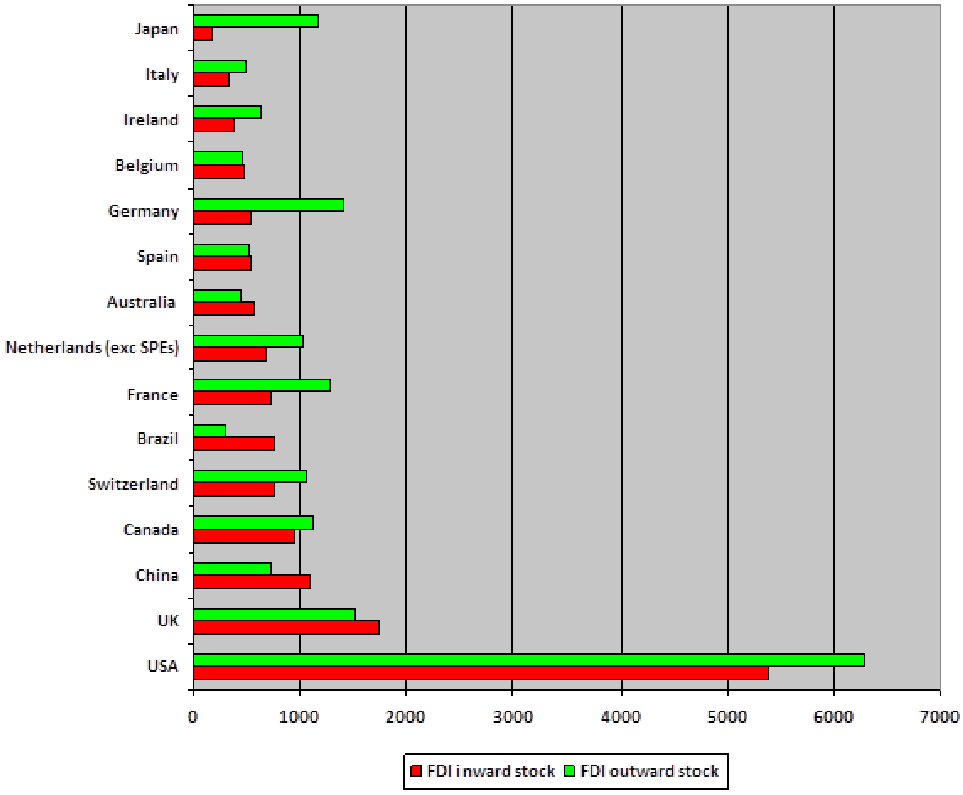
The OECD is one of the main international organisations which provide international FDI data, UNCTAD being the other.[3-5] Using OECD data, chart 1 shows the stocks of inward and outward direct investments for 15 of the world's key investing countries at end-2014.[6]

The broad conclusions are:

- The US is in a league of its own. It is clearly the largest outward investor and, whilst there is substantial inward investment, it is significant net outward investor.
- The UK is in second place in terms of both inward and outward investment, though inward investments more than offset outward investments.
- China is the next largest inward investor, though Germany is the third largest outward investor.
- The next largest outward investors are France, Japan, Canada, Switzerland and the Netherlands. All these countries are net outward investors, especially Japan.
- The main net inward investors, excluding the UK, are China, Brazil and Australia.

- Note that the data shown in chart 1 for the Netherlands exclude Special Purpose Entities (SPEs).[7] SPEs typically engage primarily in international transactions with few (or no) local operations. For this reason they are of limited economic significance to the host economy compared with operating units which have significant local operations. They are, therefore, frequently identified separately. If the SPEs are included for the Netherlands the stocks of inward and outward investments were $4,013.6bn and $4,833.8bn respectively at end-2014 (see annex table 1). Direct investment data are similarly "distorted" for Luxembourg, where investments involving SPEs dominate (see annex table 1). SPEs operate in other countries, but not to the same degree.

Chart 1 FDI, inward and outward stock, end-2014 ($bn), key investing countries



Source: OECD, database on FDI (see also annex table 1).

Turning to the UK's main investment partners, chart 3a shows that the US is the most important partner for both onward and outward investment. The presence of the Netherlands and Luxembourg in the UK's top five destinations partly reflects UK companies channelling funding through holding companies (SPEs, discussed above) in those countries to take advantage of their local tax regimes.[8] But, even after allowing for the impact of SPEs, the Netherlands and Luxembourg seem to remain significant investment partners.[9] The next most important investors in the UK – France, Germany, Switzerland, Spain and especially Japan – are all net investors in the UK.

Interestingly, the US's most economically significant investment partner is almost certainly the UK, as shown in chart 3b, and not the Netherlands. Note the US data are not exactly comparable with the UK bilateral data (see above). The UK data are derived from UK sources whilst the US bilateral data are derived from US sources.[10]

Frustratingly, the OECD's US bilateral data do not currently include any breakdown between SPEs and non-SPEs for the Netherlands (or indeed for any other country). But the bilateral data for the Netherlands with the US suggest that the vast majority of US outward FDI to the Netherlands relates to SPEs and, therefore, of limited economic significance. It is, moreover, reasonable to suggest that a similar situation pertains to Luxembourg-US investments. Unsurprisingly Japan, Canada, Germany, Switzerland and France are all major investors in the US.

Chart 2a UK FDI inward & outward stock, key partners, end-2014 ($bn)

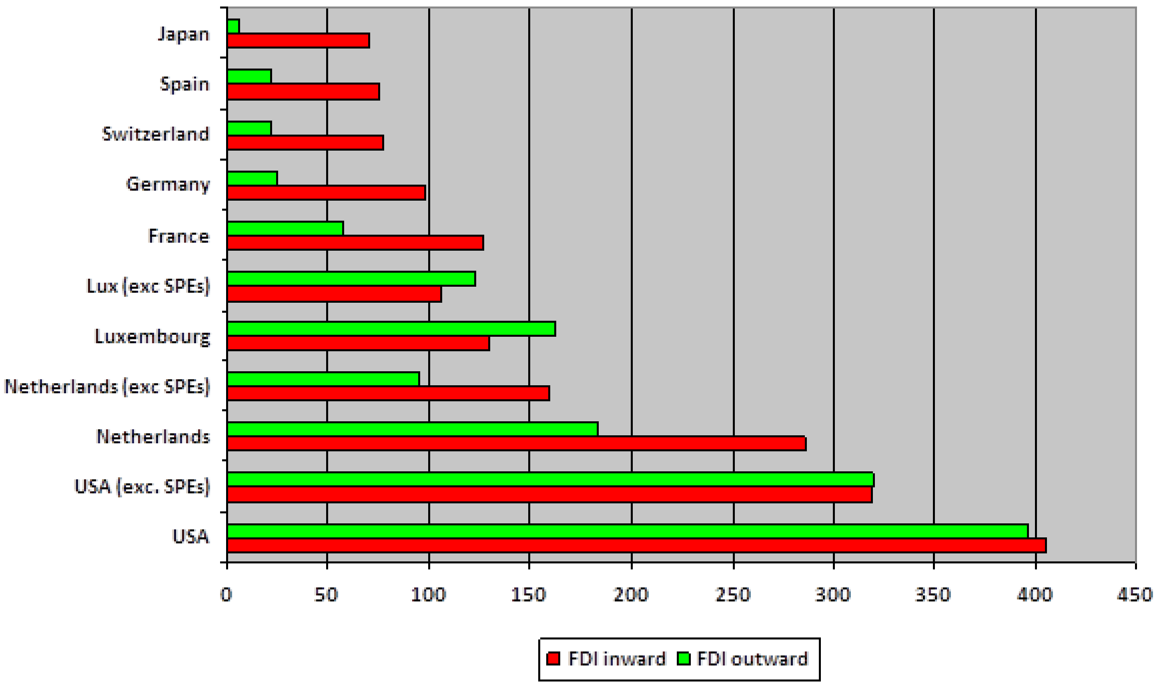
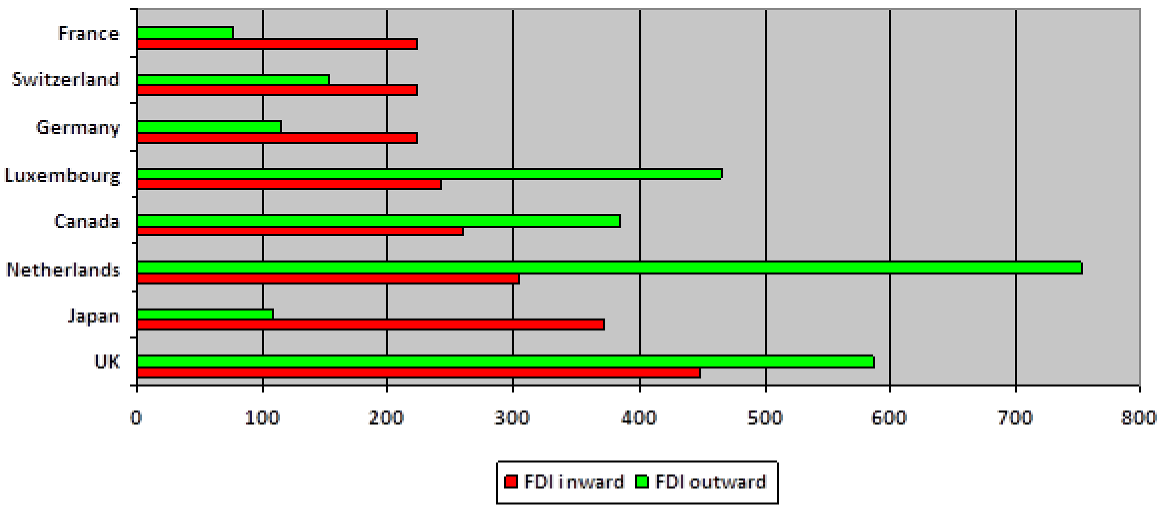


Chart 2b US FDI inward & outward stock, key partners, end-2014 ($bn)

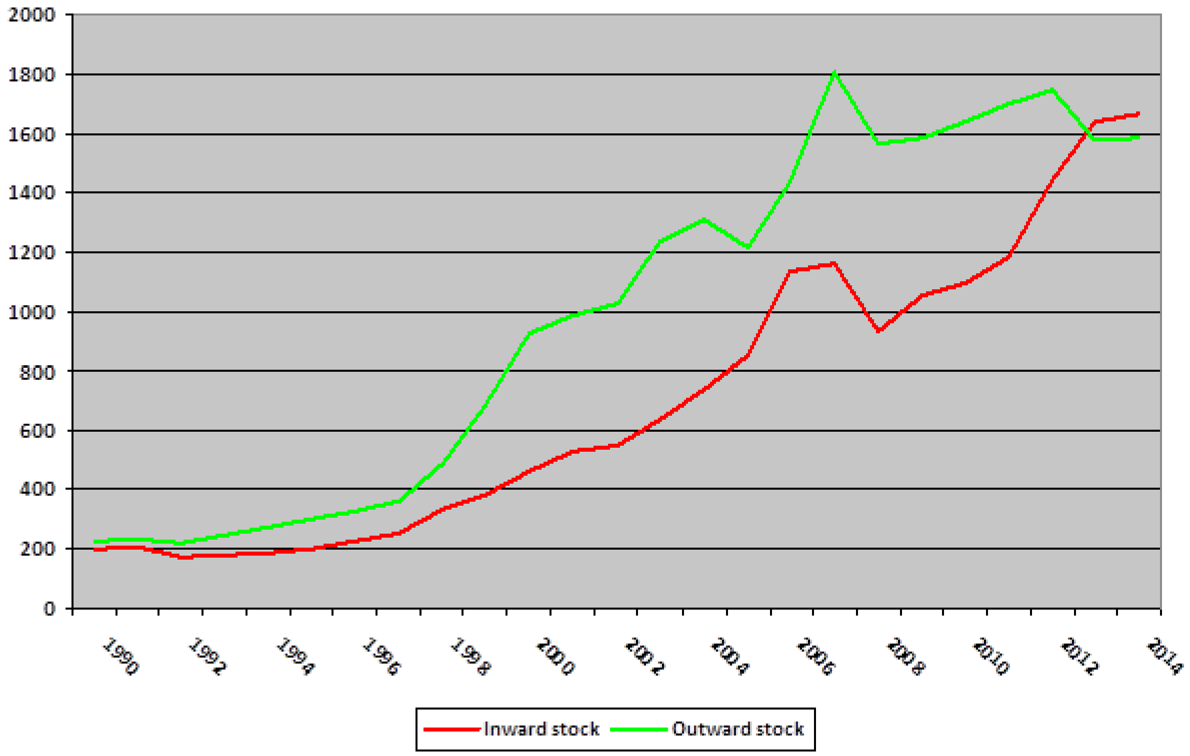


Source: OECD, FDI database (see annex tables 3a and 3b).

UK foreign direct investment

Chart 3 shows that the UK's stock of outward investment well outstripped that of inward investment for much of the period, 1990-2014.[11] But whilst inward investment has picked up sharply after the Great Recession, outward investment has tended to weaken so inward investment is now being outstripped by outward investment, contributing to the UK's deteriorating net international investment position (NIIP).[12]

Chart 3 UK FDI, inward and outward stock, 1990-2014 ($bn)



Source: UNCTAD, "World Investment Report, 2015", annex tables.

The UK's outward disinvestment in recent years primarily reflects a lack of confidence in European markets. OECD data suggest that there was a net disinvestment flow of $164.7bn from Europe in 2014, whereas investment flows to the US were positive to the tune of $6.8bn.[13]

Inward investment, on the other hand, is buoyant, doubtless helped by the promotional activities of "UK Trade and Investment" (UKTI) as well as good economic prospects. Inward investment is actively promoted in the UK, reflecting the belief (almost certainly justified) that foreign multinationals tend to be productivity-enhancing, bringing with them new technologies and management practices.

Highlights of the UKTI's latest, rather triumphalist, annual report were:[14]

- The OECD's preliminary estimates suggested that, despite a reduction in global FDI flows by 11% and a 16% reduction in European FDI, UK net FDI inflows increased by more than 50% in 2014. The UK received net FDI inflows of £44bn ($72bn) in 2014, representing one-third of total EU inflows and making the UK the Number 1 destination in Europe.
- According to the FT's fDi Report (sic, 2015) the UK received 909 FDI projects in 2014, 8% higher than in 2013 and significantly more than other major European economies, including Germany (378), Spain (252) and France (237).[15]
- According to the EY investment report (2015), the UK received a record number of FDI projects (887) in 2014, 11% higher than in 2013, which helped the UK to increase its market share in Europe to 20.4%, its highest share since 2009. The UK performed especially well in attracting brand new investments - 12% more than in 2013, closing the gap on Germany from 45 to 7 projects.[16]
- The UK was expected to continue performing strongly in the global FDI markets in 2015-16. It was, moreover, ranked by 2015 AT Kearney FDI Confidence Index as the 3rd most attractive market after the USA and China, and ahead of Canada and Germany.
- All in all, an encouraging report.

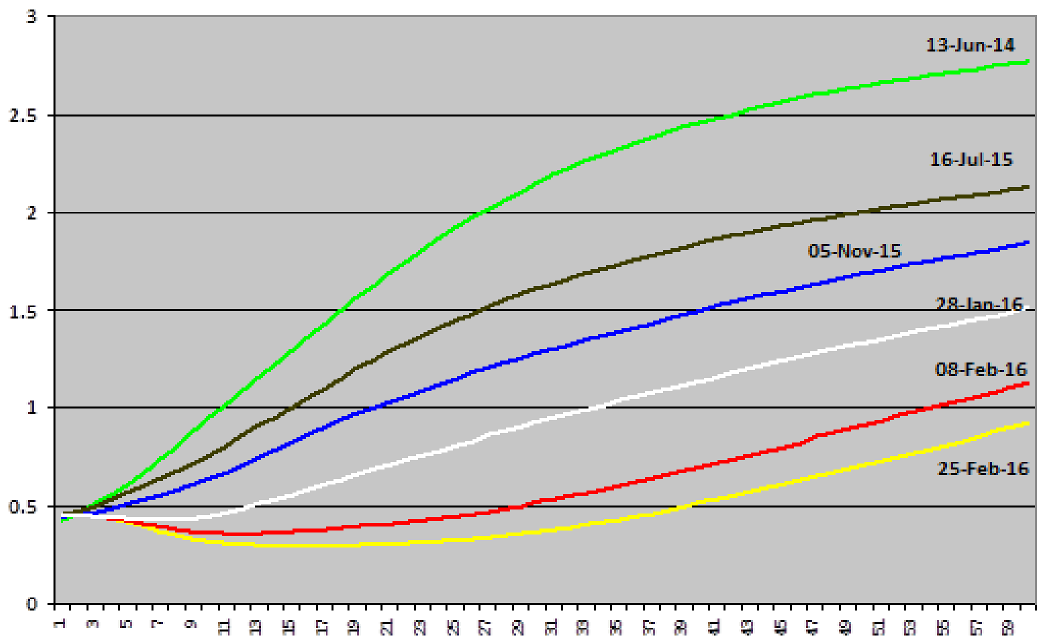
UK economy: update

A key event in recent weeks has been the accelerated depreciation of the pound. This reflects market perceptions that any increase in interest rates is being pushed further and further out, as well as market sensitivities to the "Brexit" campaign. Crucially the Bank's comments since the turn of the year have added to the belief that any rate hike is some way off. The Bank's "steers" have included:

- The dovishness of Governor Carney's "turn of the year" speech.[17-18]
- Reductions in the Bank's forecasts for both GDP and CPI in February's Inflation Report.[19] GDP is now expected to grow by 2.2% in 2016 (2.5% in November) and CPI inflation to be 0.4% in 2016Q4 (0.7% in November), though this could now prove to be an underestimate given the weak pound (see annex table 4).
- The MPC voted unanimously for no change in interest rates in February.[20]
- Governor Carney's exceptionally dovish evidence to the Treasury Select Committee last week.[21]

Chart 4 shows how expectations of the first rate hike were pushed out after the Inflation Report and after the Governor's evidence to the Treasury Select Committee. The markets now appear to believe that the first increase will not happen until 2019, though we still take the view an increase could happen before the end of the year (2016).

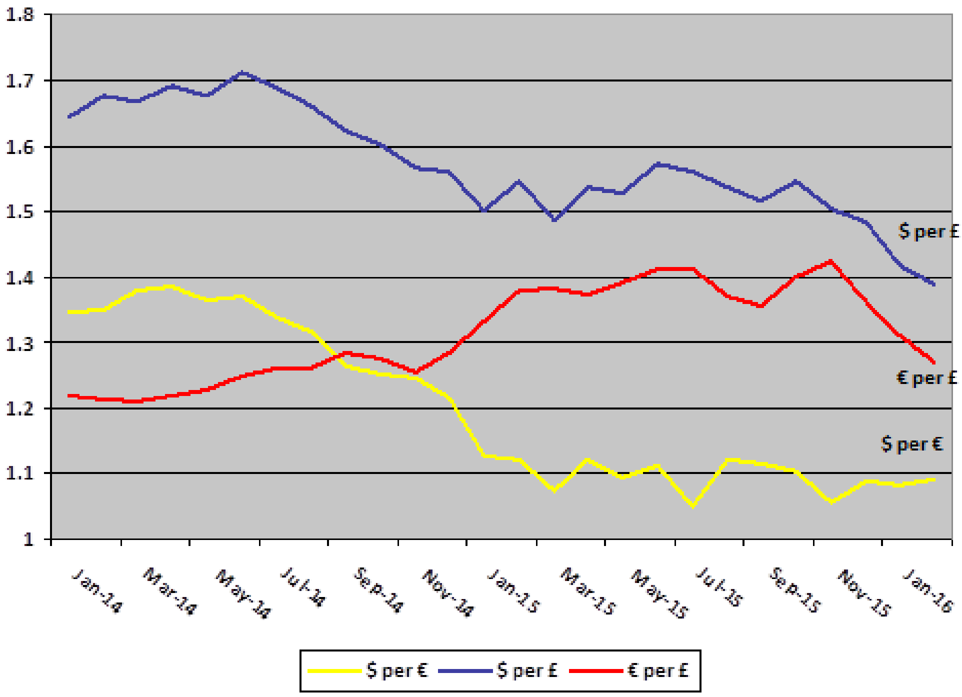
Chart 4 UK instantaneous nominal forward curve (overnight index swap rates (OIS), %), months out to 60 months, at selected dates



Source: Bank of England, webpage on yield curves.

Chart 5 updates the pound's fortunes in recent weeks.[22] We regard the depreciation as benign. It should help exports and, insofar it increases inflation, it should curtail unhelpful talk of "deflation".[23] The upward revision to the US GDP (see below) on 26 February gave another downward push to the pound.

Chart 5 End-month exchange rates, January 2014-January 2016 and 26 February 2016: \$ per £, € per £, \$ per €



Sources: (i) BoE database (spot rates) for end-months to end-January 2016 for \$, € and £, (ii) figures for 26 February 2016 (BBC website, 26 February 2016).

There has been the usual mid-month spate of figures recently, which confirm that the economy is continuing to grow and has, as yet, not been thrown off course by either global turmoil or Brexit. Briefly they include:

- Industrial production decreased by 0.5% (QOQ) in 2015Q4 to be just 0.6% higher than a year earlier. Within the total, manufacturing output was flat (QOQ) to be 1.0% down (YOY).[24]
- January's CPI annual inflation rate was +0.3%, compared December's +0.2%.[25]
- There was another strong employment report.[26] The unemployment rate was 5.1% in 2015Q4, the lowest since the three months to October 2005. Regular annual earnings growth (excluding bonuses) was 2.0% in 2015Q4. After firming in mid-2015, there now appears to be some moderation in earnings increases, though this may reflect compositional changes (with more younger, less experienced workers entering employment).
- Public Sector Net Borrowing showed a surplus of £11.2bn in January 2016 compared with a surplus of £10.2bn in January 2015.[27] In the first ten months of FY2015 the PSNB was £66.5bn compared with £77.0bn in the equivalent period of FY2014. At this stage it looks as though the OBR's forecast for FY2015 could be overshot by £5-6bn. We will return to the public finances in our next Perspective, which will discuss the upcoming Budget (16 March).
- The second estimate for GDP showed an unrevised increase of 0.5% in 2015Q4, to be 1.9% higher than a year earlier, also unrevised. The annual growth for 2015 was 2.2% (also unchanged), compared with the OBR's Autumn Statement forecast of 2.4%.[28]

International bodies: gloom and doom

Both the IMF and the OECD have revised their growth forecasts down since the turn of the year. But they are still expecting world economic growth, albeit not as buoyantly as they would wish. In January the IMF clipped 0.2% off the GDP projection for 2016, to show a 3.4% increase (see annex table 5).[29] More recently the IMF warned that they would be probably downgrade their forecasts further in April and called for leading economies to stimulate their economies.[30] In February the OECD clipped 0.3% off their GDP projection for 2016, amid slowing trade, market turmoil and renewed concerns over China, giving a 3.0% increase for the world economy.[31]

Prior to last week's G20 meeting there was some speculation over a possible coordinated policy response to the slowdown. Suffice to say, the final statement declared agreement to use all policy tools available to lift sluggish global growth. But, given German disquiet over fiscal and monetary stimulus, it is difficult to see what will be achieved.[32] There were no "bold measures".

The Fed and the ECB: updates

Meanwhile the US economy seems to be in reasonably robust health. The February employment report suggested a resilient labour market. The unemployment rate fell to 4.9%, the lowest since February 2008.[33] And GDP growth in 2015Q4 was revised up to 1.0% (annualised) compared with the previous estimate of 0.7%.[34]

Moreover, mindful of the market turmoil, the Fed seems to be having second thoughts about pushing ahead with the rate hikes "pencilled in" for 2016 at last December's Federal Open Markets Committee (FOMC) meeting.[35] The minutes of the FOMC's January meeting, for example, suggested that they were in no hurry to raise rates.[36-37] Low rates for longer will help the US economy.

Turning to the Eurozone, and in the absence of any coordinated fiscal stimulus, there are solid expectations that ECB President Draghi will "do more" at the next ECB policy meeting (10 March), especially as the December package proved to be a disappointment.[38] Markets are expecting the ECB's deposit rate to be cut, probably to -0.40% from -0.30%, and a probable increase in the monthly €60bn QE programme launched last year.[39-40]

Moreover, the minutes of the ECB's January meeting showed that the Governing Council unanimously concluded that its current policy stance "needed to be reviewed and possibly reconsidered" in March, when the ECB's quarterly projections will be available, which was widely interpreted as implying further stimulus.[41] It should be noted, however, that Bundesbank President Jens Weidmann has warned recently about the risks ofexcessive monetary stimulus.[42]

References

1. Ruth Lea, "Britain's external deficit: large and widening", Arbuthnot Banking Group, 21 December 2015.
2. ONS, "UK Balance of Payments, the Pink Book, 2011 edition", 2011 (sic). Direct investment: net investment by UK/foreign companies in their foreign/UK branches, subsidiaries or associated companies. A direct investment in a company means that the investor has a significant influence on the operations of the company, defined as having an equity interest in an enterprise resident in another country of 10% or more of the ordinary shares or voting stock. Portfolio investment: investment in equity and debt securities issued by registered companies, other than that classed as direct investment, and in equity and debt securities issued by governments. A portfolio investment, unlike a direct investment, does not entitle the investor to any significant influence over the operations of the company or institution, and represents less than 10% of the equity capital.
3. OECD database on FDI. The OECD provides flow and stock ("position") data and bilateral data.
4. UN Conference on Trade and Development (UNCTAD), "World Investment Report, 2015".
5. The also ONS provides data on FDI flows relating to the UK.
6. Annex table 2 discusses the distinction between assets/liabilities and the directional approach to inward and outward investment.
7. Eurostat explains that a multinational enterprise (MNE) often diversifies its investments geographically through an SPE. Examples are financing subsidiaries, conduits, holding companies, shell companies, shelf companies and brass-plate companies. See Glossary: Special Purpose Entity (SPE).
8. HM Government, "Outward Investment: Selected Economic Issues", January 2014.
9. It would appear that much of Luxembourg's FDI (excluding SPEs) is with the UK, but the appropriate OECD data are not available.
10. National sources provide comprehensive databases, but definitions, treatments and nomenclatures differ noticeably from one country to another.
11. The change in direct investment positions from one period to the next is equal to the value of financial transactions recorded during the period plus other changes in prices, exchange rates, and volume.
12. Ruth Lea, "Britain's external deficit: large and widening", Arbuthnot Banking Group, 21 December 2015.
13. OECD FDI website.
14. UKTI, "Inward Investment Report 2014 to 2015", June 2015, online viewing. UKTI's website. www.gov.uk/government/organisations/uk-trade-investment.
15. FT fDi Report 2015, fDi (sic) Intelligence, "Global greenfield investment trends".
16. EY, "Attractiveness Survey", May 2015,
17. Bank of England, "The turn of the year - speech by Mark Carney", 19 January 2016.
18. Ruth Lea, "Britain is a major contributor to the EU Budget and the bill is rising", Arbuthnot Banking Group, 1 February 2016, discussed the Governor's speech.
19. Bank of England, "Inflation Report, February 2016", 4 February 2016.
20. Bank of England, "Monetary policy summary and minutes of the MPC meeting ending on 3 February 2016", 4 February 2016. Members voted to keep interest rates at their record low of 0.5% by 9 to 0.
21. Daily Telegraph, "Mark Carney: Bank of England could cut rates - but not below zero", 23 February 2016.
22. Ruth Lea, "Turmoil in the markets: but Britain's economic recovery will not be derailed", Arbuthnot Banking Group, 18 January 2016, discussed the pound.

23. Talk of deflation seems wholly misplaced. And, insofar as the Bank is targeting inflation, it could be argued that this is displaced as well. Inflation targeting proved to be successful while inflation continued to be determined by demand shocks. In recent years, however, inflation has been affected more by externally determined (positive) supply shocks, notably low oil prices. As this is broadly benign for the economy, the attempt to restore the higher inflation through monetary policy is a mistake (arguably). Moreover, the error could be compounded when it entails negative interest rates. Not only have they (negative interest rates) failed to raise inflation, such a monetary policy could be undermining the stability of the banking system and, hence possibly, global financial stability.
24. ONS, "Index of production, January 2016", 10 February 2016.
25. ONS, "Consumer price inflation, January 2016", 16 February 2016.
26. ONS, "UK labour market, February 2016", 17 February 2016.
27. ONS, "Public sector finances, January 2016", 19 February 2016.
28. ONS, "Second estimate of GDP, 2015Q4", 25 February 2016.
29. IMF, "Subdued Demand, Diminished Prospects", January update, January 2016.
30. FT, "IMF urges joint action in push for growth", 25 February 2016.
31. OECD, "February Interim Projection", February 2016.
32. AFP, "G20 nations pledge all tools to lift growth", 27 February 2016.
33. FT, "US unemployment drops to pre-crisis low", 6 February 2016.
34. FT, "US growth revised up as inflation quickens", 27 February 2016, reported that the U economic data remained robust, with a strong jobs market and rising housing prices. The dollar rose on the upward GDP revision.
35. See Ruth Lea, "Britain's external deficit: large and widening", Arbuthnot Banking Group, 21 December 2015, for discussion of the Fed's December meeting.
36. Federal Reserve Board, "Minutes of Federal Open Market Committee meeting (26-27 January 2016)", 17 February 2016.
37. FT, "Fed frets over growing risks to US economy amid market turmoil", 18 February 2016.
38. Ruth Lea, "The Autumn Statement: optimistic forecasts and extra tax measures help to "balance the books"", 7 December 2015, discussed the ECB's 3 December package.
39. FT, "Draghi wins backing for tougher action amid OECD growth alert", 19 February 2016.
40. The QE programme has already been extended to March 2017 (in December 2015). The Deposit Rate is the interest rate paid on the surplus liquidity that credit institutions may deposit overnight in an account with a national central bank that is part of the Eurosystem.
41. ECB, "Account of the monetary policy meeting of the Governing Council of the European Central Bank, 20-21 January 2016", 18 February 2016.
42. Fox 25 News, "ECB board member warns of risks from excessive stimulus", 24 February 2016.

Annex

Table 1 FDI inward & outward stock, by region and economy, 2014 ($bn), selected countries (OECD data)

	Inward stock	Outward stock
World (operating units, excluding SPEs)	32,384.0	24,084.7
OECD:		
Australia	564.6	443.5
Belgium (all resident units)	476.4	460.0
Belgium (operating units, excluding SPEs)	415.7	439.6
Canada	954.5	1,120.5
France	729.1	1,279.1
Germany	530.7	1,415.9
Korea (liabilities-assets)	182.0	258.6
Japan	169.4	1,169.1
Ireland	378.2	634.8
Italy	339.9	485.3
Luxembourg (all resident units)	2,345.9	2,980.0
Luxembourg (operating units, excluding SPEs)	180.4	130.2
Netherlands (all resident units)	4,013.6	4,833.8
Netherlands (operating units, excluding SPEs)	681.8	1,032.4
Spain (all resident units)	537.8	516.5
Spain (operating units, excluding SPEs)	541.5	492.7
Sweden (all resident units)	311.8	374.5
Sweden (operating units, excluding SPEs)	3534.4	349.8
Switzerland	764.1	1,067.9
UK	1,744.2	1,513.2
USA	5,390.1	6,285.3
EU (operating units, excluding SPEs)	7,544.1	8,577.1
Non-OECD:		
Brazil (liabilities/assets)	755.4	303.0
China	1,085.3	729.6
India (liabilities/assets)	252.1	129.8
Mexico	339.2	134.1
Russia	272.2	307.2

Source: OECD, FDI database, using the directional principle (except where marked "liabilities/assets") for all resident units (except were marked "operating units, excluding SPEs"). All resident units = Resident operating units (non-SPEs) & Resident SPEs. Special purpose entities (SPEs) are: (1) generally organised or established in economies other than those in which the parent companies are resident; and (2) engaged primarily in international transactions but in few or no local operations.

Table 2 Asset/liability versus directional presentation (OECD)

Item	Components
Assets/liabilities:	
Country's direct investment assets	• Resident parents' equity in & lending to foreign affiliates **plus** • Resident affiliates' equity in & lending to foreign parents
Country's direct investment liabilities	• Foreign parents' equity in & lending to resident affiliates **plus** • Foreign affiliates' equity in & lending to resident parents
Directional presentation:	
Country's outward investment	• Resident parents' equity in & lending to foreign affiliates (=assets minus resident affiliates' equity in & lending to foreign parents) **minus** • Foreign affiliates' equity in & lending to resident parents
Country's inward investment	• Foreign parents' equity in & lending to resident affiliates (=liabilities minus foreign affiliates' equity in & lending to resident parents) **minus** • Resident affiliates' equity in & lending to foreign parents

Source: OECD, "Asset/liability versus directional presentation", December 2014.

Table 3a UK FDI inward & outward stock, key partners, end-2014 ($bn)

	Inward stock	Outward stock
World (all resident units)	1,743.9	1,512.4
World (operating units, excluding SPEs)	1,433.8	1,244.5
France	127.5	57.5
Germany	98.5	25.0
Japan	70.7	6.1
Ireland	37.6	54.4
Luxembourg (all resident units)	130.6	163.2
Luxembourg (operating units, excluding SPEs)	106.6	123.2
Netherlands (all resident units)	286.1	183.6
Netherlands (operating units, excluding SPEs)	159.9	95.3
Spain	75.6	21.8
Switzerland	77.8	22.3
USA (all resident units)	405.1	395.9
USA (operating units, excluding SPEs)	318.7	320.3

Source: OECD, FDI database, using the directional principle, the bilateral data are slightly different from the aggregate data. It would appear that much of Luxembourg's FDI (excluding SPEs) is with the UK, but this is impossible to cross-check as the OECD data are not available.

Table 3b US FDI inward & outward stock, key partners, end-2014 ($bn)

	Inward stock	Outward stock
UK	448.5	587.9
Japan	372.8	108.1
Netherlands	304.8	753.2
Canada	261.2	386.1
Luxembourg (all resident units)	242.9	465.2
Germany	224.1	115.5
Switzerland	224.0	152.9
France	223.2	76.8

Source: OECD, FDI database, using the directional principle, all resident units. The database omitted any data on SPEs.

Table 4 Bank of England's Forecast summary: February 2016 and November 2015 (in brackets)

	2015	2016	2017	2018
GDP growth rate (%)	2.5 (2.7)	2.2 (2.5)	2.4 (2.7)	2.5 (2.6)
	2016Q1	2017Q1	2018Q1	2019Q1
CPI inflation rate (%)	0.4 (0.7)	1.2 (1.5)	2.1 (2.1)	2.2 (na)
Unemployment rate (LFS, %)	5.0 (5.3)	4.8 (5.2)	4.7 (4.9)	4.7 (na)
Bank Rate	0.5 (0.5)	0.5 (0.7)	0.8 (1.1)	1.1 (na)

Source: Bank of England, Inflation Report, February 2016, modal projections for GDP, CPI inflation & LFS unemployment. +=The conditioning path for Bank Rate implied by forward market interest rates (the curve is based on overnight index swap rates).

Table 5 Downgraded IMF GDP growth forecasts: January update

	2015	2016		2017	
		Jan 2016	Difference from Oct 2015	Jan 2016	Difference from Oct 2015
World	3.1	3.4	-0.2	3.6	-0.2
US	2.5	2.6	-0.2	2.6	-0.2
Euro area:	1.5	1.7	0.1	1.7	0
Germany	1.5	1.7	0.1	1.7	0.2
France	1.1	1.3	-0.2	1.5	-0.1
Japan	0.6	1.0	0	0.3	-0.1
UK	2.2	2.2	0	2.2	0
China	6.9	6.3	0	6.0	0
World trade (volume)	2.6	3.4	-0.7	4.1	-0.5

IMF, "Subdued Demand, Diminished Prospects", January update, January 2016.

Table 6 Downgraded OECD GDP growth forecasts: February interim forecast

	2015	2016		2017	
		Feb 2016	Difference from Nov 2015	Feb 2016	Difference from Nov 2015
World	3.0	3.0	-0.3	3.3	-0.3
US	2.4	2.0	-0.5	2.2	-0.2
Euro area:	1.5	1.4	-0.4	1.7	-0.2
Germany	1.4	1.3	-0.5	1.7	-0.3
France	1.1	1.2	-0.1	1.5	-0.1
Japan	0.4	0.8	-0.2	0.6	+0.1
UK	2.2	2.1	-0.3	2.0	-0.3
China	6.9	6.5	0	6.2	0

Source: OECD, February Interim Projection, February 2016, compared with November 2015 “Economic Outlook”.