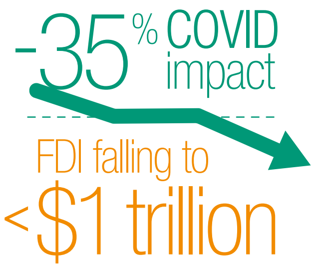
KEY MESSAGES

INVESTMENT TRENDS AND PROSPECTS



The COVID-19 crisis caused a dramatic fall in foreign direct investment (FDI) in 2020. Global FDI flows dropped by 35 per cent to $1 trillion, from $1.5 trillion in 2019. This is almost 20 per cent below the 2009 trough after the global financial crisis.

The decline was heavily skewed towards developed economies, where FDI fell by 58 per cent, in part due to oscillations caused by corporate transactions and intrafirm financial flows. FDI in developing economies decreased by a more moderate 8 per cent, mainly because of resilient flows in Asia. As a result, developing economies accounted for two thirds of global FDI, up from just under half in 2019.

FDI patterns contrasted sharply with those in new project activity, where developing countries are bearing the brunt of the investment downturn. In developing countries, the number of newly announced greenfield projects fell by 42 per cent and the number of international project finance deals – important for infrastructure – by 14 per cent. This compares to a 19 per cent decline in greenfield investment and an 8 per cent increase in international project finance in developed economies.

All components of FDI were down. The overall contraction in new project activity, combined with a slowdown in cross-border mergers and acquisitions (M&As), led to a decline in equity investment flows by more than 50 per cent. With profits of multinational enterprises (MNEs) down 36 per cent on average, reinvested earnings of foreign affiliates – an important part of FDI in normal years – were also down.

The impact of the pandemic on global FDI was concentrated in the first half of 2020. In the second half, cross-border M&As and international project finance deals largely recovered. But greenfield investment – more important for developing countries – continued its negative trend throughout 2020 and into the first quarter of 2021.

FDI trends varied significantly by region. Developing regions and transition economies were relatively more affected by the impact of the pandemic on investment in GVC-intensive and resource-based activities. Asymmetries in fiscal space for the roll-out of economic support measures also drove regional differences.

- Among developed countries, FDI flows to *Europe* fell by 80 per cent. The fall was magnified by large swings in conduit flows, but most large economies in the region saw sizeable declines. Flows to *North America* fell by 42 per cent; those to other developed economies by about 20 per cent on average. In the United States the decline was mostly caused by a fall in reinvested earnings.
- FDI flows to *Africa* fell by 16 per cent to $40 billion – a level last seen 15 years ago. Greenfield project announcements, key to industrialization prospects in the region, fell by 62 per cent. Commodity exporting economies were the worst affected.
- Flows to *developing Asia* were resilient. Inflows in China actually increased, by 6 per cent, to $149 billion. South-East Asia saw a 25 per cent decline, with its reliance on GVC-intensive FDI an important factor. FDI flows to India increased, driven in part by M&A activity.

- FDI in *Latin America and the Caribbean* plummeted, falling by 45 per cent to $88 billion. Many economies on the continent, among the worst affected by the pandemic, are dependent on investment in natural resources and tourism, both of which collapsed.
- FDI flows to *economies in transition* fell by 58 per cent to just $24 billion, the steepest decline of all regions outside Europe. Greenfield project announcements fell at the same rate. The fall was less severe in South-East Europe, at 14 per cent, than in the Commonwealth of Independent States (CIS), where a significant part of investment is linked to extractive industries.

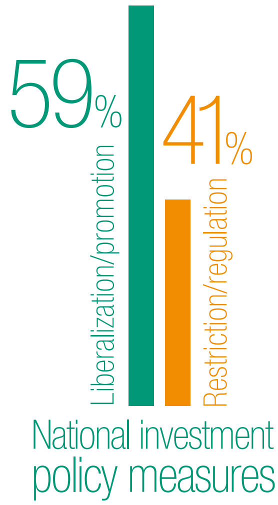
FDI in structurally weak and vulnerable economies was further weakened by the pandemic. Although inflows in the least developed countries (LDCs) remained stable, greenfield announcements fell by half and international project finance deals by one third. FDI flows to small island developing States (SIDS) fell by 40 per cent, and those to landlocked developing countries (LLDCs) by 31 per cent.

COVID-19 has caused a collapse in investment flows to sectors relevant for the SDGs in developing countries. All but one SDG investment sector registered a double-digit decline from pre-pandemic levels. The shock exacerbated declines in sectors that were already weak before the COVID-19 crisis – such as power, food and agriculture, and health.

Large MNEs, key actors in global FDI, are weathering the storm. Despite the 2020 fall in earnings the top 100 MNEs significantly increased their cash holdings, attesting to the resilience of the largest companies. The number of State-owned MNEs, at about 1,600 worldwide, increased by 7 per cent in 2020; several new entrants resulted from new State equity participations as part of rescue programmes.

Looking ahead, global FDI flows are expected to bottom out in 2021 and recover some lost ground, with an increase of about 10 to 15 per cent. This would still leave FDI some 25 per cent below the 2019 level. Current forecasts show a further increase in 2022 which, at the upper bound of projections, would bring FDI back to the 2019 level. Prospects are highly uncertain and will depend on, among other factors, the pace of economic recovery and the possibility of pandemic relapses, the potential impact on FDI of recovery spending packages, and policy pressures.

INVESTMENT POLICY DEVELOPMENTS



The number of investment policy measures of a regulatory or restrictive nature more than doubled in 2020. UNCTAD's monitoring of national investment policy measures counted 50, against 21 in 2019. The increased use of screening mechanisms driven by national security concerns over FDI in sensitive industries was a key factor. Most measures that liberalized, promoted or facilitated investment were adopted in developing economies; the total number of these measures remained stable. As a result, the share of more restrictive policy measures reached 41 per cent, the highest on record.

The international investment agreements (IIA) regime is going through a process of rationalization. The entry into force of the EU agreement to terminate all intra-EU bilateral investment treaties (BITs) and the emergence of new megaregional IIAs are adding to the consolidation of bilateral investment policymaking and accelerating regional rulemaking.

+21
in 2020
Total IIAs
3 360

The number of ISDS cases surpassed 1,100. Most of the 68 publicly known ISDS cases initiated in 2020 were brought under IIAs signed before the turn of the century. In 2020, ISDS tribunals rendered at least 52 substantive decisions in investor–State disputes. Discussions on the reform of the investor–State dispute settlement (ISDS) system continued at the multilateral level.

All newly signed IIAs now include reform-oriented clauses. IIAs concluded in 2020 all contain features in line with UNCTAD's Reform Package for the International Investment Regime, with the preservation of States' regulatory space being the most frequent area of reform. In 2020, UNCTAD launched its IIA Reform Accelerator to support the reform process.

Investing in the health sector

Most countries actively encourage domestic as well as foreign investment in the health sector, according to an UNCTAD survey. The range of policy tools deployed varies by region and level of development and includes incentives, investment promotion and facilitation, and dedicated special economic zones. While the pandemic has led some countries to increase oversight of health-sector investment, it has also led many governments to double down on efforts to encourage investment in the industry. Internationally, these efforts are complemented by market access and national treatment commitments for health services in the GATS and in some free trade agreements, and by treaty regimes for the protection of investment and intellectual property rights. However, low- and lower-middle-income countries (LLIMCs) face specific challenges that limit their capacity to attract investment in the health sector. Therefore, UNCTAD proposes an Action Plan for the promotion of investment to build productive capacity in key segments of the health-care industry, in support of SDG 3.

INVESTING IN SUSTAINABLE RECOVERY

The recovery of international investment has started, but it could take some time to gather speed. Early indicators on greenfield investment and international project finance – and the experience from past FDI downturns – suggest that even if firms and financiers are now gearing up for "catch-up" capital expenditures, they will still be cautious with new overseas investments in productive assets and infrastructure.

Resilience framework

The focus of both policymakers and firms is now on building back better. Resilience and sustainability will shape the investment priorities of firms and governments. For firms, the push for supply chain resilience could lead to pressures in some industries to reconfigure international production networks through reshoring, regionalization or diversification. For governments, recovery stimulus and investment plans focusing on infrastructure and the energy transition imply significant project finance outlays. The implications for international investment flows of both sets of priorities are significant.

Supply chain resilience

MNEs have three sets of options to improve supply chain resilience. They include (i) network restructuring, which involves production location decisions and, consequently, investment and divestment decisions; (ii) supply chain management solutions (planning and forecasting, buffers, and flexibility); and (iii) sustainability measures that have the additional benefit of mitigating certain risks. Because of the cost of network restructuring, MNEs will first exhaust other supply chain risk mitigation options.

In the short term, the impact of the resilience push on international investment patterns will be limited. In the absence of policy measures that either force or incentivize the relocation of productive assets, MNEs are unlikely to embark on a broad-based restructuring of their international production networks. Resilience is not expected to lead to a rush to reshore but to a gradual process of diversification and regionalization as it becomes part of MNE location decisions for new investments.

However, in some industries the process may be more abrupt. Policy pressures and concrete measures to push towards production relocation are already materializing in strategic and sensitive sectors. Recovery investment plans could provide further impetus: most investment packages, in both developed and developing countries, include domestic or regional industrial development objectives.

Recovery investment priorities

Recovery investment plans in most countries focus on infrastructure sectors – including physical, digital and green infrastructure. These are sound investment priorities that (i) are aligned with SDG investment needs; (ii) concern sectors in which public investment plays a bigger role, making it easier for governments to act; and (iii) have a high economic multiplier effect, important for demand-side stimulus.

A broader perspective on priorities for promoting investment in sustainable recovery includes not only infrastructure but also industries that are key to growth in productive capacity. Investment in industry, both manufacturing and services, was hit much harder by the pandemic than investment in infrastructure. A slow recovery of investment in industrial sectors – in which FDI often plays a more important role – will put a brake on productive capacity growth. For developing countries in particular, initiatives to promote and facilitate new investment in industry, especially in sectors that drive private sector development and structural change, will be important to complement recovery investment in infrastructure.

Recovery investment challenges

Recovery investment packages are likely to affect global investment patterns in the coming years owing to their sheer size. The cumulative value of recovery funds intended for long-term investment worldwide is already approaching $3.5 trillion, and sizeable initiatives are still in the pipeline. Considering the potential to use these funds to draw in additional private funds, the total "investment firepower" of recovery plans could exceed $10 trillion. For comparison, that is close to one third of the total SDG investment gap as estimated at the time of their adoption.

The bulk of recovery finance has been set aside by and for developed economies and a few large emerging markets. Developing countries account for only about 10 per cent of total recovery spending plans to date. However, the magnitude of plans is such that there are likely to be spillover effects – positive and negative – to most economies. And international project finance, one of the principal mechanisms through which public funds will aim to generate additional private financing, will channel the effects of domestic public spending packages to international investment flows.

Investment in developing countries

10% of total recovery push

The use of international project finance as an instrument for the deployment of recovery funds can help maximize the investment potential of public efforts, but also raises new challenges. Addressing the challenges and maximizing the impact of investment packages on sustainable and inclusive recovery will require several efforts:

- Swift intervention to safeguard existing projects that have run into difficulty during the crisis, in order to avoid cost overruns and negative effects on investor risk perceptions.
- Increased support for and lending to high-impact projects in developing countries, as the deployment of recovery funds in developed economies will draw international project finance to lower-risk and lower-impact projects.
- Efforts by bilateral and multilateral lenders and guarantee agencies to counter upward pressure on project financing costs in lower-income developing countries.
- Vastly improved implementation and absorptive capacity, because recovery investment plans imply an increase in global infrastructure spending of, at a minimum, three times the biggest annual increment of the last decade, for several years running.
- Strong governance mechanisms and contracts that anticipate risks to social and environmental standards on aggressively priced projects.

A policy framework for investment in sustainable recovery

Promoting investment in resilience, balancing stimulus between infrastructure and industry, and addressing the implementation challenges of recovery plans requires a coherent policy approach. At the strategic level, development plans or industrial policies should guide the extent to which firms in different industries should be induced to rebalance international production networks for greater supply chain resilience (from a firm perspective) and greater economic and social resilience (from a country perspective). They should also drive the promotion and facilitation of investment in industry, needed for complementarity with infrastructure spending.

For developing countries, industrial development strategies should generate a viable pipeline of bankable projects. The lack of shovel-ready projects in many countries remains a key barrier to attracting more international project finance. The risk now is that, in the absence of projects that have gone through the phases of design, feasibility assessment and regulatory preparation, the roll-out of recovery investment funds will incur long delays.

At the level of execution, addressing recovery investment challenges can draw on initiatives included in UNCTAD's Action Plan for Investment in the SDGs, which includes actions aimed at funds mobilization, channeling and impact management.

UNCTAD believes that the drive on the part of all governments worldwide to build back better, and the substantial recovery programmes that are being adopted by many, can boost investment in sustainable growth. *The goal should be to ensure that recovery is sustainable, and that its benefits extend to all countries and all people.*

CAPITAL MARKETS AND SUSTAINABILITY

UNCTAD estimates that the value of sustainability-themed investment products in global capital markets amounted to $3.2 trillion in 2020, up more than 80 per cent from 2019. These products include sustainable funds (over $1.7 trillion), green bonds (over $1 trillion), social bonds ($212 billion) and mixed-sustainability bonds ($218 billion). Most are domiciled in developed countries and targeted at assets in developed markets.

Sustainability-themed funds continued their growth despite volatile markets in 2020. Their number increased to almost 4,000 by June 2020, up 30 per cent from 2019, with assets under management now representing 3.3 per cent of all open-ended fund assets worldwide.

Social bonds boomed in 2020. Social and mixed-sustainability bond issuance grew more than five-fold. COVID-19 response bonds led by supranational entities such as the African Development Bank and the European Union gave a significant boost to the social and sustainability bond markets and demonstrated proof of concept for tackling other public crises and financing the SDGs.

There are persistent concerns about greenwashing and about the real impact of sustainability-themed investment products. The fund market needs to enhance credibility by improving transparency. Funds should report not only on ESG issues but also on climate impact and SDG alignment. Importantly, to maximize impact on sustainable development more funds should invest in developing and transition economies. Nevertheless, the rapid growth of the sustainable investment market confirms its potential contribution to filling the SDG financing gap.

Institutional investors and financial service providers

Institutional investors are in a strong position to affect change on sustainability. They can do so primarily through two routes: (i) asset allocation – where they choose to invest the capital at their disposal, which can have a determinative impact on companies and markets; and (ii) active ownership – how they influence the policies of the companies they invest in through corporate governance mechanisms.

The potential influence on corporate sustainability of pension funds and sovereign wealth funds (SWFs) is enormous. They manage assets of $52 trillion and $9.2 trillion, respectively. More than 40 per cent of their assets are invested in publicly listed equities, making them “universal owners” with large shareholdings in companies across a wide range of sectors and markets.

However, public pension funds and SWFs could do more to promote sustainability. Only 16 of the 50 largest public pension funds and 4 of the 30 largest SWFs in the world published a sustainable investment report in 2019. More fundamentally, public pension fund portfolios largely bypass developing-country markets, limiting their contribution to sustainable development.

Insurance companies can contribute to sustainable development through their role as risk solution providers, as well as through their role as investors (with assets under management of more than $30 trillion in 2018). Climate change is a systemic risk for the world. Total economic losses from disasters globally were an estimated $202 billion in 2020, up from $150 billion in 2019, with about $190 billion resulting from natural catastrophes.

The banking sector can foster sustainable development through corporate lending. The volume of sustainable financial products has grown in recent years – the sustainable loan market was valued at about $200 billion in 2020 – driven by increased demand and by campaigns to promote financial sector sustainability efforts.

Stock exchanges and derivatives exchanges

Stock exchanges and derivatives exchanges affect sustainability in their markets through their influence on corporate ESG behaviour and through the promotion of sustainable finance products. Derivatives exchanges can contribute through sustainability-aligned derivates products, ESG data products and enhanced transparency. Stock exchanges contribute through a wider set of mechanisms. The number of stock exchanges with written guidance for issuers on ESG disclosure (SDG 12.6) has grown rapidly, from 13 in 2015 to 56 at the end of 2020. The number of exchanges that provide training on ESG topics to issuers and investors also continues to rise, with over half offering at least one training course.

Mandatory ESG reporting is on the rise, supported by both exchanges and security market regulators. The number of exchanges covered by mandatory rules on ESG disclosure more than doubled in the past five years, to 25 today. The number of stock exchanges with dedicated sustainability bond segments (including green bond segments, SDG 13) increased by 14 between 2019 and 2020, taking the total to 38.

The future of sustainable finance

Global $ustainable Finance Observatory

In the coming years, the sustainable investment market needs to transition from a niche to a mass market that fully integrates sustainability in business models and culture, leading up to 2030 and beyond. To do so, the market needs to tackle concerns of greenwashing and SDG-washing, and address its geographical imbalance. Much work has been done over the past decade by asset owners, financial institutions, exchanges, regulators and policymakers. Better coordination and effective monitoring of their activities can help accelerate the transition.

To this end, UNCTAD, together with partners, will launch the UN Global Sustainable Finance Observatory. The Observatory will address the challenges of fragmentation in standards, proliferation in benchmarking, complexity in disclosure, and self-declaration of sustainability. It will integrate the relevant instruments and outputs on its virtual platform to facilitate the assessment, transparency and integrity of sustainable finance products and services. The Observatory will work in tandem with the standards-setting processes of the financial industry and regulatory bodies to promote the full and effective integration of sustainable development (as defined by the SDGs) into all aspects of the global financial ecosystem.

The UN Global Sustainable Finance Observatory will be launched officially in October 2021 at UNCTAD's World Investment Forum, which brings together the global investment-for-development community, including all capital market stakeholders along the global investment chain.