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MACRO MORNING BRIEFING

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New Policy Regimes To Accentuate FDI Trends

BoJ and Fed adjustments material for FDI flows

- Lower US rates will affect returned earnings supporting US FDI
- Industrial policy not affecting global manufacturing FDI, for now
- European FDI flows to China and US continue to alternate

Monetary and industrial policy changes will redirect FDI flows

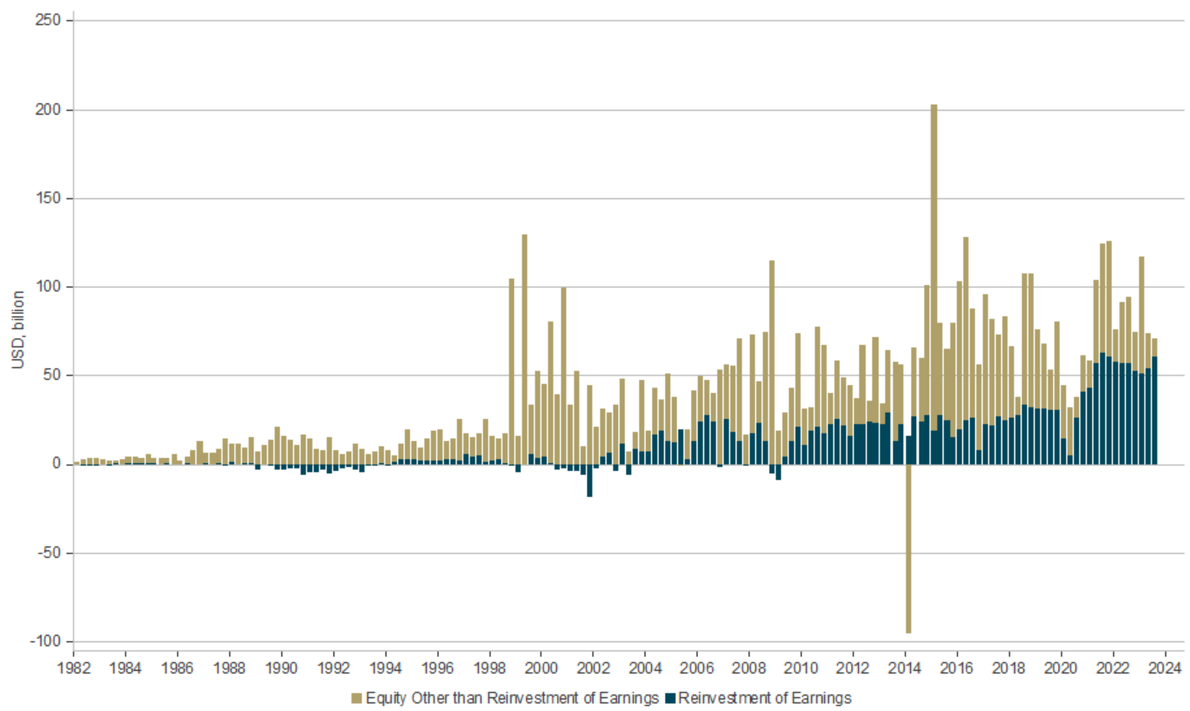
It should come as no surprise that a day after the Bank of Japan abandoned yield-curve control and negative-interest-rate policy, peer central banks in Asia were asked about changes in capital flows. During its own press conference, Bank Indonesia said it did not expect the BoJ decision to have a “big effect on capital flows and the IDR”. This is likely true, for now. If anything, the BoJ decision could prove inhibitive, as central banks in the region attempt to avoid nominal effective exchange rate strength due to JPY weakness. However, now that Japan has crossed the policy Rubicon, markets will be assessing whether its large, positive overseas net asset position will start to head home or to where yields will rise and currency valuations are more attractive – namely, APAC and places like Indonesia.

While Bank Indonesia may have been referencing “capital flows” in a financial markets context, we believe foreign direct investment flows (FDI) are on the cusp of a period of profound change. Assuming USDJPY declines and rate differentials between Japan and the rest of the world narrow, the drop in reinvestment of overseas earnings in Japanese FDI assets will likely be a significant driver of changes in FDI. However, keeping everything onshore is not possible, either (for any economy). De-globalisation, the ever-rising geopolitical impact on financial flows and the race for supply-chain resilience in high value-added goods will be as important as valuations. As such, this would be a good time for Japan, and perhaps all major counterparties in global FDI flows, to revisit exposures.

The global focus at present is clearly on the US and technology. The race for advanced microchips and leadership in artificial intelligence will be a defining economic trend for the rest of the decade. While concentration risks in the likes of fabrication and lithography are acute, we don't think this will stop diversification risks. Most eyes are on the US for now given its leadership in the most advanced technology, software and microchip design industries. US FDI inflows have strengthened (exhibit #1) since the pandemic, but we would remain cautious on how much these flows have actually strengthened the dollar through the financial account excluding investment in portfolio assets: foreign buying of US-listed equities may help ease financial conditions in the US, but that doesn’t directly translate into new workers and factories on the ground. Even the repatriation generated by previous changes in tax regimes was disproportionately reflected in dividends and buybacks.

Reinvestment of earnings remains the dominant component in credit items, and there's been a decline in non-equity FDI in the last two quarters. We think foreign companies are likely using their retained US earnings to invest in new people, equipment and capital expenditure, but the structural shift in reinvestment levels vs. previous decades suggests that high US interest rates have played a role. As such, the true test for US FDI is whether such flows can continue while US rates fall, and key investors in the US also see changes in rate differentials – something Japanese corporates will need to start re-assessing closely. Other ‘differentials’, e.g., subsidies, regulation and geopolitics, will play roles, too.

Exhibit #1: US FDI Changes

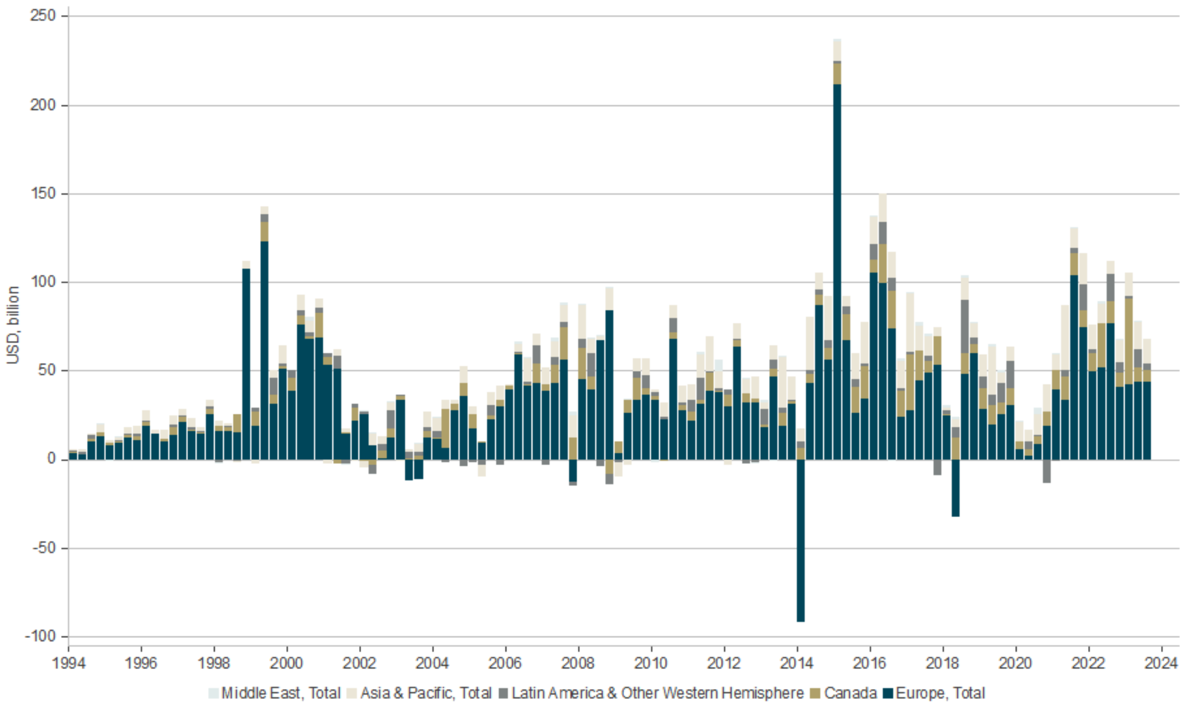


Source: Macrobond, BNY Mellon

Europe historically has been the primary source of FDI for the US (exhibit #2). While the continent is a major source of savings, largely thanks to Germany’s current account surplus, we would not discount the presence of funds domiciled in major money centres such as the United Kingdom, Ireland and the Benelux countries. As a result, European flow into the US would have broader global representation in terms of beneficial owners. Canada is also a major source of flow. We are somewhat surprised, however, that total APAC flow – despite the growth in surpluses over the past two decades – remains relatively low. This contrasts strongly with the level of securities holdings of these economies, suggesting that the preference within this region is more through the portfolio account rather than FDI.

As the US continues to provide subsidies in favour of re-/near-shoring as part of its industrial policy, APAC economies ex-China could become a major source of FDI. There are already signs of this in the automotive and semiconductor industries. However, we stress that this may not generate as strong an FX impact because it would be an asset rotation away from existing portfolio and into direct investments. Given current price trends and financing trajectories, the risk of further reallocation away from Treasuries needs to be considered. For foreign investors, total returns from FDI could look much more favourable in comparison. Treasuries could also face pressures from more supply and long-term USD valuations.

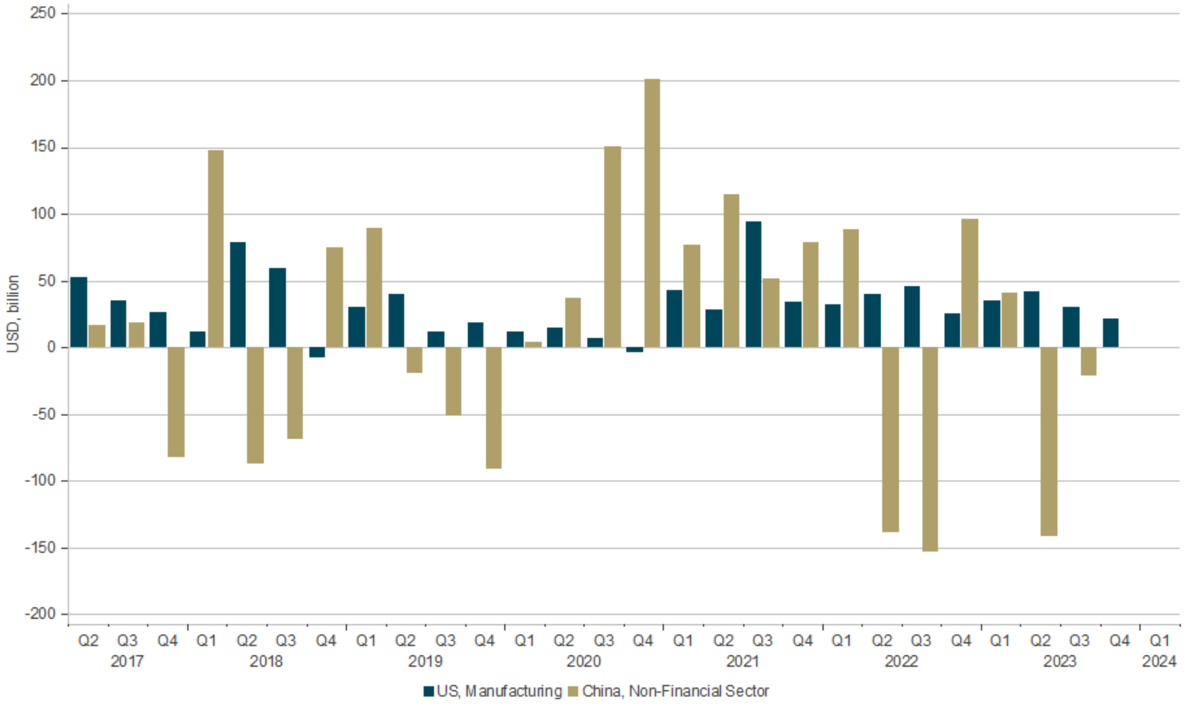
Exhibit #2: Source Composition Of US FDI



Source: Macrobond, BNY Mellon; PCL = Prime Central London

As for industry preferences, we see no clear sign of a new manufacturing boom anywhere. Significant flows into US and China manufacturing were seen in 2021, but this was probably more associated with pandemic-related production rather than the new technologies currently sought. The US Inflation Reduction Act (IRA) was only passed in 2022, but there has not been any noticeable pick up in FDI into US manufacturing, a sector that faced headwinds and, per ISM, has been in contraction since Q4 2022. China, meanwhile, has faced significant outflows in FDI in recent quarters. While much of the reporting around this has focused on geopolitics and weak growth, we would not discount the impact of interest-rate differentials. After all, China is the largest global economy still cutting interest rates.

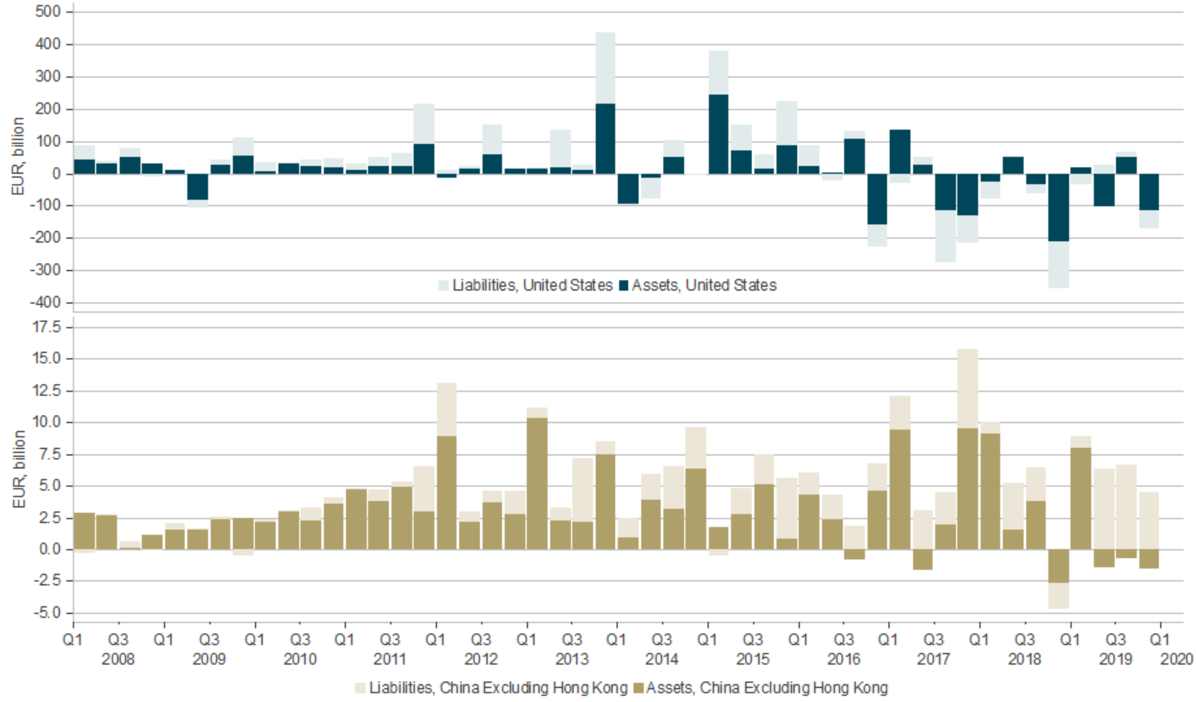
Exhibit #3: FDI Into China & US Manufacturing



Source: Macrobond, BNY Mellon

Eurozone FDI trends with key partners point to some material changes towards the end of the last decade (exhibit #4). After steady accumulation of assets in the US, flows receded between 2017 and 2020, which likely reflected difficulties in the EU-US trade relationship at the time. Brexit also likely had an impact due to reasons highlighted above, with the EU losing a major funding centre for beneficial owners. There was also a reduction in liabilities, indicating less US investment in Europe during the same period. Asset acquisition in China became more volatile from 2016 onwards, but 2019 and 2020 were characterised by major increases in liabilities from China, indicating strong levels of Chinese investment into Europe – even as European companies were leaving China. At the time, Sino-European trade relationships were warming and EU countries were keen to sign up to FDI-based initiatives such as the Belt and Road Initiative (BRI). Cooperation culminated in the Comprehensive Agreement on Investment concluded at the end of 2020, but implementation has stalled and in 2024, talk of a trade conflict focused on Chinese Battery Electric Vehicles (BEVs) is moving up the agenda. Even so, investment intentions by Chinese firms in the EU manufacturing industry remain strong, but whether this can be realised is a different story.

Exhibit #4: European Union FDI balance, China And US



Source: Macrobond, BNY Mellon

Although often flying under the radar, FDI remains a key component for corporate financial conditions for any economy. These flows are long-term in nature and focused on favourable regulation, industrial policy and productivity. But they are also exposed to short-term changes such as monetary policy and currency valuations. As new monetary regimes arise, capital flows – both portfolio and direct investment – will adjust accordingly. In the current geopolitical environment, these flows will likely attract greater prominence. Markets should take note of the policy (monetary and industrial) triggers which will create and turn the tides.

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNYMellon.com

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

bnymellon.com