European Commission

Executive summary

Analysis of developments in EU capital flows in the global context (2023)

Geo-economics and the risk of fragmentation

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Executive summary

Since early 2022, with the start of the war in Ukraine, geo-economics and the risks of economic fragmentation have come to the centre of the debate. A fast-evolving scenario has unveiled the extent of global interdependence and intricate interconnections through trade linkages, value-chain exposure and cross-border investment. Risks associated with supply-chain disruptions and the weaponisation of trade dependencies could lead to a reconfiguration of capital flows, and in particular foreign direct investment (FDI).

The potential relocation of FDI in geopolitically aligned countries or a structural decline in inward FDI, due to the reshoring of production activities, can have major implications for growth. At the global level, the EU is one of the most important sources and destinations of cross-border investments, which have contributed to the EU's role as a global actor and its prosperity. For this reason, changes in FDI flows are attracting the attention of policymakers in the EU. Similar concerns are also shared by some emerging markets and developing economies, which are susceptible to the relocation of FDI.

Furthermore, in 2022, inflation reached 40-year highs in several advanced economies, driven by a combination of a rapid post-Covid recovery and a dramatic increase in energy prices. High inflation prompted central banks to tighten their policy stance. The policy shift marked a considerable and rather abrupt change in macroeconomic conditions, following a decade of (ultra-) low-interest rates. While headline inflation has eased in the majority of advanced economies, the inflationary pressure of core items is easing more slowly. As a result, inflation is expected to take longer to return to target.

While central banks are expected to maintain their stance or even ease it, the repercussions of the tightening measures are beginning to manifest in the economy. Notably, financing conditions have tightened resulting in more stringent credit standards and diminished demand for credit. Risk premia on euro area government and corporate bonds have experienced some increase, but without notable disruptions in financial.

Overall, the confluence of geopolitical uncertainty and a less benevolent macroeconomic context, characterised by high inflation and higher interest rates, has exerted downward pressure on growth. This combination has had an adverse impact on capital flows and financial integration.

Against this backdrop, this report presents an analysis of the main trends and developments in global and EU capital movements up to mid-2023.

Capital flows: Recent global and EU developments

As already noted in Alcidi et al. (2023), unlike the global financial crisis, the Covid-19 pandemic did not result in a sweeping reversal of pre-existing trends in capital flows. Rather, it marked a continuation or even an amplification of some of them. By contrast, the war in Ukraine and the ensuing energy crisis seem to be associated with new developments in capital flows.

At the global level, a declining trend in gross FDI flows started in 2016 and reached its lowest level in 2018. Since then, global FDI flows have normalised at a lower level, whereas the euro area experienced two occasional disinvestment waves in 2018 and 2022. Data for portfolio investment exhibit a shift in 2022, compared with previous trends, with an increase in China's position as a net investor and a substantial decline in euro area net flows, driven by negative gross outflows and inflows. From a global perspective, the data for the first half of 2023 seem to suggest that 2022 was an exception and both gross portfolio inflows and outflows have returned positive in most regions. The US appears to be maintaining its historically dominant position with large portfolio inflows, but much lower outflows.

Focusing on EU flows, the analysis of developments of intra- and extra-EU gross capital flows suggests that 2022 marked notable changes. Since early 2022, both intra- and extra-EU assets and liabilities have declined dramatically and the same development persists in the first half of 2023.

For intra-EU flows, the decline started around mid-2022 and became more marked in the first two quarters of 2023. FDI fell to nearly zero in the 2023Q2. Portfolio investment, which had been growing gradually over the previous five years, fell to about a third of its value in the second half of 2022 compared with the same period a year earlier. Other investment declined drastically since late 2022. The 2023Q2 value was just above a third of the peak value reached around mid-2022.

However, the extra-EU component has exhibited the largest change. Since mid-2022, all EU investment abroad has turned into disinvestment (net sales of non-EU instruments, de facto pointing to a retrenchment). Extra-EU gross portfolio investment by EU residents, which had driven the recovery post-2018, turned negative during 2022 and the first half of 2023. Although on a much smaller scale, FDI and other investment followed the same pattern. This development is quite exceptional, as disinvestment over several quarters is uncommon for the EU.

Although gross financial flows do not match the dynamics of the current account, it is worth noting that in 2022 there was a striking change in the current account balance of the euro area. After exhibiting the world's largest surpluses for more than a decade, the euro area's current account fell to zero and then turned negative in 2022. High energy prices strongly impacted the value of imports (despite falling volumes) and offset exports. However, data for 2023 point to a return to a surplus.

Supply-chain disruption and geopolitical fragmentation

Rising trade tensions between the US and China and ongoing policy changes in both countries to favour the domestic economy have led to a reconsideration of the structure of global supply chains, resulting in the relocation of some production. Such changes have the potential to alter the FDI landscape.

Anecdotal evidence points to cases of reshoring and redirection of manufacturing activities and investment from China and Europe to the US, supported mainly through US government policies, such as the Inflation Reduction Act. Preliminary evidence also suggests deteriorating US-China trade and investment links concentrated in strategic sectors (e.g. advanced semiconductors). Furthermore, data suggest that the increasing redirection of US trade away from China towards countries like Vietnam, Taiwan and Canada is being accompanied by mounting investment and trade links of these economies with China. In practice, it may be that direct linkages are being replaced by more complex and indirect linkages between the US and China through the supply chains of their trade partners and investments, leading to more tangled supply chains. As FDI is a key tool in shaping the structure and the efficiency of global supply chains, such changes are inevitably associated with changes in capital flows.

New dynamics and risks for emerging markets and developing economies

In the US subsequent interest rate hikes and dollar appreciation have resulted in important challenges for emerging markets and developing economies (EMDEs). In 2022, these challenges manifested in pronounced fluctuations in the currency and bond markets of these economies, accompanied by a substantial gross (and net) outflow of portfolio investment, primarily from China, as well as India, Mexico, Brazil and Turkey. During this period, the US experienced large net inflows of portfolio investment. Although EMDEs alone cannot entirely account for the inflows into the US, shifts in the US monetary policy stance aimed at curbing inflation have influenced portfolio investment and contributed to capital flight towards the US.

In contrast, FDI seems to have remained relatively stable in these economies, except in China, which witnessed a significant decline in FDI inflows. This decline in China's FDI could be attributed to changes in investment strategies, possibly linked to the restructuring of global supply chains to reduce dependence on China.

An examination of the foreign debt structure of EMDEs, considering both currency composition and sectoral allocation, reveals growing vulnerabilities. EMDEs, characterised by a structural reliance on foreign currency funding, have witnessed substantial growth in debt in recent years. The widespread use of the dollar as the predominant currency for debt denomination raises apprehensions regarding fiscal sustainability and overall risks for these economies. Beyond the escalating risks of default, this fragility hampers their ability to attract foreign investment, which is critical for growth.

Finally, the onset of the war in Ukraine has attracted renewed policy interest in the EU's southern and eastern neighbourhoods. The recognised significance of the economic and political stability of the region, coupled with the availability of energy resources in these regions, presented promising development opportunities for both sides. However, political risks remain a main deterrent to closer partnership in certain countries. Moreover, new trends in trade and capital flows in the EU's southern and eastern neighbourhoods are also emerging. Since 2021, there has been a clear upswing in the value of exports from some of these countries to the EU, aligned with a marked increase in Russian and Chinese imports, while in other countries, investments from Russia have seen an increase.

Financial integration and risk-sharing in the EU

This study contributes to a better understanding of EU capital flows and financial integration by looking at two specific aspects: the resilience of EU financial integration and the degree of cross-country risk sharing.

The analysis of indicators of EU financial integration indicates good resilience in the face of recent shocks (i.e. Covid-19, the conflict in Ukraine and energy crisis), although frequent and abrupt changes in the composition of investors' cross-border portfolios translated into high volatility.

The assessment of risk-sharing in the EU reveals the role of unprecedented fiscal policy measures at the national and EU levels, in response to the pandemic and the energy crisis, as the primary risk-sharing mechanism. The ECB's accommodative monetary policy is also likely to have contributed to shock absorption, particularly in euro area countries. Overall, from a historical perspective, the risk-sharing observed over the period 2020-2022 appears to be exceptionally high.

FDI network of EU Member States

The study complements the analysis of recent developments in FDI illustrated above, with an in-depth investigation of the EU Member States inward FDI network, using a combination of different data sources, including firm-level data, and estimates. The methodology allows us to identify the share of FDI directed to Special purpose entities (SPEs), often called phantom FDI, as well as to disentangle the ownership structure of non-SPE FDI, which makes it possible to distinguish where immediate and ultimate investors are located. Due to data limitations, this analysis only covers the period 2018-2021.

The total inward FDI into EU countries increased gradually from EUR 13.4 trillion in 2018 to EUR 14.1 trillion in 2021. In 2021, 46 % of the inward FDI in EU Member States originated from other EU countries (intra-EU FDI), while the remaining 54 % came from non-EU countries. SPEs located in EU countries received about 30 % of the total FDI (phantom FDI). This represents a major fall, in both the share and absolute value, since 2018, when the share was close to 50 % of the total. The decline has been gradual over the four years under investigation. The high levels of phantom FDI observed in 2018 and 2019 are likely to have been influenced by the US Tax Cuts and Jobs Act, and profit repatriation in the US, as intra-groups finance activities often go through holding companies and SPEs.

Furthermore, in 2021 95 % of real (non-involving SPEs) FDI, were direct, i.e. the immediate and the ultimate investor coincided. This is a major change compared to 2019 and 2020, when the country of the ultimate owner was different from the immediate one and a third (transitory) country appeared in about 40 % of total (real) FDI. Lastly, the analysis of FDI in SPEs reveals that specific non-EU jurisdictions are actively engaged with certain EU countries that are hosting SPEs and are receiving large inflows of FDI. In 2021, Russia was notably active in Cyprus and China had a (relatively) significant presence in Hungary. In Luxembourg and the Netherlands, 'other countries', comprising various small nations and offshore financial centres were the largest ultimate investors.

Conclusions

The examination of recent developments in global, regional and EU-level capital flows, coupled with insights from the latest literature, results in two overarching conclusions.

First, 2022 was marked by some important changes for capital flows, globally and particularly within the EU. The confluence of adverse factors – including historically high inflation, interest rate hikes in the US and Europe, uncertainty stemming from the war in Ukraine, and the subsequent energy crisis – at the global level, resulted in a significant decline in flows across various asset classes. These shifts surpassed the magnitude observed during the pandemic but then stabilised in 2023. The EU stands out as one of the regions undergoing negative dynamics and witnessing disinvestment operations in FDI and other investment, although portfolio investment seems to be holding up. This is quite a new situation for the EU, which has always been a key destination, and source, of cross-border investments.

Second, looking ahead, a crucial question arises about whether 2022 was merely a transient anomaly, or if it signifies the onset of distinct trends characterised by diminished investment in the EU, notably from the US, and across EU Member States. Several prevailing conditions in 2022 have ameliorated: inflation has retreated to lower levels, monetary policy tightening by central banks has likely peaked and energy supply no longer poses a critical risk. These factors would suggest that 2022 was an exceptional year. However, considerable downside risks persist, primarily emanating from the geopolitical context.

While accurately documenting the state of integration of the global economy is challenging, evidence indicates that pressures leading to fragmentation are already impacting investment flows across economies. Vulnerability to FDI, encompassing both rising outflows and lower inflows, as well as broader concerns about fragmentation of capital flows, is emerging as a serious concern to the EU.

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