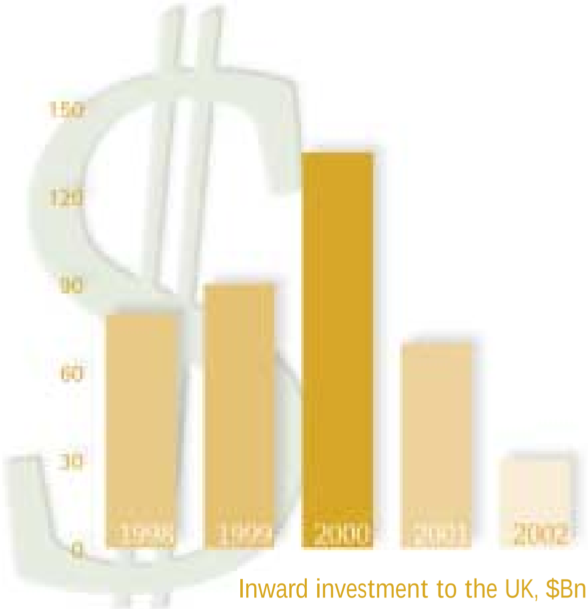
Data Bank

Inward investment - foriegn income - has always been high on Britain's agenda. Here, Jonathan Brown assesses the chances for the UK's continued success in attracting cash flows to our shores.



Inward investment to the UK, $Bn

Source: World Investment Report 2003, UNCTAD

Inward investment

For over 20 years the UK has been actively pursuing investment from abroad by marketing the UK and its regions and by providing ideal conditions for investors. This has been carried out both on a national basis and more recently by the Regional Development Agencies (RDA's). The justification for aggressively pursuing foreign investment is that it creates a new impetus for providing jobs and stimulates the domestic local economy.

Until 2001 the UK was attracting some of the highest levels of investment in Europe and was among the top performers in the world. However, the World Investment Report published at the beginning of September 2003 by the United Nations Conference on Trade and Development (UNCTAD) indicates that overseas investors shunned Britain in 2002. In view of the findings of UNCTAD's report, this article discusses the value of inward investment and the issues that Britain now faces.

Sources of investment

Inward investment can be broadly divided into five areas:

• inward private investment by a multi-site company, where the decisions are taken outside of the economy. This type of investment is not directly location dependent.

• new start-ups that increase the stock of productive firms and bring new entrepreneurial talent into the local economy.

• expansion of indigenous private sector firms.

• inward public investment for which a higher tier of government is the arbiter of the decision.

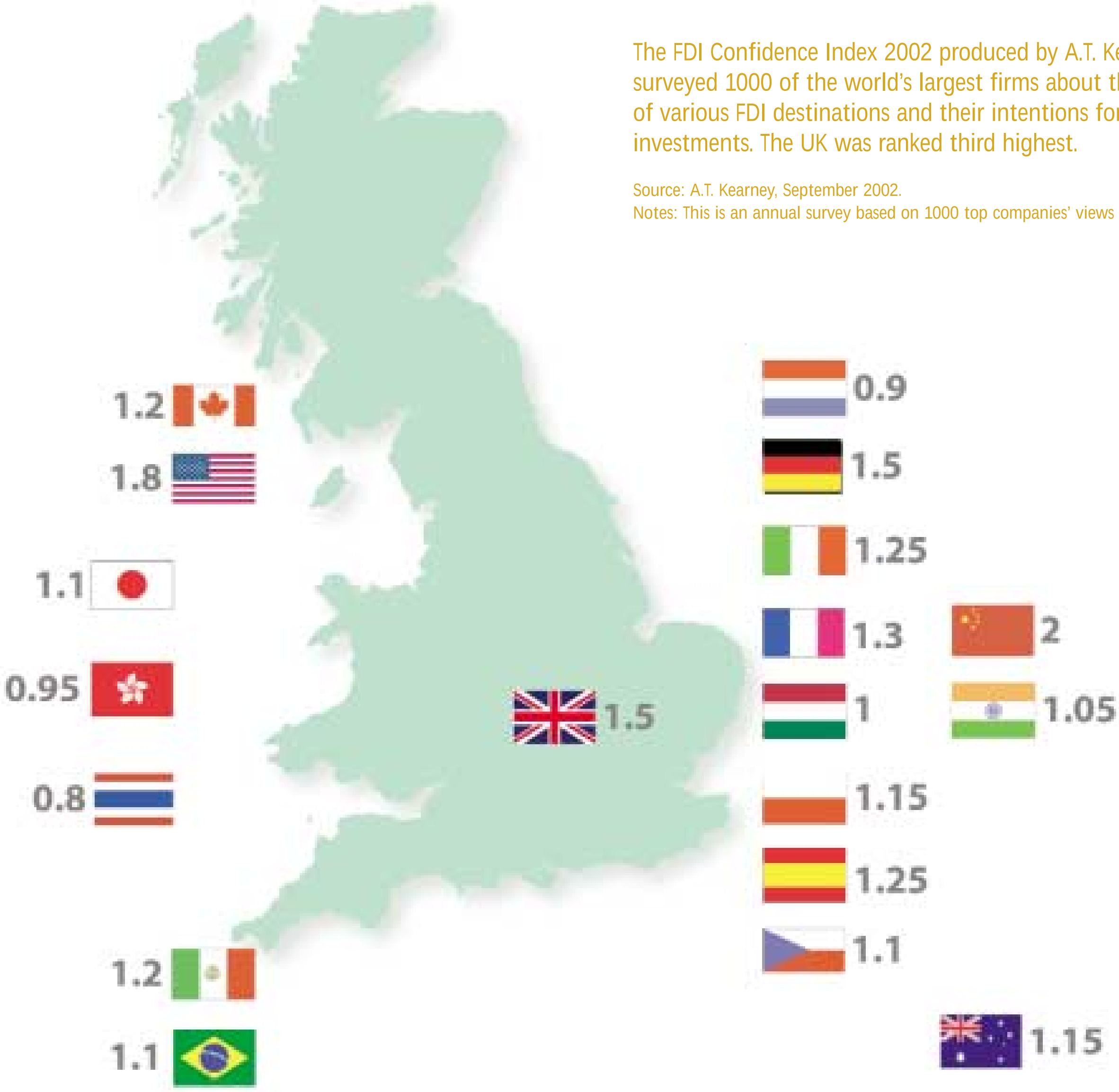
• locally determined public investment.

Foreign investment is evident in the first two of these categories and can be loosely defined as investment of foreign capital assets into domestic structures, equipment and organisations. However, another main source of Foreign Direct Investment (FDI) is also cross-border Mergers and Acquisitions (M&A).

The Value of FDI

2001 saw a sharp reduction in capital inflows which was due in part to the events of September 11th, but was probably more significantly a result of the economic downturn in the US. The root of problem lies in the UK's over-dependence on the US as a generator of investment.

In addition to monetary benefits, foreign investment can contribute technical, technological and managerial knowledge to a project and perhaps more crucially, in an age of globalisation, access to world markets. When considering that investment already made in the UK is worth £35bn it is clearly of value to the economy.



The FDI Confidence Index 2002 produced by A.T. Kearney surveyed 1000 of the world's largest firms about their opinions of various FDI destinations and their intentions for future investments. The UK was ranked third highest.

Source: A.T. Kearney, September 2002.
Notes: This is an annual survey based on 1000 top companies' views of 60 countries.

Although the UK has lost some of its share of inward investment a global downturn in FDI flows has also occurred. This does not mean that the value of FDI has become irrevocably lost because of a radical change in investor habits, but is more indicative of a cyclical downturn after an extraordinary period of economic expansion.

Of course the benefits of being an overseas investor continue to be valued by indigenous businesses, which has resulted in the UK contributing the sixth highest total investment into Europe, so that the outflow continues to be considerably greater than the inflow.

Where to invest?

The primary requirement for an investment decision is that the actual investment meets the investor's rate of return criteria. The location will feature as part of these criteria and it is on this point that locality can influence the investor's decision. Aspects of the business environment which are exogenous to the firm include: availability and quality of commercial or industrial property, the nature of the local labour market, social factors (e.g. crime rates), transport and accessibility, regulatory and planning considerations, and the quality of local services. The argument is that once these aspects of locality have been addressed then the "investibility" of the area will increase. Deriving an overall competitive advantage as opposed to a comparative advantage represents one of the greatest challenges in the global economy and provides conditions that are not easily undercut by rivals.

Without question, confidence is a high priority when considering FDI as it involves considerable investment in relations between the host and recipient. The foreign investor shares much of the risk, as the investor's income from their investment is dependent on economic fortunes of the recipient's locality and nation.

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Why has the UK been so successful?

Invest.UK attributed the UK's recent success to economic stability, a positive climate for business and one of the highest growth rates among G8 economies.

The UK excels in inviting new business start up partly due to low barriers of entry. A key pull factor is that the UK continues to offer businesses one of the lowest tax rates in Europe. This is supported by the UK government's emphasis on partnership rather than intervention, and while grants are made available to support businesses, the financial centre of London also acts as a key source of venture capital. Furthermore, there are no restrictions on sending profits overseas and no exchange controls.

Key to attracting such high levels of investment is the research and development (R&D) driven by UK universities. For example Cambridge is known as the epicentre for biotechnology in Europe, producing some of the world's top scientists and as a result continues to attract foreign investment. Overall the UK is responsible for 5.5% of global R&D (despite accounting for less than 1% of the world's population). Central to being attractive to investors is the ability to offer a well-regulated workforce. The UK has one of the lowest employer social security costs in Europe.

Source markets

The US remains by far the UK's largest source of FDI with 283 decisions to locate or expand in the UK in 2002. Whilst historically this interest by US investors has been highly beneficial it has made the UK extremely vulnerable to US economic downturn, seen most significantly in the period since 2001.

The euro debate

One of the key issues relating to staying outside of the euro is the impact this may have on inward investment. This is of such significance that it is represented in one of Gordon Brown's five economic tests on whether Britain should join.

Since 2000, the 12 Eurozone countries have seen their share of inward investment projects drop from 51% to 44%. Over the same period the non-euro 3 have seen their share fall from only 29% to 24%. Yet the news from the latest World Investment Report shows that France, Germany and the Netherlands have now overtaken Britain, which may re-ignite the debate. Are foreign investors really deterred by Britain's lack of inclusion in the euro? This is very difficult to gauge, as there are more visible explanations such as the collapse of the cross-boarder takeover boom that created such high levels of FDI at the end of the 1990's.

One of the greatest deterrents to inward investment is the myriad of anti-trust or anti-competitive regulations that can at best cause substantial delays for Mergers & Acquisitions and at worst prohibit them. Therefore contrary to benefits of unification in Europe further inclusion and expansion could expose the members to added complexities.

Future Trends

Forecasting future FDI interest is inherently difficult. The Economic Intelligence Unit has attempted to do so but, when considering their use of as many as 70 indicators, their findings must be approached with some caution. The problem of forecasting is perpetuated by an element of force mejeure, and the virtually impossible task of quantifying the impact of unreliable events.

In Britain, FDI inflows last year were a fifth of what they were in 2000 and in America only a tenth, yet Britain is expected to increase its levels of FDI in line with the global recovery predicted for 2004.

The strength of Britain's position at the forefront of Europe's inward investment is particularly compelling when you consider the very factors on which it depends. Consider the threats of terrorism, ongoing war, corporate scandals and deflation. In such a climate there is a sense of conservatism with consolidation through retrenchment and repositioning, the focus on squeezing current business operations. The vulnerability of FDI has been clearly demonstrated by the recent deflation in Germany where consumer prices have plummeted.

A capital Capital?

Predictably London dominates the UK picture but it also leads in Europe, being the top ranking regional destination with 125 projects in 2002 (33% increase on 2001). A key reason for London's position is that the city is recognised as making the biggest effort to promote itself and attract investors. Beyond the direct economic impact, attracting such high levels of FDI is a great compliment to London. It acts as an endorsement of the city's and the country's prospects and policies and represents a global statement of confidence.

Although the UK has taken a considerable fall in inward investment, the high levels of confidence we command in addition to the continued success of London as a gateway are good reasons for optimism. While it is notoriously difficult to forecast how such trends will change, the key issues to watch are the impact of the threat of terrorism, ongoing overseas military action and, of course, if and when the economy will eventually meet all five of Gordon's tests.