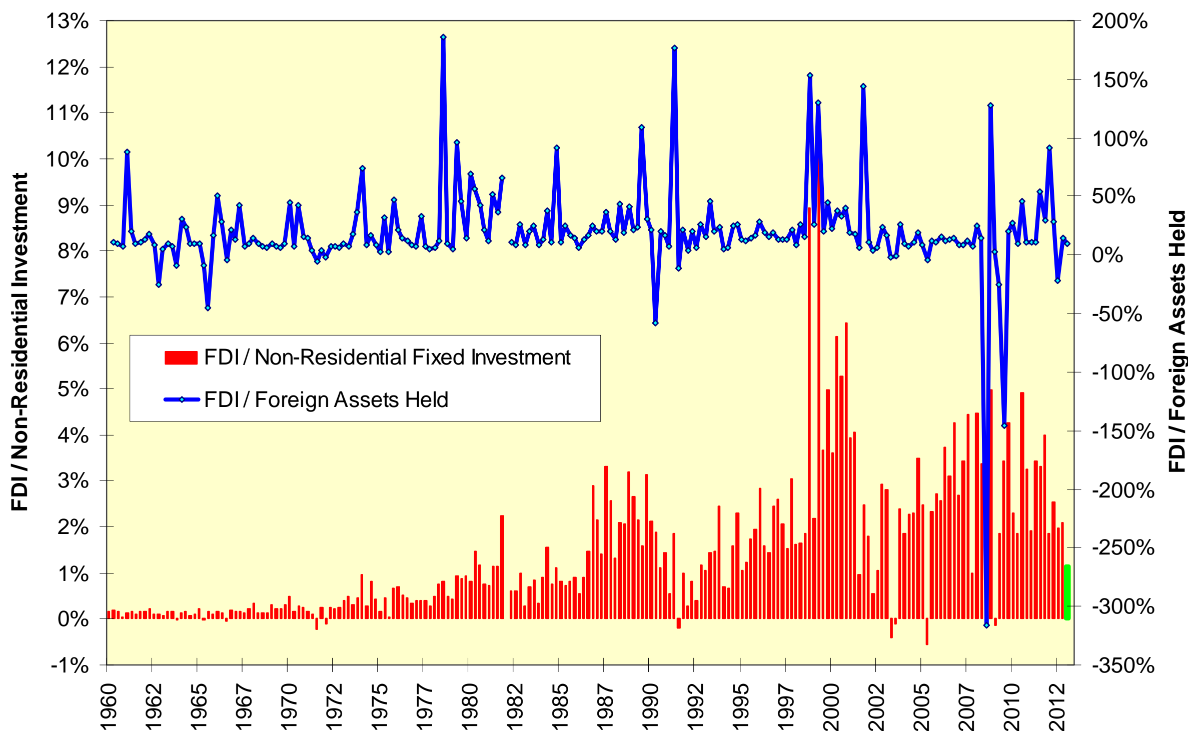
Foreign Direct Investment Lower Than It Should Be

The acid test for comparing the attractiveness of any two political systems is refugee flow. No one hops on an inner-tube and tries to flee to Cuba, boat-people left Vietnam after 1975, the flow of migrant workers during the apartheid era was into South Africa from neighboring countries, East Africans cross the Sinai in hopes of making it into Israel and the Berlin Wall was not built, Soviet-era propaganda of the time notwithstanding, to block the exit of West Berliners into various workers' paradises.

The flow of funds across international borders is similarly unblinking, especially for foreign direct investment (FDI) in productive assets as opposed to simple financial portfolio investment. As discussed in November 2010, there are three general conditions under which we should see rising foreign direct investment:

1. The investor must see the business opportunity;
2. The currency must be seen as relatively cheap; and
3. The foreign exporter must be worried about rising trade barriers

How have foreign investors been voting with their proverbial financial feet? The answers are not flattering. FDI as a percentage of non-residential fixed investment was 1.1% at the end of the first quarter. This is the lowest level since a -0.1% rate, actual disinvestment, at the end of the first quarter in 2009. March 2009 was the end of the financial crisis and the start of the QE era, not only in the U.S. but in the U.K. and Switzerland as well.



What about the currency? Here the answer is a bit of a Rorschach Test. The Federal Reserve's real broad trade-weighted dollar has declined almost 11.8% since March 2009, but it has rebounded 6.1% since July 2011. If foreign investors believed the dollar was about to embark on a long-term secular increase they might be converting their currencies for greenbacks in hopes of catching the wave. They are not.

What about business opportunities? The U.S. stock market has outperformed the MSCI-Barra World Ex-U.S. index by a substantial 170% to 125% margin since March 2009. Some of this is a hot-money response to very aggressive U.S. monetary policies, but any glance around the world has to leave Americans feeling relatively good about our

still absolutely tepid business conditions. We are and indeed should be concerned about slow GDP and employment growth, but where would you rather have been since March 2009, in the U.S. or in the Eurozone, Japan or a host of emerging markets?

The trade-barrier issue is somewhat subjective, but high-profile stories about holding the TransCanada's (TRP) Keystone XL pipeline hostage to a moving set of objections or impeding fracking across large swathes of California and New York send clear and unmistakable signals to foreign investors: Your business takes second place to U.S. political fashions.

These concerns extend outside of the energy industry, of course. Let's say you are a non-U.S. financial institution looking to expand in the U.S. You face an evolving regulatory landscape from Dodd-Frank, the Affordable Care Act and both a CFTC and a SEC eager to carve out their regulatory turf in that new landscape. Moreover, the U.S. is a nightmare for tax planners; lost in the collective amnesia is how we did not know what tax rates and policies for 2013 would be until 2013.

All countries compete with each other for investment capital. This, not good intentions alone, is what creates output and employment. That a relatively strong U.S. with an otherwise favorable environment is seeing a shrinking share of FDI tells us we are not doing as good of a job here as we should be.