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Global FDI Policy

Correcting a Protectionist Drift

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Matthew J. Slaughter

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FOREWORD

Foreign investment has been a principal engine of global economic growth in recent years. Both developed and developing countries have reaped substantial gains. This investment offers direct benefits to host countries, including job creation and increased tax revenue. In addition, it helps source countries, i.e., those where multinational firms are based, by allowing these firms to compete and earn profits abroad. Investment is also important to the global economy as a way to finance current account imbalances.

Foreign investment, though, is not immune to the sort of resistance that we are seeing with respect to the movement of goods and services. Indeed, just as with trade, calls to restrict investment are growing louder in many countries, with potentially significant adverse political and economic consequences. In this Council Special Report, David M. Marchick and Matthew J. Slaughter track the rise of investment protectionism. They examine trends in a number of countries, documenting moves toward restricting investment through both legislation and regulation. They also analyze the reasons behind these trends, such as increased concern over investment from “nontraditional” sources, both private and sovereign wealth funds.

The report ends with recommendations for policymakers. Acknowledging governments’ legitimate national security interests, it lays out clear principles for host countries to follow in regulating foreign investment. The authors also recommend actions to be taken by international organizations to help foster sound policies in these host countries. The result is a compelling analysis and a strong case for governments everywhere to take steps to maintain openness to investment.

Richard N. Haass

President

Council on Foreign Relations

June 2008

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ACRONYMS

CFIUS	Committee on Foreign Investment in the United States
CNOOC	China National Offshore Oil Corporation
EU	European Union
FDI	foreign direct investment
FINSA	Foreign Investment and National Security Act
G8	Group of Eight
GDP	gross domestic product
IEEPA	International Emergency Economic Powers Act
IMF	International Monetary Fund
IT	information technology
M&A	mergers and acquisitions
MNE	multinational enterprise
OECD	Organization for Economic Cooperation and Development
P&O	Peninsular and Oriental Steam Navigation Company
R&D	research and development
SASAC	State-owned Assets Supervision and Administration Commission
SOE	state-owned enterprise
SWF	sovereign wealth fund
TWEA	Trading with the Enemy Act
UNCTAD	United Nations Conference on Trade and Development

COUNCIL SPECIAL REPORT

INTRODUCTION

A distinguishing feature of the current era of globalization has been cross-border flows of foreign direct investment (FDI) in which businesses in one country own part or all of businesses in other countries.¹ Indeed, FDI flows have grown at much faster rates than have flows of goods and services. From 1990 through 2006, worldwide cross-border inflows of FDI rose an average of 12.4 percent annually, versus 7.7 percent growth in total exports of goods and services and 5 percent overall economic growth.² Since 2003, world FDI flows have grown even faster—at an astonishing 30 percent per year—although they will likely drop precipitously this year with the worldwide economic slowdown. Many popular accounts of the current era of globalization see its distinguishing feature as the expansion of FDI and the creation of cross-border production networks by multinational companies.³ Even more than trade liberalization, investment liberalization has been the strongest driver of growth worldwide, giving a significant boost to economies in developing and developed countries. The decision by many countries over the past two decades to abandon long-standing restrictions on foreign investment has contributed substantially to the spread of prosperity.

¹ FDI is distinct from cross-border portfolio investment with respect to the degree of ownership and control. With FDI, the owner of a foreign business holds a sufficient share (often deemed to be at least 10 percent) of that business to exert meaningful managerial control over company strategies and decisions. With portfolio investment, the owner of a foreign business holds a sufficiently small share that he exerts no such meaningful managerial control. An individual purchasing one share of British Telecom would constitute a portfolio investment. An individual purchasing all shares of British Telecom would constitute FDI. (One other important difference is that FDI describes ownership of companies only, whereas portfolio investment commonly denotes a much wider class of assets—not just companies but also government securities, bank loans, and property.)

² United Nations Conference on Trade and Development, *World Investment Report: Promoting Linkages* (New York: United Nations, 2007).

³ Michael Bordo, Barry Eichengreen, and Douglas Irwin, “Is Globalization Today Really Different from Globalization a Hundred Years Ago?” in Dani Rodrik and Susan Collins, eds., *Brookings Trade Forum 1999* (Washington, DC: Brookings Institution Press, 1999), pp. 1–50.

Against this backdrop, however, some governments are starting to move in a different direction. In the last two years, at least eleven major countries, which together received 40.6 percent of all world inflows of FDI in 2006, have approved or are seriously considering new laws that could restrict certain types of FDI, or expand government oversight of cross-border investments. Most of these measures have been justified on the basis of protecting national security or safeguarding so-called strategic industries. Some countries have passed legislation to protect “economic security.” Still others have established new national security review processes for foreign investment, or created additional tools for scrutinizing acquisitions by government-owned companies and/or sovereign wealth funds (SWF). In many of these countries, high-profile transactions are increasingly disputed. In February 2008, for example, the joint bid for 3Com Corporation by Bain Capital, an American private equity company, and Huawei, a Chinese technology company, was withdrawn after objections were raised by the U.S. government.

This shift in FDI policy is not confined to these countries. Each year in its annual report on FDI, the United Nations Conference on Trade and Development (UNCTAD) tallies all national regulatory changes toward inward FDI. Throughout the 1990s, policy changes were overwhelmingly favorable for FDI. In 2000, for example, of the 150 regulatory changes tracked by UNCTAD, only three restricted rather than liberalized FDI policy. In recent years, however, this trend is weakening. In its most recent year of data, 2006, UNCTAD reported that 37 of 184 policy changes—20.1 percent—were unfavorable to FDI.

More recently, this shift in FDI policy has been accelerated by new concerns over sovereign wealth funds (SWFs), massive pools of capital controlled by governments that have taken stakes in a growing number of companies around the world. Their significance was highlighted by the tens of billions of dollars these funds invested in several leading U.S. financial firms during the recent credit crisis. To date, most SWF investments have been passive portfolio holdings rather than controlling stakes, a distinction that carries important business and economic implications. But some SWFs have taken controlling stakes in companies, raising fears that FDI could become a tool for national governments to pursue political rather than purely economic ends. The concerns

now being heard about SWFs are spilling over into the broader debate over foreign investment, such that policies directed at SWFs might also end up restricting FDI by private investors.

A move away from FDI liberalization would raise important questions about whether the high growth rates that have accompanied the current era of globalization can be sustained. This Council Special Report analyzes the growing array of new rules governing inward FDI. This analysis has four main parts. First, it identifies these legislative and regulatory changes to see what features seem to be common across countries, and to evaluate whether these policies are actually restricting FDI flows or may be enhancing them by codifying and clarifying practices. Second, it assesses the economic consequences of greater FDI restrictions, not just for host countries but for source countries and for the global economic system overall. Third, it discusses the economic and political drivers of these FDI policy changes, including the emergence of new countries as large foreign investors, the greater role for government-linked firms, and the growing wariness in many countries toward globalization of all forms. And fourth, it recommends policies for both individual countries and multilateral organizations such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD).

Our conclusion is that a protectionist drift in FDI policy is indeed under way. The negative trend can be seen in official actions in certain countries as well as in the changed public debate; the latter has brought an increased politicization of FDI, which in itself can chill investment. This drift is already reducing the quantity and quality of global FDI flows—a reduction that could grow larger should policy become even more restrictive. Smaller and poorer-quality FDI flows, in turn, matter because it is well documented that FDI tends to benefit both host and source countries alike. The policy recommendations in this report aim to correct this protectionist drift by proposing guidelines for how countries can better regulate FDI yet still reap its economic benefits.

SETTING THE STAGE: NEW FDI POLICIES AROUND THE WORLD

Neither foreign direct investment nor laws to restrict such investment are new. In the United States, for example, Congress passed many laws in the twentieth century that either restricted foreign investment in certain sectors (including shipping, broadcasting, and air services) or that gave the president the authority to block or seize certain foreign investments. More specifically, Congress passed the Trading with the Enemy Act (TWEA) in 1917, which was used by presidents to expropriate German and even some non-German chemical and broadcasting assets in the United States, including American Marconi, the largest radio group in the United States at the time, which was controlled by British interests. In 1977, Congress passed the International Emergency Economic Powers Act (IEEPA), the successor to TWEA, which has been utilized by presidents for a variety of national security–related actions affecting trade and investment. And in 1988, in response to concern about growing levels of Japanese investment in the United States, Congress passed the Exon-Florio amendment to the Defense Production Act of 1950, giving the president the specific authority to block individual acquisitions by foreign entities without declaring an emergency under IEEPA.

Notwithstanding these laws and regulations, and similar laws and regulations in other countries, the last twenty-five years have seen the gradual liberalization of foreign investment regimes. Europe, the United States, and other industrialized countries each took major steps to encourage FDI in the 1990s, opening up certain sectors that were previously highly restricted, including telecommunications, as a result of the Uruguay Round and associated trade agreements. Liberalization has been particularly pronounced in developing countries, which have recently become important sources and destinations for FDI. China, for example, has been one of the largest recipients of FDI since 2000, a remarkable and positive change after decades of walling off its economy to foreign investment and trade. India, Brazil, Russia, and dozens of smaller developing countries have also made substantial strides in opening up their economies to FDI. As a result, even with the natural ups and downs associated with global growth cycles, FDI has grown dramatically in the past generation.

In the past few years, however, the trend toward liberalizing policy actions has either slowed or reversed. In 2005, for example, UNCTAD reported the highest number of “unfavorable” (investment-restrictive) policy actions since it began tracking many years ago: 41 of 205 total actions. To be sure, “favorable” (investment-liberalizing) actions still far outnumbered “unfavorable” actions, but the number of restrictive actions increased dramatically. The share of unfavorable actions was even higher in 2006: 20.1 percent of the total (37 of 184 actions).

To explain this trend, a summary of policy actions in five significant FDI-recipient countries is offered below.

THE UNITED STATES

After a debate of nearly eighteen months, in 2007 Congress passed the Foreign Investment and National Security Act (FINSA), which amended the Exon-Florio amendment to the Defense Production Act. Exon-Florio empowers the president to block the foreign acquisition of a U.S. company if it threatens to impair U.S. national security and if no other laws or regulations adequately protect national security. The 2007 law creates a formal statutory basis for the Committee on Foreign Investment in the United States (CFIUS) to review such acquisitions. CFIUS, an interagency body led by the Department of the Treasury, was created in 1975 to monitor foreign investment in the United States and was given authority to formally review investments in 1988. The 2007 law also requires heightened scrutiny of acquisitions by government-owned companies, mandates the involvement of high-level officials in CFIUS, and requires additional reporting to Congress.

The law, however, is not a radical departure from the original Exon-Florio amendment. It does not change the time periods for the review; it does not give Congress the explicit right to override decisions by the executive branch; and it does not ban or even discriminate against foreign investment in certain sectors of the U.S. economy. That said, exactly how this law will be implemented remains to be determined. In April 2008, the U.S. Treasury proposed implementation regulations that would, for example, tighten

government oversight of foreign investments even in cases where the foreign buyer is acquiring less than 10 percent of a U.S. business, previously considered well below the threshold for exercising control. The main catalyst for FISNA was the 2006 debate over the proposed acquisition of the British-based Peninsular and Oriental Steam Navigation Company (P&O) by Dubai Ports World, a government-owned entity based in the United Arab Emirates. P&O operated several port facilities in the United States, including major facilities in New York and New Jersey. The debate followed a similar congressional backlash in 2005 against efforts by the government-controlled China National Offshore Oil Corporation (CNOOC) to purchase Unocal, the U.S. oil producer. CNOOC backed down and withdrew its bid after the House of Representatives overwhelmingly approved a provision that would have significantly delayed a CNOOC acquisition.

The Dubai Ports World transaction roiled Congress in spring 2006, with some members of Congress expressing outrage that a state-owned entity based in the Middle East could own and control port facilities in the United States. CFIUS had previously approved the transaction, and more than a dozen congressional hearings were called during which administration officials were excoriated for their supposed lack of judgment in sanctioning the deal. Senator Frank R. Lautenberg (D-NJ), a leading opponent of the transaction, fulminated: “Don’t let them tell you this is just the transfer of title. Baloney. We wouldn’t transfer title to the Devil; we’re not going to transfer title to Dubai.”⁴ More than twenty bills were introduced that would have barred foreign investment in large parts of the U.S. economy, prohibited foreign investment in ports by government-owned entities, and/or reformed the CFIUS process. In the end, owing to the leadership of Congressmen Barney Frank (D-MA) and Spencer Bachus (R-AL) and Senators Chris Dodd (D-CT) and Richard C. Shelby (R-AL), among others, Congress passed a bill that enhanced the procedural safeguards of the CFIUS process. While it appears unlikely to chill legitimate FDI in the United States, the post-Dubai Ports World political environment has led CFIUS to be much tougher and more regulatory. CFIUS has extended more reviews into a second phase and is imposing more conditions on transactions going through the process.

⁴ John Cranford, “Defining ‘Ours’ in a New World,” *CQ Weekly*, March 3, 2006, p. 592.

RUSSIA

Russia's move to create a new foreign investment review process was formally launched in a May 2005 address to the Duma, in which Russian president Vladimir Putin called for a new law to protect "strategic industries." It was given additional impetus by the high price of oil, which has allowed Russia to feel able to accept FDI only on its own terms. But the Russian government's decision to adopt its own CFIUS-like process also reflected the debate in the United States over Dubai Ports World. Russian officials watched the congressional process that led to the passage of FINSA. They carefully studied U.S. and other countries' laws, and over a two-year period developed two new foreign investment-related laws.

The first—the so-called subsoil law—would restrict foreign ownership of mineral deposits, oil, and natural gas fields, and is still being considered by the Duma. The second—the so-called strategic industries law—has been approved, and creates a CFIUS-like process through which government officials will review foreign investments in forty-three strategic industries grouped in a number of broad sectors, including "special" and military equipment, aerospace, nuclear power, and natural monopolies. The strategic industries law creates a mandatory filing process for foreign acquisitions of Russian companies in these sectors, bans state-owned entities from acquiring controlling stakes in companies that have "strategic significance for the Russian Federation's national security," and contemplates a lengthy review period of between 90 and 180 days. Much like Exon-Florio, the law requires mitigation measures for transactions that trigger certain Russian security interests, as when the target company has access to classified information, trades in controlled goods and technologies, or has military products or recent government defense contracts. The law also takes into account a number of factors typically considered economic rather than national security considerations, including whether the target company has more than a 35 percent market share of a particular commodity. The law mandates confidential treatment of information provided to the government, except for "cases determined by the Russian Federation legislation," which presumably means for issues resolved by a Russian court.

CANADA

A similar debate has taken place in Canada, partly in response to concerns about growing Chinese investment in Canadian energy assets. In an October 2007 speech in Vancouver, Canada's industry minister, Jim Prentice, stated the government's intention to "carefully consider the creation of an explicit national security test that will be applied to foreign investment." Prentice's speech followed a number of pronouncements by Ottawa raising concerns about foreign government-controlled investments. In December 2007, the Canadian government also issued "clarifications" of the rules on foreign investment for state-owned enterprises (SOEs) under the Investment Canada Act. The new guidance clarifies that the Canadian government, when reviewing investments by state-owned enterprises, will consider whether the SOEs adhere to Canadian standards of corporate governance. It will also assess the impact the acquisition would have on a company's exports, on the location of its manufacturing and research and development (R&D) facilities, and on whether the acquirer will provide "the appropriate level of capital expenditures to maintain the Canadian business in a globally competitive position."

Canada has long screened foreign investments utilizing a rather vague "net benefit" test. But the potential consideration of a "national security" test could add a new layer to investment screening. At the time of this writing, the government is expected to consider new legislation that authorizes reviews of foreign investments for national security concerns. Existing legislation is also being tested with the April 2008 decision by the Canadian government to block the U.S. group Alliant Techsystems Inc. from purchasing the space-technology division of Vancouver-based MacDonald, Dettwiler and Associates Ltd., despite the near-unanimous approval of the deal by MacDonald shareholders. This was the first transaction ever blocked under the Investment Canada Act, spurred by a coalition including officials from many parties as well as trade unions.

CHINA

China, too, has recently added a national security test to its foreign investment review process. China has always rigorously regulated and screened foreign investments, picking and choosing which investments the government believes are in China's interest. The government has for many years prohibited foreign investment in sectors it considers crucial to national security, such as news agencies, broadcasting and programming, press and audiovisual products, arms production, and the mining and processing of certain minerals.

More recently, in December 2006, the State-owned Assets Supervision and Administration Commission (SASAC) published an expansive list of "critical economic sectors" in which China should maintain strong state control and restrict foreign participation. These "pillar" industries include automotive, chemical, construction, electronic information, equipment manufacturing, iron and steel, nonferrous metal, science and technology, and survey and design. Further, the Ministry of Commerce received authorization to review foreign acquisitions for their impact on "national economic security." In addition, in its new antimonopoly law, which goes into effect in August 2008, China provides regulators with additional discretion with respect to competition rules for state-owned companies that are "relied upon by the national economy and national security."

GERMANY

In April 2008, the German government unveiled new legislation to authorize the Ministry of Economics and Technology, along with other German ministries, to review certain foreign investments, particularly those coming from state-owned entities. German politicians have grown concerned about investments by SWFs and SOEs, particularly Russian SOEs and especially in the energy sector. German chancellor Angela Merkel expressed fears that sovereign wealth funds were often driven by "political and other motivations" rather than investment returns. "This is a new phenomenon that we must

tackle with some urgency,” Merkel stated. Under the initial draft law tabled by the government, certain foreign investment in certain sectors would be subject to a new investment screening process if the foreign stake were greater than 25 percent. The review process would examine the impact of these transactions on “public policy and security.”

The draft rejects the more populist language proposed by the Christian Democratic Union, Merkel’s own party, which would have allowed scrutiny based on whether an investment affected “strategic infrastructure” and the German “national interest.” But the draft creates considerable uncertainty not only with respect to the terms “public policy and security” but also with respect to timing. It gives the German government up to three months to decide whether it wants to review a transaction, a potentially long period for a transaction to be held in limbo.

SELECTED OTHER COUNTRIES

In August 2007, Japan updated its regulation of inward investment to address the “changed security environment surrounding Japan and trends in international investment activity,” according to the Ministry of Economy, Trade, and Industry. Among other things, the new regulations require prior notification of foreign investments in Japanese companies that manufacture certain dual-use items, defense products, and “technology infrastructure.” The term “technology infrastructure” is not defined but includes accessories or equipment designed for the production of aircraft.

Existing Japanese policy is being tested with the April 2008 decision by the Japanese government, based on national security concerns, to block UK investment group The Children’s Investment Fund from increasing its stake in electricity wholesaler J-Power. This is the first time Japan has blocked a foreign investment in a public company; the Ministry of Finance and the Ministry of Economy, Trade, and Industry jointly argued that “the investment is likely to impede the stable supply of electric power and Japan’s nuclear and nuclear fuel cycle policy, and [to] disturb the maintenance of public order.”

In October 2007, Hungary passed a new law that raises obstacles toward foreign acquisitions of companies that affect the “the security of public supply.” The act specifically covers Hungarian companies in the water and energy sectors, raises the proportion of shareholders that must vote to approve transactions in strategically important sectors, and creates the possibility of the appointment of a government representative to the board of strategically important companies. The law was apparently aimed at protecting Hungary’s top energy firm, MOL Group, from being acquired by the Austrian energy firm OMV, which is partly owned by the Austrian government. EU commissioner Charlie McCreevy issued a letter of formal notice to the Hungarian government on the grounds that the new law unjustifiably restricts the free movement of capital within the European Union.

In February 2008, the government of Australia articulated six principles that will govern reviews of foreign investments in Australia by sovereign wealth funds and other government-linked entities, as administered by the country’s Foreign Investment Review Board. These principles include consideration of how independent an investor’s operations are from the relevant foreign government; whether the investor “adheres” to common standards of business behavior; whether an investment would hinder competition; whether it might reduce Australian government revenue or influence other policies, including but not limited to national security; and how an investment might affect the operations and directions of an Australian business. This board has recently been given the high-profile task of reviewing the bid of Chinese state-owned metals company Chinalco for a stake in mining conglomerate Rio Tinto, while other potential Chinese investments in Australia’s resource sector have been delayed pending an overhaul of the country’s foreign investment rules.

In France, the government issued a new decree governing foreign investment on December 30, 2005. Under the decree, prior authorization from the Ministry of Economy, Finance, and Employment is required for foreign investments in eleven sectors that may affect the “national interest.” These include four defense-related sectors or subsectors, several related to dual-use technologies and other national security–related industries, as well as gambling. The European Union has warned France that the decree may violate

European Community Treaty rules on free movement of capital and freedom of establishment.

In South Korea, the former administration of President Roh Moo-hyun had pledged to issue a decree giving the government broader and clearer discretion to block foreign investments that affect national security. Kwon Ki-sung, a Ministry of Commerce official, told the *Financial Times*, “There have been some complaints as there are no clear guidelines about national security. So we want to make the guidelines more specific to quell concerns.” The new administration of President Lee Myung-bak, however, has promised to encourage greater foreign investment and to take steps to deregulate the South Korean economy.

In Greece, legislation was introduced in December 2007 to impose additional hurdles on private investments of more than 20 percent in companies of “strategic importance.” This followed a takeover of Greece’s dominant telecommunications company, which raised public concern over the potential role of sovereign wealth funds. The measure is still under consideration, despite public warnings from the EU Commission.

Some other countries have discussed similar measures but have not taken any concrete steps to enact them. India, for instance, has blocked some foreign acquisitions, particularly from Chinese companies, on national security grounds. It has considered creating new national security–related screening in the telecoms field—in part in reaction to a CFIUS review of an Indian company undertaking a U.S. acquisition—but has not moved to implement any new restrictions.

THE ECONOMIC COSTS OF RISING FDI BARRIERS

The danger of a protectionist drift in policies toward FDI is considerable. Restrictions on FDI flows would harm host countries, source countries, and the delicate pattern of global current-account and capital-account imbalances that has persisted for many years.

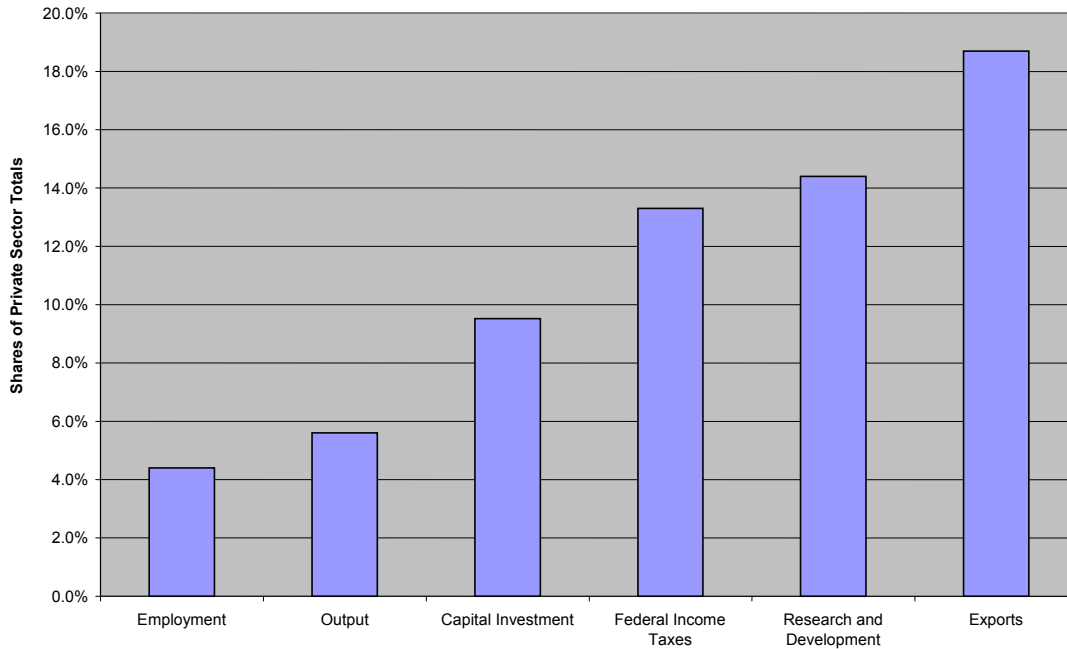
THE BENEFITS OF FDI INFLOWS TO HOST COUNTRIES⁵

Thanks to its uniquely rich and high-quality data, the United States offers some of the clearest evidence on the host-country benefits of FDI inflows. U.S. affiliates of foreign multinational corporations benefit America through their own operations. Beyond employing millions of Americans, the U.S. operations of foreign companies make American workers and the overall economy more productive through investment in physical capital, investment in R&D, and trade. Far from exploiting their host country, affiliates of foreign companies invest at a higher rate, relative to their output, than the average U.S. firm. Many of these investments are financed through their U.S. earnings; in 2006, reinvested earnings in the U.S. operations of foreign companies totaled \$65.4 billion. U.S. affiliates pay much higher average annual compensation than do U.S. domestic firms, and pay a big share of corporate income taxes, too.

For 2005, the most recent year for which comprehensive government data are available, Figure 1 reports the share of U.S. private-sector economic activities accounted for by majority-owned nonbank affiliates of foreign multinationals.

⁵ U.S. statistics in this subsection from Matthew J. Slaughter, *Insourcing Mergers & Acquisitions* (Organization for International Investment, 2007), and Thomas Anderson, "U.S. Affiliates of Foreign Companies: Operations in 2005," *Survey of Current Business* (U.S. Bureau of Economic Analysis, August 2007), pp. 194–211.

Figure 1: Affiliates of Foreign Multinationals Contribute to High U.S. Living Standards



Sources: U.S. Bureau of Economic Analysis, Internal Revenue Service, and National Science Foundation.

- *Employment:* Affiliate companies employed nearly 5.1 million U.S. workers. This was 4.4 percent of private-sector total payroll employment.
- *Output:* Affiliate companies accounted for 5.6 percent of all private-sector output—\$539.9 billion.
- *Capital Investment:* Affiliate companies purchased \$121.1 billion in new property, plants, and equipment—9.5 percent of all private-sector capital investment.
- *Federal Income Taxes:* Affiliate companies paid \$29.9 billion in federal income taxes—13.3 percent of the \$224.4 billion paid by all U.S. corporations.
- *Research and Development:* To discover new products and processes, affiliate companies spent \$31.7 billion on research and development—14.4 percent of the R&D performed by all U.S. companies.
- *Exports:* Affiliate companies exported \$169.2 billion of goods to the rest of the world—18.7 percent of the U.S. total.

The bottom line of all these productivity-enhancing activities is larger paychecks—even for traditionally disadvantaged workers such as minorities. In 2005, compensation per worker at affiliate companies was \$66,042, fully 31.8 percent above the average for the rest of the private sector, which was \$50,124. Much of this differential seems to stem from the productivity advantages achieved by these companies. A recent *American Economic Review* study of U.S. manufacturing found that workers—especially African-American workers—are more likely to hold high-wage occupations if they work in industries in which affiliates of foreign companies have a strong presence.⁶

U.S. affiliates of foreign multinationals also contribute to the economy through their interactions with other domestic U.S. firms. The performance of domestic competitors is enhanced by exposure to the new techniques and practices of foreign-headquartered companies. These companies also strengthen domestic suppliers and customers by sharing information with them and setting new standards of quality or service. The scope for these benefits is significant. Affiliate companies obtain the large majority of their intermediate inputs from domestic firms, not from imports. In 2005, affiliate companies bought \$1.5 trillion in intermediates from U.S. companies, 76.8 percent of their total input purchases of \$1.96 trillion.

The U.S. evidence on the many benefits inward FDI brings to host countries is mirrored around the world. Theodore H. Moran offers an excellent overview of the benefits enjoyed by many developing countries.⁷ He carefully examines two industries with extensive global FDI—automobiles and computers/electronics. For each industry he distinguishes two types of host country. The first permits parent companies to maintain tight control over affiliate operations and thereby allows affiliates to be integrated into global production networks as the firms see best. The other type imposes relatively

⁶ Results from Abera Gelan, Kaye Husbands Fealing, and James Peoples, “Inward Foreign Direct Investment and Racial Employment Patterns in U.S. Manufacturing.” *American Economic Review*, 97 (2), 2007, pp. 378–82. For a sample of 16,219 males aged sixteen and over in manufacturing, these researchers correlated the probability of working in a high-wage rather than a low-wage occupation with several individual and industry factors, including the share of employment in each worker’s industry accounted for by foreign affiliate companies. A one-percentage-point increase in this foreign affiliate employment share raises the probability that a white worker is in a high-wage rather than a low-wage occupation by 0.32 percentage points—and for a black worker by a further 0.35 percentage points, to 0.67 percentage points total. The sample variation in this employment share is nearly seventy percentage points, and so the range of high-wage employment probabilities accounted for by foreign investment in the United States is large.

⁷ Theodore H. Moran, *Parental Supervision: The New Paradigm for Foreign Direct Investment and Development* (Washington, DC: Peterson Institute for International Economics, August 2001).

stringent and/or widespread performance standards on affiliates, such as ownership caps, domestic-content requirements, and various technology-sharing mandates. Moran's description of the latter group raises questions about government efforts to extract benefits from inward investment beyond those that flow naturally from the way that foreign affiliates operate. Writing about affiliates in countries that set performance standards for affiliates of foreign companies, Moran says:

The implications for the development prospects of the host are not favorable. Resources are wasted. Not only are host country consumers penalized, but so too are host country producers that rely on the use of the resulting goods and services to establish their own competitive positions in the marketplace ... the plants utilize older technology, and suffer lags in the introduction of newer processes and products in comparison to wholly owned subsidiaries without such requirements. At considerable variance with the dynamic infant industry perspective, the plants are locked systematically into a position well behind the cutting edge of the industry.⁸

Thus, there is compelling evidence that inward FDI brings more benefits to developing countries than governments generally recognize, and more than they can engineer through regulatory intervention.

Much the same is true of many developed countries. Indeed, there are now many countries around the world with publicly available data that allow researchers to track the performance of companies acquired or established by foreign multinationals. The richness of many of these data sets has allowed researchers to benchmark performance against both industry averages for similar companies that were purely domestic, and also, in the case of an acquired company, against trends pre-transaction. Here is a summary of important studies, by country, data, and crucial findings.⁹

⁸ Ibid. p. 32.

⁹ The study of Denmark is Carmine Gioia and Steen Thomsen, "International Acquisitions in Denmark, 1990–1997: Selection and Performance," *Applied Economics Quarterly*, No. 1, 2004, pp. 61–88. The study of Indonesia is Robert Lipsey and Fredrik Sjöholm, "Foreign Firms and Indonesian Manufacturing Wages: An Analysis with Panel Data," National Bureau of Economic Research Working Paper No. 9417, January 2003. The study of Italy is Lucia Piscitello and Larissa Rabbiosi, "More Inward FDI? Medium-Term Effects of Foreign Acquisitions on Target Company Productivity," *Applied Economics Quarterly*, No. 1, 2004, pp. 21–40. The study of Norway is Ragnhild Balsvik, "Foreign Direct Investment and Host-Country Effects," Norwegian School of Economics and Business Administration, 2006. The study of Portugal is Rita Almeida, "The Effects of Foreign Owned Firms on the Labor Market," Institute for the Study of Labor Discussion Paper No. 785, May 2003. Finally, the studies of the United Kingdom are Martin J. Conyon et al., "The Productivity and Wage Effects of Foreign Acquisitions in the United Kingdom," *Journal of*

- *Denmark*: Companies from all sectors, 1990–97. The relative performance of firms acquired by foreign parents improved after takeover.
- *Finland*: Manufacturing plants, 1988–2001. Foreign ownership raised the productivity of acquired plants by an average of about 10 percent, and also raised worker wages by about 4 percent within three years of acquisition.
- *Indonesia*: Manufacturing plants. Large increases in average wages after foreign takeovers of domestic plants contrasts with no statistically significant wage increases after domestic takeovers.
- *Italy*: Manufacturing companies over the 1990s. Foreign acquisitions raised labor productivity of target firms, and these gains did not come via employment reductions.
- *Norway*: Manufacturing companies, 1979–2000. Foreign owners tended to reverse a negative trend in productivity and employment in acquired plants. Productivity growth reversed from an annual average of about -1 percent to about +3 percent. Employment growth reversed from an annual average of about -2 percent to about +2 percent, thanks to less gross job destruction and more gross job creation.
- *Portugal*: Companies from many sectors, 1991–98. Wages rose after foreign acquisition, by somewhere between 3 percent and 13 percent.
- *United Kingdom*: Manufacturing companies, 1989–94. After two years, firms acquired by foreign companies exhibited an average increase in labor productivity of 13 percent and increase in wages of over 6 percent. In addition, manufacturing plants acquired by U.S. multinationals over the 1990s subsequently increased the productivity of their IT capital.

Consistent with the U.S. evidence, in many countries around the world plants and/or companies acquired or established by foreign multinationals subsequently tend to enjoy faster growth in employment, wages, investment, and productivity. This seems to be true even in the poorest countries on the planet; there, too, foreign multinationals tend to bring new ideas, capital, and technology that allow them to pay above-market wages.¹⁰

Industrial Economics, 50(1), 2002, pp. 85–102 and Nick Bloom, Raffaella Sadun, and John Van Reenen, “Americans Do I.T. Better: U.S. Multinationals and the Productivity Miracle,” National Bureau of Economic Research Working Paper No. 13085, 2007.

¹⁰ Dirk Willem te Velde and Oliver Morrissey, “Foreign Ownership and Wages: Evidence from Five African Countries,” Centre for Research in Economic Development and International Trade, 2001.

Country case studies complement these econometric studies. Consider Ireland. Over the past generation it enjoyed some of the world's fastest GDP growth. Today Irish per capita GDP is among the highest in the world, at about \$46,000. This astonishing growth success was driven largely by a surge in inward FDI—and thus in technologies and capital investment—concentrated in high-technology sectors like computers and pharmaceuticals. Much of this investment was American. In 2005, majority-owned foreign affiliates of U.S. multinational firms accounted for 18.5 percent of total Irish GDP. At the same time, subsidiaries of U.S. firms accounted for about 75 percent of employment generated by Irish manufacturing affiliates of foreign companies.

Evidence that the best practices of multinationals spill over to the broader economy comes from the McKinsey Global Institute (MGI), which has examined hundreds of firms and industries in countries ranging from the United States to India. A repeated finding is that exposure to “global best-practice firms” via trade and FDI stimulates productivity, and conversely that protection from global best-practice retards it. A clear statement of this globalization-to-productivity link appears in a work by Nobel laureate Robert M. Solow and former chairman of the Council of Economic Advisers Martin Neil Baily:

A main conclusion of the studies ... has been that when an industry is exposed to the world's best practice, it is forced to increase its own productivity. This finding emerged from a study that compared nine manufacturing industries in the United States, Germany and Japan. For each industry, the country that had the highest labor productivity in that industry was designated as “best practice,” leaving 18 industries-country pairs that were below best practice. For each of these “follower” industries, a “globalization index” was calculated, reflecting the exposure of this industry to the best practice industry [via trade and FDI]. The relative productivity levels of the follower industries were then correlated with the globalization index, and there was a clear positive correlation. This positive correlation is consistent with the view that the more a given industry is exposed to the world's best practice high productivity industry, the higher is its relative productivity (the closer it is to the leader). Competition with the productivity leader encourages higher productivity.¹¹

¹¹ Martin Neil Baily and Robert M. Solow, “International Productivity Comparisons Built from the Firm Level,” *Journal of Economic Perspectives*, Vol. 15, No. 3, Summer 2001, pp. 151–72.

THE BENEFITS OF FDI OUTFLOWS TO SOURCE COUNTRIES

Source countries also gain important economic benefits from their FDI outflows. Importantly, these outflows enhance the competitiveness of their multinational parent companies by allowing them to better serve foreign markets. And these outflows can also complement important parent activities such as exports.

When most people contemplate how companies serve foreign markets, exporting is commonly the first (and often only) mode that comes to mind. But multinational companies can also serve foreign markets via host-country affiliate sales. Indeed, servicing foreign markets via subsidiaries is the more common strategy. In 2005, the most recent year for which data are available, U.S. parents of U.S. multinationals exported \$456 billion in goods to foreign markets.¹² But that same year their majority-owned affiliates sold \$2.998 *trillion* in goods. This means that in 2005, for every dollar in parent exports to foreign markets, their affiliates sold \$6.58 in these same foreign markets. Moreover, this relative importance of affiliate sales has been rising over time: In 1991 there was \$2.58 in affiliate sales for every dollar of exports.

This high and rising importance of affiliates for accessing foreign markets means that FDI restrictions in host countries directly hamper the competitiveness and profitability of these firms. Indeed, in recent years many U.S. multinationals across the full span of industries—Caterpillar, General Electric, General Motors, Goldman Sachs, Wal-Mart—have announced moderate to poor growth in sales and profits in their U.S. markets that are strikingly juxtaposed with very strong growth in sales and profits abroad.

THE BENEFITS OF FDI FLOWS TO THE GLOBAL ECONOMIC SYSTEM

For several years running, the global economic system has exhibited large and often growing imbalances in countries' trade in goods and services and thus in offsetting asset transactions.

¹² Ray Mataloni, "Operations of U.S. Multinational Companies in 2005," *Survey of Current Business*, November 2007, pp. 42–64.

The United States is particularly instructive here. Every year since 1976, the United States has run a trade deficit with the rest of the world; that is, the value of U.S. imports of goods and services from the rest of the world has exceeded the value of U.S. exports of goods and services to the rest of the world. The main economic cause of this trade deficit has been low U.S. national savings relative to U.S. national capital investment. This trade deficit is closely related to the current-account deficit, which equals the trade deficit plus net transfers to the rest of the world and net income flows from international asset holdings. In 2006, the U.S. current-account deficit reached a record high of \$811.5 billion.

To finance this excess of imports over exports of goods and services, each year the United States must, on net, sell an equivalent amount of assets to the rest of the world. So, in 2006, the United States needed to sell \$811.5 billion worth of U.S. assets to foreign investors.¹³

What assets were sold? Some were “portfolio” assets such as U.S. Treasury securities, corporate stocks, corporate and other bonds, and bank loans and other bank liabilities. But another important type of asset transaction that can finance the current-account deficit is the sale of entire U.S. companies to foreign buyers. These cross-border merger and acquisition (M&A) transactions offer two important advantages relative to the sale of portfolio assets. One is the productivity benefits of multinational companies discussed earlier in this section. Portfolio investments, by contrast, do not bring the control that is typically required for the transfer and implementation of ideas, technologies, and best practices. The other important advantage is stability. It is well documented that FDI is a less volatile form of international capital flow than portfolio investment, thanks to the long-term focus that typically motivates M&A decisions. Accordingly, FDI is less prone to sudden swings in investor sentiment that can disrupt currency or bond markets. Such swings can have large impacts on the real economy in terms of output and employment.

Global current-account imbalances are more easily financed and sustained if deficit countries allow foreign investors to purchase as wide a range of assets as possible.

¹³ A detailed discussion of the economic forces that give rise to current-account imbalances can be found in chapter six of Council of Economic Advisers, *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, 2006).

Bilateral China-U.S. investment patterns are a prime example of this. At year-end 2006, Chinese holdings (both official and private) of U.S. Treasury securities were valued at \$439.1 billion. In contrast, at that same point, companies with parents headquartered in China (either mainland or Hong Kong) owned U.S. assets worth just \$4 billion (valued at historical cost).

The macroeconomic benefit of FDI flows is clear. To reduce the probability of a disorderly drop in demand for a country's assets, it should maintain an open FDI regime. Restricting inward FDI flows makes it harder to finance a given current-account deficit at current prices and thus makes large and perhaps sudden currency movements more likely.

THREE REASONS WHY FDI POLICIES ARE CHANGING NOW

The examples in Section 2 document retrenchment and regression in the trend toward continued liberalization. Virtually all of the changes or proposed changes in foreign investment review regimes have been justified as a means to protect a country's national security. In the aftermath of September 11, 2001, in the United States, and more recently with tightening energy markets around the world, more governments have linked national security with regulation of foreign investment. And governments are extending such regulation to additional sectors of their economies.

Most countries have long had laws that limit or screen foreign ownership in the defense sector. In the United States, the Department of Defense and other agencies have for many years had significant discretion to limit foreign ownership of companies providing products and services to the Pentagon. In Germany, the Foreign Trade and Payments Act gives the German government the discretion to scrutinize foreign ownership of companies that produce or develop arms, ammunition, or war material or that handle classified information. Other European and developing countries have similar restrictions. China, for example, strictly limits foreign ownership of defense companies, while South Korea already bans investments in certain military industrial companies.

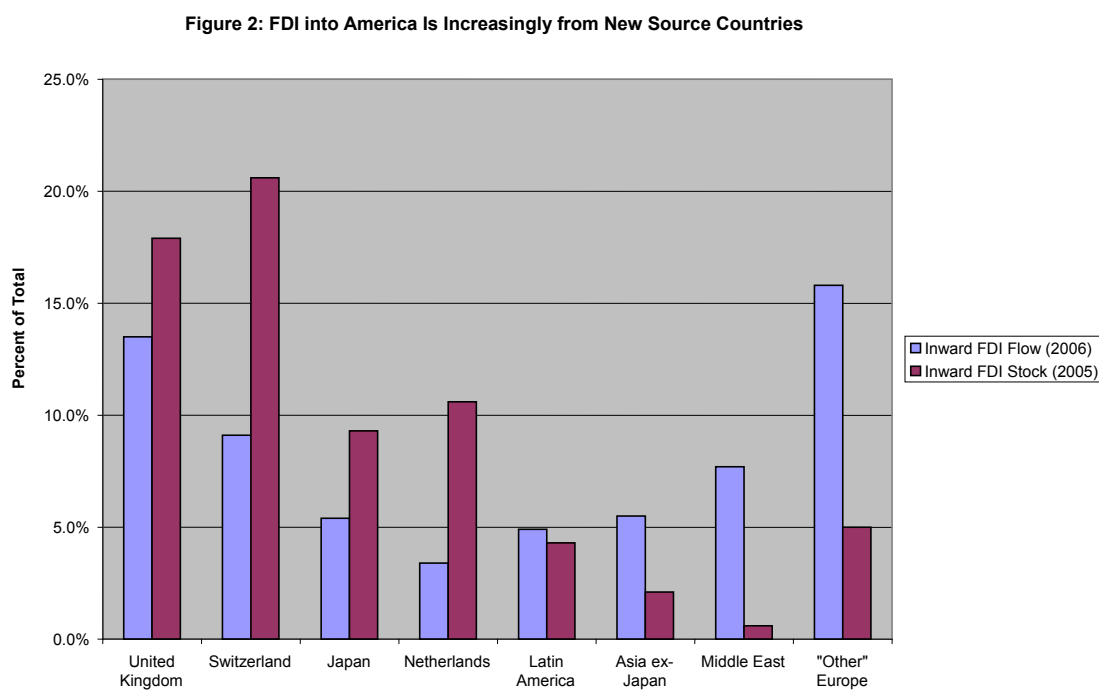
What is new is that countries are now expanding their concerns to new sectors, including "critical infrastructure" (United States, France, Germany, Japan); energy (United States, Russia, Hungary); encryption technology (Russia, Germany, France, Japan); and even gambling (France). In addition, China has expanded its scope of inquiry to include "economic security," a topic debated and rejected in the United States both during the 1988 passage of Exon-Florio and in the 2007 revisions to that amendment.

Individual countries have unique reasons for adopting new laws and regulations, based on their own security interests as well as the internal politics surrounding foreign investment. But there appear to be three common forces driving the new FDI policies: the emergence of new source countries and companies for investment; greater government ownership in multinational firms that are involved in cross-border investment; and the strong fiscal and overall economic positions of host countries.

NEW PLAYERS: NEW SOURCE COUNTRIES AND COMPANIES FOR FDI¹⁴

In the last four or five years, several new players have suddenly appeared as significant investors. Russian and Chinese companies, for example, only recently began pursuing large cross-border acquisitions.

Recent FDI inflows into the United States show this trend quite clearly. Figure 2 shows four countries and four country groupings. For each, two items are displayed. One is that country's share in the total asset stock of inward FDI in 2005. The other is that country's share of all new FDI inflows into the United States in 2006.



Source: U.S. Bureau of Economic Analysis.

The four countries on the left half of Figure 2 are traditionally large sources of FDI, as captured by their large stock shares. The four country groups on the right half of Figure 2 are traditionally small sources, as captured by their small stock shares. But notice the very different pattern for shares of new FDI inflows. Each of the four traditional countries has much smaller inflow shares than existing stock: together, 31.4

¹⁴ This subsection is taken from Matthew J. Slaughter, *Insourcing Mergers & Acquisitions*.

percent versus 58.4 percent. In contrast, the four nontraditional country groups have much larger inflow shares than stock: 33.9 percent versus just 12.0 percent. The evidence is clear: A rising wave of new multinational firms from new countries is investing in the United States.

Two major forces are driving the growth in FDI from new companies located in nontraditional countries. One is sustained, rapid economic growth based on tighter linkages to the world economy in countries such as China, India, and the formerly Communist countries of Central and Eastern Europe. This has fostered the emergence of world-class companies headquartered in these countries. These new multinationals are looking to expand into advanced countries like the United States for many reasons, such as exploiting new opportunities in the world's largest and most stable single-country market, or gaining greater access to American capital and technology. Bottom line: developing countries are becoming more important sources of FDI. From 2000 to 2006, global outward FDI from China grew 6.9 times, from Russia 5.9 times, and from some Gulf states more than 35 times.

The second major force driving the growth in FDI from new sources is the evolving pattern of global imbalances. As is well known, the U.S. current-account deficit has grown dramatically in recent years. Reaching \$811.5 billion in 2006, it now accounts for about 70 percent of the world's total across all deficit countries. At the same time, the number of offsetting current-account surplus countries has been increasing. Beyond traditional surplus countries like Japan, fast-growth countries such as China, Russia, and Saudi Arabia have assumed a larger financing role. As these new surplus countries expand their purchases of U.S. assets, some of these purchases are already—and will continue—taking the form of acquisitions of U.S. companies.

A recent survey in *The Economist* of new multinational firms in nontraditional countries described them as “globalization’s offspring.”

While globalization has opened new markets to rich-world companies, it has also given birth to a pack of fast-moving, sharp-toothed new multinationals that is emerging from the poor world ... These are very early days, of course. But the new multinationals are bent on the course taken by their counterparts in Japan in the 1980s and South Korea in the 1990s. Just as Toyota and Samsung eventually obliged western

multinationals to rethink how to make cars and consumer electronics, so today's young thrusters threaten the veterans wherever they are complacent ... Nobody said that coping with a new brood of competitors was going to be easy ... But [some of today's established multinational companies] will emerge from the encounter stronger than ever. And consumers, wherever they are, will gain from the contest.¹⁵

The growth of Indian multinationals is a good example. In 2006 outward M&A transactions by Indian multinationals totaled \$23 billion, more than five times the 2005 total and approximately twenty times the annual average since 2000 of about \$1 billion. And it is not just large Indian businesses undertaking foreign acquisitions. "Conditions are encouraging many smaller Indian businesses to buy globally, in pharmaceuticals, computing, car parts, energy, and so on. With gross domestic product (GDP) growth averaging 8 percent and efficiencies wrought in leaner times, Indian firms have been minting money in the past three years. Their average profit margins are around 10 percent—more than twice the global average. By one estimate, 60 percent of India's two hundred leading companies are looking to invest this loot in foreign purchases ... the tide of foreign acquisitions by Indian companies will continue to rise, with more and bigger deals."¹⁶

India's rising FDI outflows are being mirrored by many other countries and regions. The same is true of the Middle East, for example, thanks to "rising energy prices and a regional economic boom ... Middle Eastern firms and funds shopping around the globe have spent \$64 billion so far this year, compared with \$30.8 billion in all of last year and \$4.5 billion in 2004."¹⁷ The pace of investment from West Asia, including in the Persian Gulf, has accelerated rapidly. Brazilian and Mexican companies have also made substantial acquisitions recently.

These new players have changed the politics of foreign investment. The U.S. Congress, for example, has reacted negatively to several Chinese investments, as well as to the Dubai Ports transaction. European politicians have worried over Russian investment in the energy sector given the dependence in several European countries on Russian natural gas and the perception that Gazprom and other Russian companies are

¹⁵ "Globalization's Offspring," *The Economist*, April 7, 2007.

¹⁶ "Marauding Maharajahs," *The Economist*, March 29, 2007.

¹⁷ "As Oil Hits High, Mideast Buyers Go On a Spree," *Wall Street Journal*, September 21, 2007.

advancing the government's political objectives rather than the company's business objectives. This reaction to new FDI sources is not entirely new; for example, in the 1980s many in Washington opposed new investments from Japanese multinationals. But the recent surge in new players from new countries is notable.

MORE GOVERNMENT OWNERSHIP IN CROSS-BORDER FDI

Government ownership and control of companies making cross-border investments has been a second important force behind new FDI regimes. Just as the last three decades have been marked by the trend toward liberalization of FDI, there has similarly been a trend toward privatization, both in the developed and developing worlds. Britain privatized important segments of its economy under Prime Minister Margaret Thatcher, and other Western European countries have followed suit. Eastern Europe and Russia privatized rapidly following the breakup of the Soviet Union, and Russia's inward FDI grew from approximately \$8 billion in 2003 to almost \$28 billion in 2006. China has attracted between \$53 billion and \$73 billion in inward FDI over the past five years, most of it from privately owned companies.

But the last few years have seen expanded government control of companies in certain countries, notably Russia, and there has been a dramatic growth in sovereign wealth funds and increased foreign direct investment by government-owned companies. While sovereign wealth funds have been in existence for more than fifty years—the Kuwait Investment Authority was created in 1953—the number and size of such funds have sharply increased in the past five years with the rapid rise of oil prices and the exploding current account surpluses in countries such as China. Of the forty known SWFs in existence today, sixteen were created in the last seven years.¹⁸ Moreover, the size of these funds has grown dramatically. SWFs are now worth an estimated \$3.2 trillion, and some project that number will reach \$10 trillion by 2012.

As a result of the growing number and size of SWFs, as well as accompanying concerns about SWFs in some countries, certain governments have begun to put in place

¹⁸ Richard Cookson, "For a Few Sovereigns More," HSBC Global Research, February 2008.

tighter controls on acquisitions by state-owned companies—notwithstanding the fact that no one has pointed to a SWF investment that compromised national security in any country in the last five decades. In the United States, for example, FINSAs requires heightened scrutiny in CFIUS of acquisitions of U.S. companies by state-owned entities, including sovereign wealth funds. Canada and Australia are adding new factors for screening investments by government-owned companies. Even Russia, which hosts not only a new sovereign wealth fund but also some of the largest state-owned entities in the world, is set to place new restrictions on acquisitions by government-owned companies from outside of Russia. In addition to new restrictions, government officials' rhetoric against sovereign wealth funds has sharpened, which in itself can chill investment. In recent months, several well-respected sovereign wealth funds, Isthimar and the Kuwait Investment Authority, have said they feel unwelcome in both the United States and Europe and therefore will look to decrease their asset allocations to those places.

Moreover, investments from developing countries are more likely to be affiliated with government ownership than are cross-border investments from developed countries. In 2007, UNCTAD reported that of the top one hundred multinational companies in the world, only five are government-owned. By contrast, of the top one hundred developing-country multinational companies, twenty-five are government-owned. Since large multinational companies tend to be the biggest players in cross-border investments, investments from developing countries have a greater likelihood of foreign government ownership. Some of today's most prominent SWFs hail from countries with surging revenues from production of oil and other natural resources, and many funds aim to manage these revenues for sound goals such as intergenerational transfers. Despite their recent prominence, however, it is important to keep their size in perspective: Last year SWFs accounted for just 1.6 percent of all global M&A activity.

RISING OIL PRICES AND CURRENT ACCOUNT SURPLUSES

Rising oil prices and ballooning current-account surpluses are a third important factor in the decisions by at least two major recipients of FDI—Russia and China—to adopt tougher new FDI-review standards. Both Russian and Chinese foreign reserves have grown rapidly, and there is evidence that this has fostered a belief among some leaders that they now need less inward FDI given their extraordinarily large foreign reserve positions.

Russia has taken steps to enhance domestic control of the energy sector. China has recently rejected a number of investments by well-respected foreign companies and shown a growing preference for investments that bring new technology and technical benefits to the country. The experiences of these two major economies suggest that stronger economic performance—which itself has been much driven by inward FDI—can, paradoxically, lead policymakers to discourage rather than encourage additional inward FDI.

DO FDI POLICY CHANGES REPRESENT REDUCED OPENNESS OR GREATER CLARITY?

There are at least two ways to view the proliferation of new foreign investment review regimes. They could represent a clear drift toward protectionism and exclusion of foreign investors, or, on the other hand, they may simply provide greater clarity (“rules of the road”) for investors. Many in the press have fretted over what they see as a closing of markets for investment. Yet governments, when adopting these new rules, have rejected these assertions, arguing that the new rules clarify the procedures for seeking approvals for investment and therefore should give investors greater confidence.

The data clearly show that global FDI has grown in the last several years, even with the adoption or debate of investment restrictions, although global FDI in the first quarter of 2008 dropped precipitously. Investment from and to developed countries has grown, investment from and to developing countries has grown, and investment between developed and developing countries has grown. What is very difficult to measure is whether there has been a decrease in FDI in those areas that have recently been deemed sensitive, such as energy and transportation.

Consider the U.S. evidence. Even before FINSA became law, the CFIUS process tightened up in the wake of the February 2006 blowup over Dubai Ports World. The number of transactions filed with CFIUS increased from 65 in 2005 to 113 in 2006 (the spike occurred after the Dubai Ports controversy) to 147 in 2007. Similarly, the number of transactions that required a second-stage, or more in-depth, investigation also grew dramatically; in 2006–2007, there were thirteen second-stage investigations, more than in the previous fifteen years combined. The number of “mitigation agreements,” in which CFIUS imposed conditions in exchange for approving a transaction, spiked in 2006–2007; there were twenty-seven in those two years versus thirteen in the previous three. The growth in CFIUS investigations and mitigation agreements is compounded by an unknown number of instances in which companies abandon transactions rather than endure legal costs and delays. Ironically, the growth in the number of filings, investigations, and mitigation agreements occurred not after September 11, 2001, when

the security environment in the United States changed dramatically. Rather, the spike occurred after the Dubai Ports controversy, suggesting that the CFIUS's efforts to tighten the process were more related to institutional tensions with Congress—and the CFIUS agencies' desire to inspire congressional confidence in the process—than to a change in the security environment. Notwithstanding the costs associated with a dramatic spike in the number of CFIUS reviews, the Treasury Department correctly argues that no transactions were formally blocked during these years. President Bush has been clear in his support of inward FDI. In May 2007 he issued a Statement on Open Economies, the first such presidential statement since 1991, acknowledging the critical contributions of inward FDI to the U.S. economy. And new FDI flows into the United States have grown strongly in recent years, from a 2003 trough of \$63.6 billion to \$161.5 billion in 2006 and likely more than \$200 billion in 2007 (though still well below the 2000 record of \$335.6 billion). On balance, then, it is difficult to quantify from publicly available data the extent to which heightened scrutiny has slowed FDI inflows. But the existence of some chilling effect seems probable.

The evidence is similarly mixed for other countries. In France, the number of investments reviewed increased from twenty-five in 2005 to thirty-one in 2006, the first year of the new regulations. But most of these reviews were confined to the defense sector and the French government reportedly did not block any deals.

One reason it is difficult to see clear impacts of new FDI rules may be that world FDI flows have pronounced waves, most recently with the post-2003 surge in FDI after the sharp downturn from 2000–2003. Another reason may simply be that it is too early to tell. It is well known that the lion's share of new FDI flows is accounted for by acquisitions of existing companies rather than by new “greenfield” investments. From 1987 to 2006, the United States received a total of \$2 trillion in new FDI. Of this amount, \$1.78 trillion—fully 88.8 percent—was for acquisitions, versus just \$220 billion for businesses established. This pattern holds true around the world: each year since 2000, mergers and acquisitions have accounted for somewhere between 67.1 percent and 83.5 percent of total global FDI inflows.¹⁹ With the capital-market turmoil that started in August 2007, however, the world's most recent FDI and M&A wave appears to have

¹⁹ These statistics come from Matthew J. Slaughter, *Insourcing Mergers & Acquisitions*.

crested. Forecasts suggest sharp declines in 2008 and perhaps beyond, and indeed, global FDI in the first quarter of 2008 dropped precipitously. In the first quarter of 2008, overall FDI fell 42 percent year over year. New FDI restrictions imposed during a period of broadly falling FDI flows may have more impact than during a period of robust investment.

The reaction of important parts of the business community in various countries is also informative. In the United States, passage of FINSA was welcomed by leading business organizations, including the U.S. Chamber of Commerce and the Organization for International Investment, which represents many of the biggest foreign investors in the United States, not because the business community wanted new regulation of FDI but rather because of the business community's view that passage of FINSA would improve the increasingly hostile political environment surrounding FDI. In Russia, the American Chamber of Commerce urged passage of the new foreign investment laws primarily because they would create greater predictability and clarity for foreign investors. Companies that have bought sensitive assets in Russia have raised concerns about the ad hoc process that exists today for foreign investments. Therefore, they welcome the new rules in Russia since they will provide a timeline under which proposed investments will be reviewed and greater clarity around the criteria. In Germany, however, the business community has reacted negatively to the proposed new regulations. The Federation of German Industries has argued that the government has not justified the need for additional investment restrictions, and that existing laws and regulations adequately protect national security.

Anecdotal evidence plus interviews and discussions with government officials, investment advisers, and companies that have pursued recent investments in strategic sectors suggest three conclusions to date on the impact of new regulations on FDI inflows.

First, the majority of foreign investment has been and will continue to be unaffected by the new rules and regulations. Most governments are not increasing scrutiny of foreign investments in big sectors such as real estate or retail sales.

Second, in those sectors considered "strategic" or deemed to affect national security, transactions are being subjected to more scrutiny. This is clear in the United

States and France, for example, and appears to be the case in Russia, where a number of foreign investors have lost control over, or have been forced to sell, interests in energy-related assets.

Third, the number of investments facing review has increased as governments have broadened their scope of inquiry beyond the defense sector, which was traditionally the focus of regulations restricting foreign investment. In various countries, the affected sectors now include critical infrastructure or technology, energy, water, transportation, and companies that control dual-use technologies. It is this broadening of sector coverage that poses the greatest potential for chilling actual FDI inflows.

On balance, it seems that many of the recent changes in FDI policies do in fact constitute the start of a protectionist drift. At a minimum, the shifts clearly demonstrate a more regulatory approach toward FDI. To date, this protectionist drift has not evidently led to a contraction in global FDI flows, which continue to be influenced primarily by economic factors rather than by government regulatory measures. But in certain countries and industries, this drift has led to some proposed transactions being denied, and has curtailed other potential investments through an indirect but still important “threat” effect. Thus, at the margins, these policies have discouraged FDI flows.

They have also impaired the quality of some FDI transactions above and beyond aggregate transaction values. New policies that mean longer, more complex, and more regulated transactions can mean that the deals that result are less beneficial economically than they would have been without such restrictions.

POLICY RECOMMENDATIONS

This report has documented the recent rise in FDI policy changes around the world, discussed how many of these policy changes are already or have the potential to become protectionist restrictions, and explained the economic costs of rising FDI barriers. It is still too early to tell to what extent new and/or contemplated regulations will slow global FDI flows. But many countries are already experiencing new FDI frictions in terms of more government involvement and scrutiny of a discrete set of investments. Such reviews themselves can shape the duration, price, and ultimately the viability of FDI transactions. Looking ahead, an even stronger protectionist drift in FDI policy could exacerbate the ongoing turmoil in global capital markets, with widespread consequences for the real economy in many countries.

This closing section offers two sets of policy recommendations, one at the level of individual countries and the other at the level of intergovernmental bodies.

FOUR PRINCIPLES TO GUIDE NATIONAL FOREIGN-INVESTMENT-REVIEW MECHANISMS

Every government has the right and responsibility to protect its own national security, and countries have long seen a nexus between certain foreign investments and national security. With the growth in global FDI, new players making significant foreign acquisitions, and increased investment by government-owned entities or sovereign wealth funds, it is inevitable that political pressures will develop in favor of restricting foreign investment. In one sense, a narrowly tailored, well-crafted, and effectively implemented national security review regime could actually facilitate additional FDI by reducing protectionist pressures while building confidence that national security is being protected.²⁰ In the Dubai Ports World case, the lack of congressional confidence in the

²⁰ The OECD has done very good work in this area and has produced a different set of principles. See also *Sovereign Wealth Funds and Recipient Country Policies*, OECD Investment Committee, spring 2008, and OECD Roundtable VI on Freedom of Investment, National Security, and “Strategic” Industries, December 13, 2007, available at <http://www.oecd.org/dataoecd/53/55/40034426.pdf>.

existing CFIUS process made it easier for critics to denounce the transaction and accuse the administration of ignoring its security consequences; with Congress now having endorsed a new law, it will be harder for critics to claim that the review process is in some way fundamentally flawed.

In addition to the new national security review mechanisms discussed in this report, the U.S. Treasury, the European Union, the IMF, and others have proposed establishing a code of conduct for sovereign wealth funds. This could help to reduce growing political pressures for broader restrictions. If SWFs abide by general rules that are agreed upon by the host countries, it will be more difficult for their critics to allege that such investments jeopardize security or other national interests.

While such regulatory and oversight measures are important for building public confidence and reducing protectionist pressures, there is an equal danger that regulation in the name of national security could become a pretext for blocking or restricting investments that do not implicate real national security interests. Therefore, investment recipient countries should adopt a code of conduct that embodies the following four principles.

Principle 1: The investment review law should be narrowly tailored and focused on national security and not on economic factors.

One of the fundamental principles of international trade and investment agreements over the past fifty years is that any restrictions should be the least that are needed to achieve the government's objective. This principle should apply today to the new foreign investment regimes being debated and enacted. Government restrictions on foreign investment should be limited to those problems that the market itself cannot prevent, such as anticompetitive impacts or threats to national security.

Governments should refrain, however, from reviewing transactions for their economic, as opposed to national security, impacts because such inquiries could easily devolve into actions to restrict investment for protectionist reasons. China's new regulations authorize reviews of foreign investments based on principles of economic

security. Canada's new guidelines for foreign investments by state-owned enterprises include consideration of, among other things, the investor's plans with respect to exports, manufacturing, and capital expenditures. Again, unless national security, competition, or some other market failure is addressed, these decisions should be left to investors, not governments.

Why is this important? It is important because investors make decisions based on the prospect of risk-adjusted returns. If the assessed risk increases, so must the projected returns. Government scrutiny of investments by definition raises risk, and therefore if governments unnecessarily get involved in reviewing investments, investment flows could diminish.

To be clear, this is in no way to argue that governments should not protect legitimate interests, including national security. They should. Rather, investment review laws should be as narrowly tailored as possible in order to avoid chilling investment in transactions that do not raise national security or other governmental interests.

Principle 2: The investment review process should provide predictability to transaction parties by ensuring that reviews will be conducted within a definite timeframe.

With the exception of price, few other factors are more important for investors than the speed with which a transaction can close. Investors frown on uncertainty, and the longer a transaction takes to close, the greater the uncertainty. In the time between the signing and closing of a transaction, business fundamentals could change, senior executives could depart, and competitors could introduce new products and services. Thus, in order to avoid chilling investment, foreign-investment review mechanisms should include short and defined time periods during which the investor is guaranteed to receive a decision from the government.

In the United States, most reviews are completed in thirty days, with the possibility for CFIUS to take another sixty days for the more difficult cases. The proposed new Russian law contemplates ninety-day reviews for most transactions with the possibility of additional time for complex investments, creating the potential for

lengthy delays before deals can be completed. The draft German regulations have been criticized because the government similarly has up to three months to act, creating uncertainty during those ninety days. Based on discussions with government officials, lawyers, and investment advisers, most transactions filed with authorities do not raise complex national security issues. In general, therefore, review mechanisms should be designed to facilitate reviews of most transactions in a very short period of time—say thirty days—while giving governments additional time to review transactions that raise novel or particular complex national security issues.

Principle 3: The investment review process should ensure confidentiality to the transaction parties.

Strict confidentiality within an investment review mechanism is essential to create confidence that data and information provided to governments will be protected from the public and competitors. Investment review authorities frequently ask for inventors' plans, customer lists, and personnel and technical information. It is critical to ensure parties have confidence in the government and its regulatory mechanisms and can trust that confidential business and proprietary information will not be compromised. Furthermore, given the nature of national security-based investment reviews, confidentiality is imperative to preserve the interests of the government. The United States has faced particular difficulties in maintaining confidentiality of its reviews, particularly in high-profile cases such as the 2003 effort by Hutchinson Whampoa Limited of Hong Kong to acquire Global Crossing that was withdrawn under CFIUS scrutiny, the successful acquisition of IBM's personal computer business by Lenovo of China in 2005, and the failed Bain/Huawei bid for 3Com earlier this year.

Principle 4: Countries should avoid sector-based lists for determining transactions requiring investment reviews or, as a second-best alternative, should draft such lists as narrowly as possible.

Some countries, including the United States and (if it adopts its new draft law) Germany, use broad-based national-security review mechanisms without identifying specific sectors for which reviews are required. Other countries, including France and Russia, have chosen a sector-based approach in which they identify the sectors that require government approval for foreign takeovers.

There are benefits and drawbacks to each approach. Sector-based lists can provide a measure of clarity and predictability for foreign investors because they know with certainty whether an investment requires pre-approval. In the United States, the lack of a sector-based list leaves some investors and their advisers guessing as to which transactions should be filed with CFIUS. FINSA, the new statute governing CFIUS, makes clear that foreign investments in “critical infrastructure” are within the scope of CFIUS reviews. Yet the statute does not define critical infrastructure, and in four different reports in recent years the Department of Homeland Security has used four different definitions. On the other hand, publishing a sector-based list is very difficult for regulators because the facts and circumstances in which a foreign investment may raise national security issues vary significantly. Moreover, the ever-increasing complexity of global business structures makes it very hard to apply clear ex-ante lists to actual transactions. In practice, then, a list that is intended to boost investor certainty can end up actually reducing it.

Overall, the possible investor-certainty benefit of sector-based lists is outweighed by the practical implementation problems of sensibly creating and applying these lists. Accordingly, countries should not create such lists. If a government does choose to create a sector-based list, however, it should be tailored to those transactions that are at the core of a government’s national security interests. When drafting a sector-based list, regulators—who tend to be cautious and conservative in the first place—may be inclined to draft an extremely broad list that covers every conceivable transaction that could raise national security issues. This tendency should be resisted. For example, while foreign

investments in energy have become more sensitive and of greater interest to governments in Europe, Asia, and North America, not all energy investments are sensitive. A government has a keen and legitimate interest in regulating nuclear energy, including who owns a nuclear energy company. Alternatively, it is hard to see how a foreign investment in, for example, a wind farm could raise national security issues. Thus, instead of deeming energy as a broad sector of interest to government regulators, it would be better to identify, as narrowly as possible, those specific subsectors that raise national security concerns.

RECOMMENDATIONS FOR INTERGOVERNMENTAL ORGANIZATIONS

The previous section laid out four principles to guide a country's FDI-review regime. But intergovernmental forums can also help to support sound FDI policies. This report closes by recommending roles for three essential institutions: the OECD, the IMF, and the G8.

The OECD has a long-standing comparative advantage at documenting and analyzing member-country best practices—for example, its ongoing work on labor-market policies and, more recently, on policies to support long-run economic growth. Building on these strengths, the OECD should institute a similar program for FDI policies that spans not just all OECD members but also important nonmember recipient countries such as China, India, and Russia. This new program should receive attention not just at the senior staff level but at the ministerial level as well, to support a peer-review process to help countries incorporate best practices. Part of this OECD effort should include data collection. The OECD should create and maintain a database to house information supplied by participating countries on items including the number of FDI reviews, the transactions on which conditions were imposed, and the number of transactions that were blocked by the government or in which the prospective acquirer withdrew. The database should also contain information on the industries that triggered reviews and the countries from which prospective investments originated. One of the difficulties in assessing the impact of the contemplated FDI regimes is the lack of quantitative and qualitative data on FDI reviews. Governments simply do not publish these data, and they should.

The IMF includes both prominent source and destination countries for FDI flows. Consistent with its recently initiated efforts to generate conduct guidelines for sovereign wealth funds, the IMF can similarly work toward guidelines on FDI policies directed at state-involved enterprises. These guidelines could broadly accord both with our four principles above and with the SWF goals of encouraging investments for economic rather than political reasons, of providing transparent information on broad investment philosophies (without divulging competitive secrets), and of providing transparent information on governance and decision-making methods. In practice, these IMF activities would complement the OECD activities just described.

Finally, meetings of the G8 nations—and related broader meetings with additional countries—can reinforce the core messages of sound FDI policies. The regularity and high level of these meetings can make them especially useful as another venue to amplify and endorse the efforts both of individual countries and of the OECD and the IMF as just outlined.

At this time, it does not make sense to try to craft a binding multilateral agreement on FDI policies. While a binding agreement would offer foreign investors greater certainty than currently exists, at the moment the risks outweigh the potential benefits. The OECD attempted to foster such a deal in the 1990s when it launched negotiations on a Multilateral Agreement on Investment, and more recently the WTO has attempted something similar with its Multilateral Investment Agreement initiated in Cancun in 2003. Although well-intentioned, these efforts failed because of disagreements over the central topics, including the nature of negotiations themselves and the enforceability of any rules on multinational companies and/or governments. There is little prospect for new multilateral agreements, both because of the stalemate in the WTO's Doha Development Round and because of the earlier-discussed widening opposition to globalization. An ambitious effort to negotiate new, binding arrangements in the current political environment is likely instead to produce a backlash that increases rather than decreases the drift towards protectionism.

In the absence of a binding multilateral agreement, the mechanisms for discouraging countries from introducing new restrictions on foreign investment are necessarily limited. The OECD has been, and should continue to be, a forum for

generating peer pressure on its members to adopt sound practices with regard to the review of foreign investment. These informal pressures have helped to convince most countries that maintaining an open door to FDI is valuable to their own countries. In order to encourage such openness, finance ministers from the countries involved in international investment should meet annually to discuss and refine the four principles outlined above.

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