Regulatory risk and the growth of FDI

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Introduction

Almost every week, if not every few days, one can read that the laws and regulations governing foreign direct investment (FDI) in some country have been changed to make them more welcoming, that another investment promotion agency (IPA) has been set up, and that FDI into some country has broken another record. World FDI inflows were US$1.3trn in 2006 and are expected to reach US$1.5trn in 2007 (just above, in current US dollar terms, the all-time high of US$1.4trn in 2000). They are predicted to increase further over the next five years, albeit at slower annual rates than during the recent recovery in global FDI (see the article by Laza Kekic elsewhere in this volume). As discussed below, the economic and other forces driving FDI upwards continue to be very strong.

At the same time, however, one can also read that a crossborder merger and acquisition (M&A) is being questioned or blocked, a contract between a multinational corporation (MNC) and a host country is being renegotiated or cancelled, or laws and regulations are being introduced that make the business environment less hospitable for FDI.[1]

Are these restrictions straws in the wind or do they indicate a storm in the making? Will the forces that drive the expansion of FDI continue to trump the risks, especially the political and regulatory risks that may slow down drastically or even stop the growth of FDI flows?

The pressure of competition

The growth of FDI is driven by the interests of MNCS and those of host- and home-country governments. All firms are subject to the pressures of globalisation. As a result of the liberalisation of international economic transactions in recent decades and improved communication technologies, global competition has intensified. This puts considerable pressure on firms to internationalise, including through FDI. MNCs are motivated to establish a portfolio of locational assets to secure competitive advantage. They are driven to invest abroad to have better access to resources (including skills and technology) and to be close to their markets. No wonder, then, that the number of MNCs has multiplied in recent decades (the total number of MNCs in the world is about 80,000). The pressures of globalisation will continue to drive firms to invest abroad to develop their own portfolios of locational assets, driving up global FDI.

Host countries still seek FDI

Host countries are interested in the tangible and intangible assets that FDI represents, outweighing whatever negative effects are associated with it. These assets include capital and, even more important, skills, technological know-how and access to markets (often in combination with brand names). The latter is particularly important for countries that pursue an export-oriented development strategy, as it is extremely difficult to break into highly competitive markets, especially in the developed world.

Today, almost all countries in the world seek to attract FDI and they pursue increasingly similar strategies in this respect. The most basic strategy has been, and continues to be, to make the regulatory framework for FDI more welcoming. This includes, first of all, opening more sectors to foreign investment. Out of 2,349 changes in national FDI laws between 1991 and 2005, 92% were in the direction of creating a more favourable climate for foreign investors.[2]

The bulk of manufacturing in an overwhelming number of countries is now open to FDI. Natural resources are less so, but MNCs have access through various non-equity forms. Even the services sector—which, traditionally, has contained many activities that are off-limits for foreign investors—has

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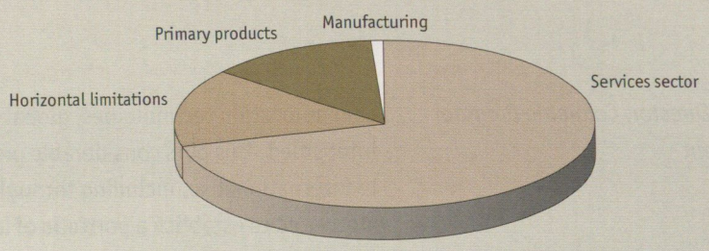
1. Even the G8 leaders, at their June 2007 summit, warned of an increased tendency towards FDI protectionism.

2. UNCTAD, *World Investment Report 2006: FDI from Developing and Transition Economies. Implications for Development*, Geneva, 2006, p. 23.

Reservations on investment, by economic sector, selected international investment agreements (a)
(share of total)



(a) The agreements are: the Andean Pact (Decision 510); the Canada-Chile and US-Chile Free-Trade Agreements; the Agreement between Columbia, Mexico and Venezuela; the Mercosur Colonia Protocol; NAFTA; the OECD National Treatment Instrument; and the draft OECD MAI.
Source: UNCTAD, Preserving Flexibility in IIAs: The Use of Reservations, Geneva, 2006, p. 40.

increasingly been opened, although (compared especially with manufacturing) many restrictions still apply.[3] Nevertheless, the liberalisation trend has been clear, indeed overwhelming.

To strengthen and make more credible the improvements of the national regulatory framework, 174 countries had concluded 2,572 bilateral investment treaties (BITs) by the end of 2006.[4] They enshrine key protection standards in legally binding international agreements. Increasingly, moreover, preferential free-trade and investment agreements also include various investment protection standards and sometimes prescribe further liberalisation of the investment framework; as of the end of 2006, 241 such agreements had been signed.[5]

Economic determinants

A country's regulatory framework needs to be enabling and investment promotion can help. However, whether FDI will be undertaken will in the end depend mainly on economic factors such as market size and growth; the quality of infrastructure, skills and the

3. An indication of the uneven liberalisation process and the room that still exists in this respect as regards services is the distribution of reservations in international investment agreements (IIAs) across sectors: out of 4,806 non-conforming measures scheduled in eight IIAs, close to three-quarters (71%) of them relate to services; that number is almost six times higher than the number of reservations for primary sector industries and 70 times higher than that for manufacturing industries (see chart). UNCTAD, *Preserving Flexibility in IIAs: The Use of Reservations*, Geneva, 2006, pp. 39-40.

4. See, UNCTAD, "International investment rulemaking", TD/B/COM.2/EM.21/2 (May 22nd 2007), mimeo, p. 3. Relevant are also double-taxation treaties (DTTs) not discussed here; 2,651 such treaties existed at the end of 2006; see *ibid*.

5. *Ibid*., p. 4.

Attracting FDI: beyond mere liberalisation

The great majority of countries have gone beyond liberalisation by protecting and actively seeking to encourage foreign investors to enter their markets. The instruments of choice of this second generation of investment promotion strategies are investment promotion agencies (IPAs); investment guides and websites; and especially incentives. IPAs of one kind or another have been established in the great majority of countries during the past decade. Although highly uneven in terms of size, competence and effectiveness, they all try actively to attract foreign investors within the context of a liberalised foreign direct investment (FDI) framework. They do this by, among other things, building a positive image of their countries in the investment community, undertaking "road shows", providing after-investment services to existing investors and, increasingly, engaging in policy advocacy.

The role of incentives

Most IPAs also make use of financial, fiscal or other (including regulatory) incentives. In fact, all indications are that incentive competition is becoming stronger, especially as far as taxes are concerned. How effective incentives are in swaying investors is very much debated, but unless the key economic determinants are favourable, they may frequently be only icing on the cake. This may be particularly the case for natural resource and market-seeking investors, as for them the major attractions are clear. It may be less the case for efficiency-seeking investors, especially when they produce goods or services for the world market for which alternative, equally attractive, investment locations are available. Incentives that bring in flagship investors (the attraction of which could entice other investors to follow suit) may be useful; this is particularly the case for locations that are not yet prominently on the radar screen of investors. Regardless of what the overall effectiveness of incentives is, unless a multinational agreement is reached to tame incentives competition (and such an agreement is not even in sight in the foreseeable future), the use of incentives will increase and, at least at the margins, help to attract FDI.

technology base; and the availability of natural resources in host countries (see the FDI determinants model elsewhere in this volume).

Home countries encourage outward FDI

What about home-country governments and their interests? Developed-country governments support outward FDI in the interest of the international competitiveness of their firms. They provide, for example, information about investment opportunities, finance feasibility studies, conclude bilateral treaties for the protection and promotion of FDI (as well as the avoidance of double taxation), and offer insurance for outward FDI projects.

Some emerging markets have begun to follow suit, be they small countries such as Singapore (which wants to create, through outward FDI, an "external wing" of its economy), or large ones such as China (with its "Go Global" policy). For example, most recently the vice-minister of the National Development and Reform Commission of China, Zhang Xizoqiang, indicated that Chinese government entities will provide diplomatic, foreign-exchange, tax, customs, credit, insurance and other support to Chinese firms investing abroad in target industries.[6] Most emerging markets, however, do not yet have a coherent set of policies in place on outward FDI. Yet, where their firms are successful in international acquisitions, there are visible expressions of national pride. Many countries are likely to continue to support their firms' expansion abroad, thus increasing the likelihood that investment flows will grow.

Potential sources of FDI

What are the main sources of future FDI? There are, first of all, the traditional MNCs, that is, the firms that are already established abroad. Quite a number of them already have a high share of their assets abroad, but most can be expected to continue to expand. That is even more the case for firms that have only a moderate share of their assets abroad, the low-level transnationalisers, and firms that are not yet transnational at all (including most small and medium-sized enterprises—SMEs).

The services sector

Firms in the services sector are a particularly important source of future FDI, as these firms are considerably less transnational (in terms of the share of their assets abroad) than industrial firms. Moreover, since most services are still not tradeable, if services firms want to expand abroad, they need to do that via FDI. In fact, services firms have dominated outward FDI flows in recent years, indicating that the catch-up process with industrial firms is in full swing—and the chances are that it will continue. The growth of offshoring services functions will be particularly important here.

Emerging market MNCs

Another key pool of potential FDI consists of firms headquartered in emerging markets. FDI outflows from these economies have risen considerably over the past 25 years, from negligible amounts at the beginning of the 1980s to, according to Economist Intelligence Unit estimates, US$160bn in 2005 and US$210bn in 2006 (see p. 28). An estimated 20,000 MNCs are now headquartered in emerging markets. Most of them have the potential to become much more transnational. There are many more firms that have not yet taken the first steps abroad, but are likely to do so in the future. As emerging markets grow, therefore, they will not only become more attractive for inward FDI, but increasingly also become sources of more outward FDI.[7]

Sovereign investment agencies

The sovereign investment agencies (SIAs) of a number of countries—that is, investment vehicles of governments (see Table 1)—could potentially have a considerable impact on FDI flows. Such entities are not new. Perhaps the oldest is the Kuwait Investment Authority; it has substantial holdings in a number of companies, including Germany's DaimlerChrysler. Another well-known example is Singapore's Temasek Holdings; it bought, for example, Shin Corp. (Thailand) for US$3.8bn. The biggest one is the Abu Dhabi Investment Authority, which has some US$875bn at its disposal.

It is difficult to determine the number of these

6. At the Chinese Enterprises Outbound Investment Conference, Beijing, May 15th 2007; see *China Daily*, June 15th 2007, p. 11.

7. For a discussion of the range of issues related to the rise of emerging market MNCs, see Karl P Sauvant with Kristin Mendoza and Irmak Ince (eds), *The Rise of Transnational Corporations from Emerging Markets: Threat or Opportunity?*, Edward Elgar, Cheltenham, forthcoming; UNCTAD, *World Investment Report 2006: FDI from Developing and Transition Economies. Implications for Development*, Geneva, 2006; and Andrea Goldstein, *Multinational Companies from Emerging Economies: Composition, Conceptualization and Direction in the Global Economy*, Palgrave McMillan, Hampshire and New York, 2007.

state-owned entities, as the boundary line between public funds in general and SIAs is difficult to draw. For example, many pension funds of public institutions could technically be included, but many of them are passive investors that control only small stakes and do not seek active involvement in the management of the assets they have acquired. However, a growing number of these entities are becoming active shareholders and are acquiring controlling stakes.

Add to that the resources SIAs have at their disposal. Morgan Stanley estimates these to be around US$2.5trn in mid-2007, projected to rise to US$12trn in 2015 (based largely on the assumption that oil prices will remain at current levels).[8] These figures compare with a forecast US$1.5trn of world FDI flows in 2007 and a world stock of inward FDI of about US$12trn at the end of 2006.

These SIAs draw on the official reserves accumulated by their governments, typically in the context of commodity-price booms (especially for oil) or surpluses generated by the export of other goods

8. Stephen Jen, "How Big Could Sovereign Wealth Funds Be by 2015?", Morgan Stanley Research: Economics, May 3rd 2007, p. 2. Note that, apart from SIAs, state-owned enterprises will invest more abroad. The China Development Bank, for example, may invest as much as US$13.5bn in Barclays (*Financial Times*, July 25th 2007).

Table 1

Estimated assets of sovereign investment agencies, Jul 2007

(US$ bn unless otherwise indicated)

Economy	Sovereign investment agency	Estimated assets[a]	Year of establishment	Country's foreign-exchange reserves[b]	Source of funds
Abu Dhabi	Abu Dhabi Investment Authority	875.0	1976	34.8[c]	Oil
Saudi Arabia	Saudi Arabian funds of various types	300.0	n/a	23.2	Oil
Singapore	GIC	330.0	1981	143.6	Export surplus
Norway	Government Pension Fund - Global	300.0	1996	56.0	Oil
China	China Investment Corporation[d]	300.0	2007	1,332.6	Export surplus
Kuwait	Kuwait Investment Authority	167.0	1953	20.6	Oil
Singapore	Temasek Holdings	100.0	1974	143.6	Export surplus
Australia	Australian Future Fund	40.0	2004	64.9	Other
Qatar	Qatar Investment Authority	40.0	n/a	5.2	Gas
Brunei	Brunei Investment Agency	30.0	1983	0.5	Oil
US (Alaska)	Alaska Permanent Fund	39.4	1976	41.5	Oil
Russia	Fund for Future Generations[e]	32.0	2008	397.0	Oil
Republic of Korea	KIC	20.0	2005	250.3	Export surplus
Malaysia	Khazanah Nasional Berhad	18.3	1993	90.8	Export surplus
Taiwan	National Stabilisation Fund	15.0	n/a	268.0	Export surplus
Canada	Alberta Heritage TF	15.4	1976	39.4	Oil
Iran	Oil Stabilisation Fund	12.0	1999	58.2	Oil
Kazakhstan	National Fund	17.0	2000	20.9	Oil, gas
Botswana	Pula Fund	6.2	1966	8.0	Diamonds
Chile	Copper SF	3.9	1981	16.7	Copper
Oman	State General RF	2.0	1980	6.9	Oil, gas
Azerbaijan	State Oil Fund	1.5	1999	2.8	Oil
Venezuela	FIEM	0.8	1998	16.3	Oil
Trinidad & Tobago	Revenue Stabilisation Fund	0.5	2000	5.5	Oil
Kiribati	Revenue Equalisation Fund	0.4	1956	n/a	Phosphates
Uganda	Poverty Action Fund	0.4	1998	1.9	Aid

[a] It is not know what portion of these funds will be used for FDI purposes. [b] Most recent 2007 figures. [c] Reserves for the United Arab Emirates. [d] Still formally to be established. Includes Huijin Co. [e] Still formally to be established. Source: Columbia Program on International Investment, based on estimates by Morgan Stanley, Economist Intelligence Unit and the IMF.

and services. Originally, the funds involved were primarily meant to protect a country against volatile commodity price fluctuations or to cushion it against exchange-rate risks. However, some of these have evolved, to quote Stephen Jen, "from 'stabilization funds' to 'wealth accumulation' or 'wealth preservation' funds".[9] In that new function, they are diversifying their assets into equities—they are becoming SIAs. As public institutions, their ultimate responsibility is, at least in principle, to increase the welfare of their countries, with the general public being the ultimate stakeholders. It is not known what share of their funds SIAs have used for FDI purposes or, for that matter, how much they would use (and how much of their reserves countries will allocate to these agencies). However, if they were to use substantial funds for FDI purposes and were not hindered from doing so, emerging markets would come to account for a large share of growing world FDI flows.

In summary, there is considerable potential for more FDI, both from the demand and the supply side. The dominant trend for the main FDI determinants will remain favourable. In particular, the trend medium- and long-term economic conditions for FDI are likely to remain benign, despite inevitable cyclical fluctuations. These are powerful forces pushing the growth of FDI. So what could disturb this rosy picture and slow down or even stop the growth of FDI?

Countervailing factors

Although the economic determinants of FDI are crucial, they can only come into play if and when the regulatory framework is enabling. The risk of adverse changes in regulatory frameworks represents the single most important threat to the future of FDI flows. Various other risks also loom, including geopolitical risks and the risk of political violence or government instability (see the article elsewhere in this volume on a survey of more than 600 investors on attitudes to political risk).

The regulatory framework for FDI is the concrete expression, via the political process, of the attitudes towards FDI of governments in home and host countries. The latter are, in turn, embedded in attitudes towards globalisation, of which FDI is one of the most important components. To the extent that there is a backlash against globalisation (although most of the discussion so far has focused on trade and its effects on jobs), attitudes towards FDI will be affected as well.

The regulatory framework for FDI reflects the balance of the economic and other costs and benefits that countries associate with FDI. Countries seek to attract FDI because it is judged to help them advance their economic development without jeopardising other national objectives, such as national security, control over strategic industries and firms, preserving cultural identity, or a reluctance to allow firms from particular countries to play a key role in one's own economy. There are indications that regulatory risk (including FDI protectionism) is becoming more salient in many host and home countries, especially when it comes to M&As and offshoring.

The risk of host-country FDI protectionism

As mentioned, the regulatory framework for FDI has been characterised, in recent decades, by a strong trend of liberalisation. Although this overall trend continues, there has in recent years been a marked rise in the number of regulatory changes *unfavourable* to foreign investors: compared with a total of 90 such changes over the 12-year period 1991-2002, the number rose to 101 in 2003-05.[10]

A number of these changes signal a more cautious approach to crossborder M&As. Crossborder M&As are by far the most important mode of entry for MNCs in developed countries, and they account for an increasing share of FDI flows to emerging markets. (For a discussion of M&A trends, see the article by Laza Kekic elsewhere in this volume.)

From a firm's perspective, M&As have certain advantages, including the speed with which new tangible and intangible assets can be acquired and the corporate network expanded. From a host-country perspective, crossborder M&As do not add to its productive capacity (at least immediately), but merely represent a transfer of ownership from domestic to foreign firms. Moreover, such transactions are often accompanied by restructuring, typically implying job losses or the closing down of activities, in order

9. Stephen Jen, "Sovereign Wealth Funds and Official FX Reserves", Morgan Stanley Research: Economics, September 14th 2006, p. 2.

10. See UNCTAD, *World Investment Report 2006*, p. 24.

to increase the efficiency of the assets involved, integrate them profitably into the new parent company or simply ensure their survival.

A more cautious attitude towards crossborder M&As can therefore have a major impact on FDI flows. Caution can be heightened if the acquirer is a private equity group, is from an emerging market or is a state-owned entity; or if the targeted firm involves national security, is in a strategic industry or is regarded as a national champion.

The role of private equity groups

The increasingly prominent role of private equity groups in FDI has affected attitudes. In 2006 private equity investments accounted for an estimated one-fifth of the value of all crossborder M&A flows. Although their acquisitions may make perfect sense from an economic efficiency point of view, they are at times surrounded by controversy. Private equity groups are often seen as taking advantage of a company in distress. Resistance may only be magnified if the foreign investor succeeds in rescuing the firm, turning it into a successful venture and then selling it for a considerably higher price.[11]

Discussions of the role of private equity groups have been particularly heated in Germany; not so long ago, a leading politician compared them with the biblical plague of locusts. Underlying these hostile reactions is that private equity groups are not regarded as strategic investors interested in, and bound to, the long-term economic development of a host country. Rather, they are seen as firms out to make a "quick buck", to maximise as rapidly as possible their own returns on investment, including by breaking up, if need be, the firms acquired and selling individual pieces to the highest bidder. It may well be that sceptical attitudes towards private equity groups will lead to more restrictions in host countries on these types of investors.

National security or just protectionism?

The needs of national security, tightly linked to strategic sectors and national champions, are often explicitly invoked when it comes to stymying crossborder M&As. National security is a vague concept; it easily lends itself to misuse for protectionist purposes.[12] For the US, preoccupied with terrorism, this concept has primarily military and strategic political connotations—witness the Dubai Ports World and CNOOC cases. For the EU, Japan and a number of developing countries, "national security" is also economic in nature and easily blends with talk of strategic industries and national champions. French policymakers, for example, speak about "economic patriotism" and include casinos among the country's strategic industries.[13] The issue of national champions came into play when there was a rumour that Pepsi (US) might want to acquire France's Danone, one of the world's leading yogurt producers.

A number of crossborder M&As in Europe have invoked considerations of strategic industries or national champions and hence triggered government resistance. Examples are the attempt by Enel (Italy) to buy Suez (France); German E.ON's bid to acquire Endesa (Spain); Italy's blocking the Albertis (Spain) bid for Autostrade; and the reported failed takeover attempts by Russia's Gazprom of Centrica (UK) in 2005-06. As it happens, Gazprom itself benefits from its government's determined strategy to re-establish state control over Russia's natural resources, considered to be of strategic importance. As part of that strategy, some MNCs have had to relinquish controlling stakes in a number of projects. Russia is in fact considering declaring a number of activities as being "strategic", with implications for the participation of foreign firms.[14]

Most of the difficulties that crossborder M&As have faced so far seem to have taken place in developed countries. But the change in attitude is catching on in developing countries. An earlier Economist Intelligence Unit survey of 258 senior executives across Asia, for example, found that the US (24%), China (23%) and France (13%) are regarded as the countries most likely to block M&As because of strategic and political concerns.[15]

In the survey conducted for this report, respondents expressed considerable concern about possible protectionism in a number of emerging-market regions. Among developed countries, France and the US were the two that stood out in terms of

11. The acquisition of the Korea Exchange Bank by Lone Star (US) had elements of this reaction when Lone Star sought to sell the firm for a much higher price than for the one it had paid when it made its acquisition.

12. In its 2007 Summit Declaration the G8 noted: "we remain committed to minimize any national restrictions on foreign investment. Such restrictions should apply to very limited cases which primarily concern national security".

13. In a December 31st 2005 decree, the French government announced that it would protect eleven priority industries from foreign takeovers: casinos; private security; research, development and production of products with potential illicit or terrorist use; surveillance equipment; information security; government information technology security services; dual-use(military/civilian) technologies; cryptography; companies with access to defence secrets; arms and munitions; and defence subcontracting (*Financial Times*, January 4th 2006).

14. Most of the activities mentioned in the current (August 2007) bill before the State Duma (the lower house of the Russian parliament) relate to arms, nuclear facilities, cryptography, espionage, aerospace and natural monopolies (including pipelines, power transmission, rail transport, ports, airports, mail). The bill also foresees that no foreign state-controlled entity can control over 25% of a Russian firm that engages in a strategic activity.

15. Norton Rose, "Cross-border M&A: the Asian perspective", Economist Intelligence Unit and Norton Rose, London, 2007, p. 4.

concern about attitudes of officials to FDI.

In China, the leading FDI recipient among emerging markets, questions have been posed about the desirability of certain M&As. The reaction in the US to the Dubai Ports World acquisition played a role in this respect: if the US, as the world's leading economy, has concerns regarding FDI, should not China, as a developing country, be also concerned about the role of FDI in its economy? As a result, the concept of "economic security" has gained currency. Thus, the demonstration effect of blocking M&As in developed countries may well ripple through an increasing number of emerging markets.

Emerging-market and state-owned investors receive special attention

There seems to be special scepticism towards large M&As by emerging-market firms. Such M&As have increased from 5% to 17% in terms of number of deals and from 4% to 13% in terms of value between 1987 and 2005, representing 1,072 deals worth US$90bn in 2005.[16] Some prominent examples include:

- the US$1.25bn acquisition by Lenovo (China) of the personal computer (PC) division of IBM (US) in 2005;
- the takeover by CVRD (Brazil) of INCO (Canada) in 2007, for US$16.7bn; and
- the successful bid by Tata (India) for Corus (UK/Netherlands) for US$13.5bn in 2007.

One certainly cannot say that M&As are *typically* resisted (all of the ones just mentioned were successful). However, it appears that especially high-profile ones are receiving increasing attention and may encounter resistance. The 2006 acquisition of Arcelor (Luxembourg) for US$32bn by Mittal Steel, a company registered in the Netherlands and managed out of London, is an example.

Scepticism, at times bordering on hostility, becomes stronger if the emerging-market entity is state-owned. Acquisitions by a developed-country state-owned entity such as Deutsche Bahn AG (Germany—it acquired the US's DHL, a logistics firm) do not seem to present problems, even if they take place in sensitive sectors. However, UAE-based Dubai Ports World's acquisition of P&O Steam Navigation Company (UK), with assets in the US, was only approved in 2006 once Dubai Ports World agreed to divest itself of its US assets. In the case of CNOOC (China), and its 2005 attempt to purchase Unocal (US), the fact that it is a state-owned enterprise played a role.

There is, however, a special breed of state-owned entities that has entered the spotlight and created considerable anxiety in a number of countries: SIAs. As these entities are not new (see above), the obvious question is: why do they (apart from state-owned firms) suddenly get so much attention? A confluence of reasons is responsible, first and foremost among them the growing number and size of such agencies. The key, however, is that most of them are controlled by emerging-market governments.

The size of the resources available to SIAs combines with the fear that emerging-market SIAs are basically instruments of government policy, meant to advance not only the public good in general but to support political goals. This was not much of an issue, at least in the past, with regard to the SIAs of small countries such as Singapore and Norway. (In fact, entities of this type from developed countries—such as Norway's Government Pension Fund, which has some 3,500 investments and is an activist investor—have so far not drawn much attention; the focus of the public and policy debate is on emerging-market agencies.) But it becomes an issue when large countries and especially strategic competitors are involved. Hence the foray of Russian state-owned enterprises into western Europe, and the expected investments by Russia's SIA (to be formed in 2008), are regarded with trepidation in much of the developed world. This applies even more so to China's SIA, to be set up later in 2007. (Fear of China's and Russia's government-controlled entities—and to a certain extent also those controlled by Gulf states—fuels a good part of the discussions and concerns on this issue.) China's prospective agency may well have US$200bn-300bn at its disposal, including for FDI.[17] If China's investment arm embarks on a major acquisition spree, this is bound to lead to strong reactions in a number of countries.

16. UNCTAD, *World Investment Report 2006*, p. 108.

17. An early transaction of this still-to-be-established agency was the acquisition, in June 2007, of 9.9% of the Blackstone Group, a leading US private equity firm. China's new investment agency was careful to remain, in this acquisition, below the 10% threshold at which it would have been considered a direct investment, and it took its share in non-voting stock, in this manner not triggering a review by the Committee on Foreign Investment in the United States. But even then this move was front-page news when the plan was announced on May 19th 2007.

To cope with the reaction to SIAs, China (as well as other countries) may need to learn from the experience of Japan. When that country's (private) firms began to make large-scale foreign investments in the 1980s, there was widespread fear that they would come to dominate the world economy, and attitudes in some countries (such as the US) were quite defensive. These fears only calmed down when Japan entered a period of stagnation in the 1990s and, perhaps even more important, when Japanese firms moved to much more acceptable foreign investments, namely by establishing assembly facilities and eventually full greenfield production units in the US. (Additional effects were that, in this manner, they not only circumvented "voluntary" export restraints but also reduced the bilateral trade deficit, thereby neutralising other sources of friction between Japan and the US.) State-owned entities may need to have a similar trajectory in order to allay a good part of the fears associated with their emergence as significant outward investors and, in the case of China, the rise of that country as an economic power.

So far there is little, if any, systematic evidence that SIAs are instruments of specific government policies; their actions would most likely also have been taken if they had been purely commercial enterprises. Nevertheless, the suspicion is there. It is fuelled by a lack of transparency as to what the strategic objectives of SIAs are and, in particular, what investments they have undertaken (a notable exception is Norway's SIA). This is part of a broader concern, namely the quality of corporate governance of these entities, a concern that is also voiced with respect to state-owned enterprises.[18] Part of that is the fear that such state entities also enjoy certain advantages (such as cheap financing), as this could put private-sector firms at a competitive disadvantage. The financing advantage acquires a particular edge for countries that are seen to have an undervalued currency.

Finally, one cannot avoid the impression that the very rise of emerging-market MNCs as new and powerful competitors, the need to accept that they are here to stay and the challenge of integrating the newcomers into the world economy all play a role. And, as we know from other contexts (such as international relations among states), accommodating rising newcomers is not easy.

Points to watch

The various instances of crossborder M&As that have encountered difficulties so far represent only a very small share of all M&As that take place each year. Nevertheless, they are becoming more frequent. Moreover, the greater prominence of SIAs will almost certainly lead to defensive reactions in a number of countries, thus reducing FDI flows below what they otherwise might be. What we will need to watch are three things:

- the frequency and nature of instances of opposition to M&As;
- how much pressure there will be for reciprocity between governments in their treatment of FDI deals; and
- whether governments create new mechanisms that allow them to block crossborder M&As.

It is likely that an increasing number of crossborder M&As will encounter resistance. The only question is how many? The answer is probably only a limited number. The reason is that the bulk of M&As are normal commercial transactions (with the only principal constraining consideration being anti-competitive M&As) that receive little attention. The key will be how active state-owned entities (and especially SIAs) will be in the M&A market.

With respect to reciprocity, the argument is being made that, if state-owned entities from one country are allowed to invest in another country, the latter country's firms should have equal access to the former country.[19] As most developed countries are much more open to FDI than emerging markets, reciprocity becomes a tool to open other countries to FDI—or to protect oneself from undesirable inward FDI. Where reciprocity is not forthcoming, FDI flows may be dampened; where it is, they may go up. To quote US deputy Treasury secretary Robert Kimmitt, speaking in the context of the discussions to strengthen the Committee on Foreign Investment in the United

18. See, for example, Rainer Geiger, "Corporate Governance of Emerging Market TNCs: Why Does it Matter?", in Sauvant with Mendoza and Ince (eds), *The Rise of Transnational Corporations from Emerging Markets*. For a broader discussion of developed countries' concerns as regards M&As by state-owned enterprises, see Andrea Goldstein, "Who's Afraid of Emerging Market TNCs? Or: Are Developing Countries Missing Something in the Globalisation Debate?", in the same volume.

19. See, for example, Jeffrey Garten, "We need rules for sovereign funds", *Financial Times*, August 8th 2007.

States (CFIUS): "Reciprocity is not a factor that CFIUS considers. However, investments that take place inside a broader political context, and the degree to which American companies are afforded access to their investment opportunities in countries abroad will be related to the opportunities available to their companies in the US."[20]

CFIUS is the best-known example of a mechanism to monitor, and potentially block, crossborder M&As; it is an inter-agency committee chaired by the secretary of the US Treasury. It implements the Exon-Florio provision of the 1988 Omnibus Trade and Competitiveness Act, which gives authority to the country's president "to suspend or prohibit any foreign acquisition, merger or takeover of a US corporation that is determined to threaten the national security of the United States".[21] On July 26th 2007, CFIUS was strengthened with the signing into law of the "Foreign Investment and National Security Act of 2007".[22]

Other countries are also considering establishing CFIUS-type defence mechanisms. Countries such as Germany and Hungary are considering the creation of review mechanisms, especially for investments by SIAs, perhaps at the EU level (which France would support). German Chancellor Angela Merkel is quoted as saying: "With those sovereign funds we now have a new and completely unknown element in circulation ... One cannot simply react as if these are completely normal funds of privately pooled capital."[23] A bill may still be considered this year by the Bundestag. The UK, on the other hand, is more cautious, although the need for reciprocity is also emphasised. As in the case of the US, the intention is to install the equivalent

20. Quoted in Deborah Solomon, "Foreign investors face new hurdles across the globe", *Wall Street Journal*, July 6th 2007. This is perhaps also what is behind the following observation in the 2007 G8 Summit Declaration: "Companies from G8 countries investing in emerging economies expect to find the same open investment environment as companies from such countries investing in G8 countries."

21. US Department of Treasury: http://www.ustreas.gov/offices/international-affairs/exon-florio/

22. US Senate, 110th Congress, S. 1610, "Foreign Investment and National Security Act of 2007".

23. *International Herald Tribune*, July 14th-15th 2007.

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CFIUS reviews must be completed within 30 days. A review of a covered transaction leads to an investigation (which needs to be concluded within 45 days) if any of the following conditions apply: (1) a transaction threatens to impair the national security of the US, and this threat has not been mitigated during or prior to the review of the transaction; (2) a transaction involves a foreign government-controlled entity; (3) a transaction would result in control of any critical infrastructure and could impair national security; or (4) the lead agency and CFIUS agree that an investigation should take place. Crucially, the law creates a presumption that an investigation must take place if a state-owned entity is the acquirer, unless the secretary of the Treasury and the head of the lead agency jointly determine that the transaction will not impair national security. Factors that CFIUS needs to consider when determining the national security impact of a transaction include the risk of technology transfer to a country that is a threat to the US; the impact on critical infrastructure and critical technologies; and foreign government ownership.

During its first years of existence, CFIUS reviewed relatively few cases. That number has increased, however, in recent years, as has the number of mitigation agreements. To quote from the testimony on February 7th 2007 of Todd M Malan, president and chief executive officer (CEO) of the Organization for International Investment, Washington, to the House Financial Services Committee: "A recent study published by the National Foundation for American Policy showed that, in the last year, the number of CFIUS filings increased by 73%, the number of investigations jumped by 350% and the number of companies withdrawing their filings with CFIUS grew by 250%. There were more second-stage investigations last year than during the previous five years of the Bush administration and more than during 1991-2000. The number of mitigation agreements, or conditions imposed on companies, more than tripled last year. More specifically, the Department of Homeland Security required an average of 4.5 mitigation agreements per year between 2003 and 2005. Last year, DHS required mitigation agreements in fifteen transactions."[1]

Although the percentages quoted are based on low absolute numbers, they do reflect a changing attitude in the US towards crossborder mergers and acquisitions (M&As). CFIUS reviews are likely to become more frequent and stringent, if only because the number of M&As in which the acquirer is a state-owned enterprise or a sovereign investment agency (SIA) is likely to go up.

1. Testimony of Todd M Malan before the House Financial Services Committee, February 7th 2007.

of an emergency brake, to put the government into a position to block undesirable crossborder M&As. As in the case of the US, it is of course difficult to draw the line between "desirable" and "undesirable" transactions, to determine which industries are "strategic" and to avoid an outcome whereby the institutions created become overly restrictive, be it in response to public concerns or protectionist pressures.

Outside Europe, China has already established (in 2006) a defence mechanism, in the form of a "National Economic Security Review Mechanism". Under this system, approval is required for the following categories of acquisitions: important industries, elements that may affect national economic security, and famous trademarks and long-established Chinese trade names/companies. None of these categories is defined.[24]

It would not be surprising if other countries were to follow suit, creating in this manner new screening mechanisms for FDI. This is reminiscent of a time some 20-30 years ago when various countries (such as Canada) had review mechanisms in place to screen out undesirable FDI. Most of these (along with the laws that restricted inward FDI) were eventually dismantled, became less stringent in terms of enforcement or were replaced by investment promotion agencies (IPAs).

In addition, crossborder M&As can also be discouraged or stymied informally, for example by the very knowledge that they have to go through a formal review process, through statements by leading politicians that rumoured or proposed M&As are frowned upon and through resistance in legislative bodies or among the public at large. These informal barriers are difficult to quantify, but they have been rising.

MNC-host country conflicts

Concrete cost/benefit considerations, combined with strategic industry concerns, are also at the heart of conflicts between host developing countries and MNCs in natural resource industries. Many assets in these industries were nationalised in the 1960s and 1970s, with nationalisations of this kind reaching a peak during the early 1970s. The rationale at that time was that governments needed to exercise direct control over their natural resources, as these, as strategic industries, were central to their economic development and because the distribution of rents from their exploitation was considered to be lopsided in favour of MNCs. At that time, heated discussion took place on the right of "permanent sovereignty over natural resources", with developing countries reaffirming this right in various UN resolutions.

This discussion subsequently died down, but the *problematique* is re-emerging. Reference was already made to Russia. A number of governments in Africa (Congo, Liberia) and Latin America (Bolivia, Ecuador, Venezuela) have re-visited the contracts concluded between MNCs and host-country entities in order to see whether the host country did get the best possible deal for the exploitation of what are often the only significant assets a country has (although ideological considerations also play a role in some of these countries). The situation is further complicated by the fact that many of the deals in national resource industries are subject to the "obsolescing bargain".

Prospecting for natural resources is a risky business in that a firm typically does not know whether it will be successful; in order to entice firms to undertake prospecting, countries often offer very generous terms. Once prospecting is successful and a firm has invested heavily, it becomes, in a sense, a captive of the country, which, in turn (and not surprisingly), will seek to increase its share of the rents derived from its natural resources. (For the firm, the benefits of successful prospecting in one country need to be offset by the costs of unsuccessful prospecting in another country.) If differences cannot be resolved through renegotiations of the underlying contract, they may well result in unilateral action by the governments. Where this takes the form of nationalisation or similar action, FDI is reduced. Equally important, such action can have a chilling effect on future FDI flows, including to other countries, if firms see this type of political risk increasing. More countries may well become more assertive in this area (especially if the commodities boom lasts), with the risk of conflicts between them and MNCs increasing and FDI flows in the natural resource sector declining.

24. Robert D Lewis, "Cross-border M&A in China: a comparative analysis", Lovells, Beijing, 2007, mimeo. However, China had been screening inbound FDI before that.

Increased litigation

The relationship between MNCs and host countries is becoming more confrontational, judging from the number of international arbitration cases. There were few such cases during the 1980s and the early 1990s. By the end of 2006, however, 258 international treaty-based arbitration cases had been initiated, some two-thirds before the International Centre for Settlement of Investment Disputes (ICSID).[25] Some 47% have arisen in the past three years, and 73% during the past five years; 70 countries in all parts of the world are (or were) respondents in cases initiated by MNCs (see Table 2). Bolivia's denunciation of the ICSID Convention in May 2007 may be an indication of the growing scepticism towards FDI and the international arbitration of investment disputes.

There is considerable potential for a substantial further increase in the number of investment disputes, if one considers that (1) there are some 3,000 international investment agreements, most of which contain dispute-settlement provisions; and (2) there are more than 80,000 MNCs, over 800,000 foreign affiliates and even more shareholders, most of which, depending on the treaty language, could in principle initiate a case if they felt aggrieved. The growth of investment disputes reflects the confidence of international investors to stand up for what they consider to be their rights and for the rule of law,[26] but it comes at a time when the role of FDI is under reassessment in some countries.

Table 2
Leading respondents in international investment disputes, end-2006

Defendant	No. of claims
Argentina	43
Mexico	18
Canada	12
Czech Republic	11
US	11
Moldova	9
Russia	9
India	9
Ecuador	9
Egypt	8
Poland	7
Romania	7
Ukraine	6

Source: UNCTAD, Database of Investor-State Dispute Settlement Cases.

Home-country protectionism

As discussed earlier, most home countries are supportive of "their" MNCs and their outward FDI. There are, however, two imponderables that may change this situation, one relating to developed countries, the other to emerging markets. Developed countries are faced with a profound transformation affecting more than two-thirds of their economies—the services sector. A similar transformation some 40 years ago as regards the manufacturing sector triggered a broad discussion as to what this meant for employment and how this could lead to a hollowing-out of the economies involved—and, ultimately, whether or not FDI was desirable. At that time, part of the answer was presented by trade adjustment programmes and the prospects of moving into the services sector. Outward FDI in manufacturing gathered speed, contributing significantly to the growth of FDI flows and the emergence of an integrated international production system in manufacturing.

Resistance to offshoring

We are now at the threshold of a similar development in the services sector. In particular, the process of offshoring the production of services, and efforts by largely white-collar workers to protect their jobs are likely to spark debates on the desirability of outward FDI. Such a discussion has already flared up in the US (which led to a series of bills seeking to introduce restrictions on offshoring) and, under the heading of "*délocalisation*", in France. Given the magnitude of the transformation we are facing, it may well be that, as the offshoring of services gathers speed, the call for restrictions on outward FDI will become louder and may be heeded. A key consideration will be the overall performance of the economies of the developed countries and hence their ability to absorb the shock of this transformation.

Similar considerations apply also to emerging markets and their outward FDI. The underlying reality,

25. UNCTAD, "International investment rulemaking", TD/B/COM.2/EM.21/2 (22 May 2007), mimeo, p. 5. For a discussion of the reasons for this explosion of investment disputes, see Jeswald W Salacuse, "Explanations for the Increased Recourse to Treaty-based Investment Dispute Settlement: Resolving the Struggle of Life against Form?", in Karl P Sauvant with Michael Chiswick-Patterson (eds), *Coherence and Consistency in International Investment Law*, Oxford University Press, Oxford, forthcoming.

26. For comparison: during the entire existence of the General Agreement on Tariffs and Trade (GATT; 1948-94), a total of 101 disputes were brought; another 366 disputes have been brought under the World Trade Organisation (WTO) from its inception up to July 12th 2007. It must be noted, however, that only states can use the WTO dispute settlement mechanism.

however, is that emerging markets, by definition, are economies that do not have sufficient productive capacity. Hence, outward FDI may begin to be questioned, and may affect the regulatory framework for (outward) FDI.

There is another reason why the outcome is uncertain, and it cuts across developed countries and emerging markets: as firms transnationalise, their interests are no longer necessarily identical with those of their home countries; they become, as their name implies, "multinational", with their own interests being paramount and no longer attached to any particular country. It used to be said that what is good for General Motors is good for the US. Globalisation, and especially outward FDI, has put this dictum in question, as reflected in the famous debate between Robert Reich and Laura Tyson on "Who is us?": a corporation that is headquartered in the US but has a substantial part of its activities abroad, or a foreign company that has a substantial share of its activities in the US?[27] For Mr Reich, the answer was "the American worker", and he was prepared, therefore, not to give preferential treatment to US-headquartered firms. For Ms Tyson it was the US company—although she conceded that this may become less clear in the future as firms become more transnationalised (which is what happened).

This debate took place some 15 years ago. Since then, firms have become more transnational. But virtually all countries continue to believe that firms headquartered in their territories are "their" firms, and some indeed are considered national champions; hence, what is good for them is good for the country. Once it sinks in that MNCs seek to maximise their global competitiveness, as opposed to the performance of any particular economy, the support for outward FDI may wane, with implications for the regulatory framework and FDI flows.

The bottom line

The driving forces for a further expansion of FDI are strong. Over the medium and long term, the economic drivers of FDI should remain favourable. For firms, a portfolio of locational assets is crucial for their competitiveness, and there are still substantial potential sources of FDI. Host countries continue to attract investment to promote their development, and home countries promote outward FDI in the interest of the competitiveness of their firms and the performance of their own economies.

Expectations are therefore that MNCs will continue to invest abroad at historically high levels—if they are allowed to do so, that is, by host and home countries. However, there is an appreciable risk that the FDI regulatory framework—which has in the past two decades overwhelmingly moved in a liberalising direction—will become more protectionist, in both host and home countries.

Ambivalent attitudes

Attitudes to FDI do not depend on an assessment of its economic costs and benefits alone. Openness to FDI can be perceived to conflict with other national objectives. And attitudes towards FDI are ambivalent in most countries, precisely because of the "foreignness" of the investment. As a result, supportive and sceptical attitudes towards FDI often battle for supremacy when it comes to policymaking. Today, sceptical attitudes are in the ascendancy in a growing number of countries, especially towards crossborder M&As, emerging-market MNCs (particularly state-owned enterprises and SIAs) and private equity groups, and with regard to the distribution of benefits related to FDI (primarily in the natural resource sector).

Attitudes to *outward* FDI may become less favourable in developed countries if the offshoring of services accelerates. In emerging markets, where capital is scarce, attitudes towards outward FDI may also change. In both cases, such a change in attitudes would increase regulatory risk and have implications for investment flows.

In countries that are high FDI recipients, attitudes and policy towards FDI may also be affected by a feeling that a country has attracted "enough" FDI (a consideration that seems to play a role in China), or if there is a perception that a country needs to be more selective in attracting FDI by focusing on attracting "good" FDI and discouraging "bad" FDI. In such circumstances, FDI can become a victim of its own

27. See Robert Reich, "Who is us?", *Harvard Business Review*, 1990, pp. 53-64; Laura D'Andrea Tyson, "They are not us: why American ownership still matters", *The American Prospect*, 1991, pp. 37-48; and Robert Reich, "Who do we think they are?", *The American Prospect*, 1991, pp. 49-53.

success, and M&As are then particularly vulnerable. On the other hand, most countries (or regions within countries) that have been less successful in attracting FDI are more likely to eschew restrictive measures.

What is the bottom line? In particular, could a protectionist backlash trump the forces driving FDI in an upward direction? Until now, the overall interests of the three key players in world FDI were largely aligned: host countries sought inward FDI to further their economic development; home countries supported outward FDI to further the competitiveness of their firms; and firms undertook such investment to further their international competitiveness. This alignment found its expression in the liberalisation of national FDI regulatory frameworks, the strengthening of international standards of protection for FDI and the efforts of IPAs to attract such investment. The result was the dramatic growth of FDI flows in recent decades. Overall, the driving forces of FDI continue to be strong, grounded in economic considerations.

But forces sceptical towards FDI are on the rise, and the interests of the three key players are no longer as aligned as in the past. The regulatory risk is increasing, and the climate for at least some types of FDI is becoming less welcoming. One cannot exclude the possibility that increased scepticism may presage a storm in the making that could overwhelm the forces driving FDI in an upward direction.

On balance, no major backlash is likely to take place given the continuing strength of globalisation and the forces that propel FDI (and this underlies the forecasts made elsewhere in this volume). Rather, we are more likely to see a certain re-balancing in the attitudes towards, and regulatory frameworks for, FDI, tempering the dominant liberalisation trend of the past two decades and restraining the growth of future investment flows.

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