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The Rise of FDI Protectionism

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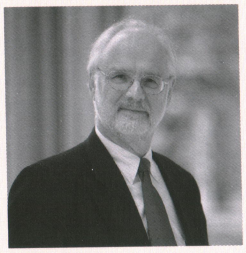

"...but there are signs that the liberalization pendulum is swinging back"

From liberalization and a strong international investment regime...

During the past 20 years or so, we have witnessed an impressive trend toward making the investment climate more welcoming for foreign direct investors. At the national level, the great majority of regulatory changes related to foreign direct investment (FDI) were in that direction, mostly in terms of opening more sectors to investment or reducing other market entry conditions and facilitating the operations of multinational enterprises (MNEs) once established. In fact, countries have actively sought to attract FDI, establishing investment promotion agencies to do that and, among other things, using a range of incentives to lure MNEs to their shores.

These national policies have been supplemented by international investment agreements (IIAs) which, in particular, enshrine the protection of investment in internationally-binding treaties and, in a number of cases, also commit governments to liberalizing entry and operating conditions for foreign investors. The result is an international investment regime which, compared to what there was, say, 30 years ago, is quite well developed, even in the absence of a multilateral investment treaty. It is enforced, moreover, through an investor-state dispute settlement mechanism that is increasingly used by firms that seek to enforce what they see to be their rights.

This dominant trend of the past two decades or so is certainly still continuing—but there are signs that the pendulum is swinging back. What is happening and why is it happening? [1]

[1] For an in-depth discussion, see Karl P. Sauvant, "Driving and countervailing forces: a rebalancing of national FDI policies," in Karl P. Sauvant, ed., Yearbook on International Investment Law and Policy 2008-2009 (New York: Oxford University Press, 2009), pp. 215-272.

... to national restrictions....

At the national level, the change has been quite distinct. UNCTAD,[2] which has monitored changes in the national framework for FDI since 1992, reported that 94% of all regulatory changes during the period 1992-2002 were in the direction of making the investment climate more welcoming, i.e. only 6 % of the regulatory changes were unfavourable to MNEs. That latter figure—unfavourable changes—doubled to 12% of all regulatory changes during 2003-2004, and again almost doubled to 21% of all regulatory changes during 2005-2007. In the case of Latin America, some 60% of all FDI regulatory changes in 2007 were unfavorable to foreign investors.[3] These data refer to formal changes in laws and regulations; no data are available on the extent to which unchanged laws and regulations are implemented in a more restrictive manner, increasing informal barriers to entry and operations in a discriminatory manner. Overall, some 40%

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of world FDI flows in 2006-2007 involved countries that had implemented at least one regulatory change that has made the investment framework less welcoming—an impressive figure that demonstrates quite convincingly that something is afoot.[4]

Why this change in national FDI regulatory frameworks? There are, first of all, rising concerns about national security or, broader, national interest. "National security" and "national interest" are typically not defined, i.e. these concepts are open to interpretation. In the case of the US, and especially after 9/11, national security involves primarily (but not only) military security, and therefore focuses on the protection of sectors that are important from that perspective, including as regards "critical infrastructure" (also undefined). In Europe, the concerns are more of a political and economic nature, involving FDI from Russia (and, perhaps in the near future, from China) and, more broadly, the protection of national champions. And in some emerging markets, national security or national interests are seen primarily in economic terms, involving especially sectors of key importance to the country's economic development, sectors governments would want to protect from foreign ownership (e.g. China, Russia).

But other factors are at work as well. In particular, firms from emerging markets have entered the world FDI market in force and are becoming formidable competitors.[5] To be sure, there have always been MNEs based in emerging markets. What is new are the dimensions this phenomenon has reached: by the end of 2007, there were more than 20,000 MNEs headquartered in these countries, responsible for some US $300 billion in FDI flows—six times the world average during 1980-1985. Like their developed country counterparts, MNEs from emerging markets increasingly enter host countries through mergers and acquisitions (M&As). These bring them often to the attention of the public, part of which looks with suspicion at the "new kids on the block." The discussion that surrounded the acquisition of Arcelor by Mittal (apparently considered by some an Indian firm because its CEO is from that country, although the firm is not Indian)—which at times even appeared to have racist overtones à la "who do they think they are?" [6] —is indicative. This attitude becomes ever more acute when emerging market investors are state-controlled entities (be it state-owned enterprises or sovereign wealth funds) and from strategic competitors (China, Russia) or countries political allegiances, rightly or wrongly, might be seen to be in doubt (Gulf countries), as it is surmised that their M&As may be driven by political rather than commercial objectives. This issue may become even more important as traditional MNEs are less in a position to invest abroad on account of the financial crisis and recession, while sovereign investors may be less handicapped and, perhaps, snap up assets at fire-sale prices (as traditional investors did in the countries affected by the Asian financial crisis in the late 1990s). Indicative of this may be that China's outward FDI—80-90% of which consists of sovereign FDI [7] —doubled between 2007 and 2008 (from $26 billion to $52 billion) and may well have surpassed the latter figure by the middle of 2009.[8]

[2] UNCTAD, World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge (Geneva: UNCTAD, 2008). [3] James X. Zhan, "Recent global trends: FDI flows, TNCs and policies" (Geneva: UNCTAD, 2008), mimeo. [4] Sauvant, Yearbook, op. cit., pp. 215-272. [5] Karl P. Sauvant with Kristin Mendoza and Irmak Ince, eds., The Rise of Transnational Corporations from Emerging Markets: Threat or Opportunity? (Cheltenham: Edward Elgar, 2008). [6] See International Herald Tribune, June 27, 2006. [7] See Leonard K. Cheng and Zihui Ma, "China's outward FDI: past and future" (July 2007), p. 15 online: http://www.nber.org/books_in_progress/china07/cwt07/cheng.pdf. These figures do not include state-owned enterprises administered by regional governments.
[8] Kenneth Davies, "While global FDI falls, China's outward FDI doubles', Columbia FDI Perspectives, no. 5, Vale Columbia Center on Sustainable International Investment, available at www.vcc.columbia.edu.

"Part of the changing attitude toward certain types of FDI is that screening mechanisms for FDI are being resurrected or strengthened"

Finally, at least when the commodities boom was in full swing, a number of natural resource producing countries (especially in Latin America) raised the question of the distribution of benefits associated with FDI in natural resources in their countries and, accordingly, sought to increase their "take."

It is not only that the regulatory framework is becoming less welcoming. Part of the changing attitude toward certain types of FDI is that screening mechanisms for FDI are being resurrected or strengthened. Such screening mechanisms were quite common during the 1970, including in a few developed countries. During the subsequent liberalization period, most of them were either abandoned or re-oriented toward becoming investment promotion agencies. In the new climate for FDI, however, they may be experiencing a renaissance. The model here is the Committee on Foreign Investment in the United States (CFIUS); filings in that Committee have risen from 55 in 2001 to 165 in 2008, and investigations from 1 to 22.[9] (It is not known how many projects did not go ahead because firms did not want to go through the CFIUS process.) In particular, there is a presumption that M&As by sovereign investors, be they state-owned enterprises or sovereign wealth funds, are subject to an investigation, unless a particular transaction is explicitly exempted. What this reflects is that the US has "discovered" that it is not only the world's most important home country (and hence has an interest in protecting the rights of its enterprises abroad), but that it is also the world's most important host country and hence wants to protect its own interests vis-à-vis foreign direct investors. The fact that it has been the respondent in a number of investment disputes was important in this respect, as is the rise of FDI from emerging markets and especially the growth of sovereign FDI.

CFIUS may work well in the US context in the sense that it may indeed focus only on transactions that are directly relevant to national security (although the lack of definition of this term introduces an unpredictability factor) and that government departments with different interests may balance each other towards a moderate approach. But CFIUS has the potential of becoming a model for other countries; and for some of them, their screening mechanisms may well be used for a broader set of objectives (especially given a different approach to what the national interest is), and/or the interests of different parts of the government may not balance each other. It would be surprising, if governments across the world would not argue that, if the US, as the world's strongest economy, felt it necessary to protect itself from certain forms of FDI, they would not have to do the same – in light of their own (typically not precisely defined and circumscribed) paramount objectives, of course.

[9] See Karl P. Sauvant, "Is the United States ready for FDI from China? Overview," in Karl P. Sauvant, ed., Investing in the United States: Is the US Ready for FDI from China? (Cheltenham: Edward Elgar, forthcoming).

... and weaker international investment regime,...

"Do FTAs give foreign investors in the US greater rights than US investors"

How governments see FDI at the national level and react to it, furthermore, is bound to influence what they do at the international level, as reflected in the international investment agreements they sign. Over 2,600 BITs have been signed so far, apart from some 250 free trade agreements that have substantial investment chapters (and, therefore, are really free trade and investment agreements). Such agreements continue to be signed, with an overwhelming emphasis on the protection of FDI and, in a growing number, the liberalization of entry and operational conditions.

In the new climate, the orientation of international investment agreements is bound to change—and, in fact, is beginning to do so. Again, the US is leading the way, as a comparison of its 1994 and 2004 model bilateral investment treaties (BITs) shows.[10] Among the many changes that limit somewhat the rights of investors and increase the rights of the host country, it is particularly noteworthy that a number of protections of foreign investors were scaled back in the 2004 model (especially regarding indirect expropriation and fair and equitable treatment). What is even more important, the US now insists on a self-judging essential security clause in its international investment agreements, i.e. a clause that, if the US or its treaty partner declare that they deem their essential security interest to be involved, allows them unilaterally to set the terms of the agreement aside, presumably at least as long as a particular situation lasts. Newer US international investment agreements reflect this approach. Other countries are bound to follow this approach as well - and in fact have done so.[11] If this should occur on a larger scale (and would not be contained by arbitral decisions), the strong international investment law and policy regime that has been build would be in jeopardy.

The 2004 US model BIT is currently under review. It would not be surprising if it were to be further revised in the direction of strengthening the rights of host countries. Indicative of this new mood are hearings in the US Congress in May 2009, focused on the following three questions in relation to the country's BITs and free trade agreements (FTAs): "whether our FTAs and BITs give foreign investors in the United States greater rights than U.S. investors have under U.S. law; whether the FTAs and BITs give governments the 'regulatory and policy space' needed to protect the environment and the public welfare; and whether an investor should have the right to submit to arbitration a claim that a host government has breached its investment obligations under an FTA or a BIT." [12] What these questions imply is whether the US should consider subscribing to the Calvo doctrine (once advocated by Latin American countries);[13] whether host country rights should be strengthened further (the concept of "policy space" is a concept used by developing countries in the WTO to either avoid taking on certain international obligations or to obtain more flexibility in applying existing rules); and whether investor-state dispute settlement should perhaps be phased out in favor of State-State dispute settlement (as in the WTO).

[10] Kenneth J. Vandevelde, "A comparison of the 2004 and 1994 U.S. model BITs: rebalancing investor and host country interests", in Yearbook, op. cit., pp. 283-316. [11] See e.g. the bilateral investment treaty between Japan and Laos, 2008. [12] Hearing on Investment Protections in U.S. Trade and Investment Agreements, United States House of Representatives Committee on Ways and Means, Subcommittee on Trade, May 14, 2009, http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=678.
[13] According to this doctrine, aliens have no more rights than the citizens of a sovereign state. Accordingly, investor-State disputes need to be settled under domestic law by the court of the countries involved.

...or a rebalancing of the FDI regime?

"there are clear and present indications of a re-evaluation of the costs and benefits of FDI"

Since about the mid-1980s, a strong trend toward the liberalization of investment conditions at the national level and the strengthening of the protection of investors at the international level characterizes the development of the international investment law and policy regime. This trend continues. Yet, there are clear and present indications of a re-evaluation of the costs and benefits of FDI and of the balance of rights and responsibilities of MNEs and host countries. At the national level, this re-evaluation expresses itself in greater reservations especially regarding incoming cross-border M&As, a regulatory framework for FDI that is becoming less welcoming in a number of countries and the resurrection or strengthening of national FDI screening mechanisms. At the international level, the international investment law and policy regime that had been established during the past two decades and that had acquired "teeth" through the investor-State dispute-settlement mechanism, shows signs of being weakened.

Some of these developments are understandable or even desirable. In particular, host countries do need to be able to pursue policies that advance their own interests. At the same time, they cannot look toward FDI as the principal engine for their growth and development; such investment can be a catalyst for growth and development, it can help and, in a few sectors, even make a crucial contribution – but the principal engine is, as a rule, a vibrant domestic enterprise sector. Similarly, the international investment law and policy regime – which, deliberately, had developed primarily with foreign investors in mind – needs to give more attention to the policy interest of host countries. There is a danger, though, that the rebalancing overshoots, especially through the use of unilateral protectionist measures and the application of the essential security clause. An FDI Protectionism Observatory that monitors and publishes—names and shames—FDI protectionist measures (both regarding inward and outward FDI) could be of help here.

In the end, what is crucial is that the investment regime, both at the national and international levels, takes into account the interest of all stakeholders and, in particular, is clear and predictable so that investors, be they domestic or foreign, can securely plan ahead while host countries can pursue their own legitimate policy priorities. This involves a delicate balancing process, which, among other things, needs to check the rise in FDI protectionism.

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